Valuing best stocks, buying them cheap

If you want to beat the stock market, stop trying to predict it and taking your investing cues from price

By ROGER MONTGOMERY

HAVE you ever been told it's too difficult to beat the stock market? It's not. Put your computer to sleep, turn the television off and read carefully. Provided you are patient, beating the market over the long term is not difficult. You don't need a crystal ball to do it because prediction is not part of the equation.

I cannot tell you what a stock will do tomorrow, or warn you that a crash is imminent with anything approaching certainty. Neither can the financial industry, no matter how much brain power they muster.

Stop trying to predict the market and stop taking your investing cues from price. Instead of "price", think about "value". And instead of "stocks", think of "businesses". Approach an investment in the stock market as you would the purchase of an entire business and beating the stock market becomes a stronger reality.

Some investors have lost sight of what the stock market is – turning it into a venue for betting on "up" and "down". This is no different to backing Gloria De Campeao ahead of Lizard's Desire at Kranji next month.

And that's step one: Approach the stock market as an avenue through which ownership of extraordinary businesses can be obtained.

What does an extraordinary business look like? Just as importantly, how does one avoid businesses that are less than extraordinary?

Follow me on a flight of fancy. It's 2001 and you have injected US$3.3 billion to kick off a new business. You have also borrowed US$3.3 billion from the bank. After the first year of operation you report a profit of about US$420 million, equivalent to 12.7 per cent return on your equity.

Purchasing power

Encouraged by these early profits, you manage and operate the business for another decade. By 2010 profits amount to less than US$145 million. On its own, if this was not a one-off decline in profits, the picture is bleak.

A serious erosion of purchasing power has occurred. What if I told you that not only are profits meaningfully less than what they were a decade earlier, you have, over the interim 10 years, injected a further US$2.6 billion of equity and borrowed an additional US$2.4 billion.

Some US$11.6 billion of combined equity and debt returning a profit of less than US$145 million. Extraordinary, or ordinary? Return on equity is now 2½ per cent, significantly less than returns available in simple banking accounts. On a risk-adjusted basis, the returns from your business are, quite simply, uneconomic.

Unfortunately this is not a fictitious company. The numbers are taken from the annual reports of an iconic Australian airline, Qantas.

Extraordinary businesses do not require large amounts of debt to generate above average rates of return on equity. Clearly, Qantas does not make the grade.

REUTERS

Price and return: *Acquiring shares in extraordinary businesses when they are truly cheap will produce returns dramatically different from acquiring shares in the same business at a much higher price. The simple fact is that the higher the price you pay, the lower your return.*

But none of this matters if stock prices ignore business performance. In the short run the stock market is nothing more than a popularity contest. Prices frequently ignore the fundamentals. But in the long run, as Ben Graham said, the market is a weighing machine.

In my experience as a fund manager and author of guide book *Value.able*, in the long run the market price of a business does tend to reflect the performance of the underlying business. It may take as little as a year or as long as 10 years, but the stock market will follow the value of a business.

Qantas' share price today remains below its share price of 10 years ago. Indeed to assuage those who may think I haven't accounted for all the additional shares issued, the market capitalisation is less than all the money that has been put in and left in the airline over the last 15 years. No amount of "time in the market" will help investors who purchased Qantas for the long term. Invest in this business and time will be your foe – the longer you stay, the more it will hurt.

Making a portfolio

Provided you are patient and can identify extraordinary businesses generating high rates of return on equity and whose prospects are likely to continue in that vein, you are well down the path of constructing a portfolio of extraordinary businesses whose performance should outperform the Straits Times Index. Find a business whose manager can compound equity at rates well above average and eventually your returns will reflect those of the business. Time in the market will be your friend. The longer you stay, the more extraordinary your returns.

Identifying extraordinary businesses is the first step. The second is knowing what price to pay. Turn the stock market off and focus on the underlying business. Don't miss out on acquiring shares in extraordinary businesses because of a fear that the share price will fall, and don't sell at depressed prices either. The world's best investors avoid such irrational behaviour because they focus on the value of the underlying business, not the price.

To do this, you must learn how to estimate the intrinsic value of a business and its shares. A reasonable grasp of multiplication and division is about as much arithmetic as you need to apply my Value.able valuation approach. You don't need a degree in high finance. Anybody can do this. The community of Value.able graduates at my blog is living proof.

But why take the time to do the calculations, I hear you ask?

JB Hi-Fi is one of Australia's premier retailing businesses. Their distinctive stores – music blaring behind trademark billboard style placards – sell everything from TVs to Nintendo Wii, digital clocks, DVDs and Mac computers.

In 2008, JB Hi-Fi's shares traded between US$15.80 and US$6.87. By September 2010 the share price had risen to just over US$23.

Supercharging returns

Had you purchased JB Hi-Fi shares at the 2008 high, you would be showing a return of 33 per cent, excluding dividends. Not a bad return, and it does indeed reflect the importance of buying extraordinary businesses. But by combining great businesses with my Value.able method to identify when the shares are truly cheap, you can really supercharge your returns.

Had you purchased shares in the very same company at the low of US$6.87 and below intrinsic value, your returns would have been over 200 per cent, and even higher if you include the dividends.

Time in the market is no good if you pay too high a price for your shares. And time in the market is no good if you buy inferior businesses.

Acquiring shares in extraordinary businesses when they are truly cheap will produce returns dramatically different from acquiring shares in the same business at a much higher price. The simple fact is that the higher the price you pay, the lower your return.

Invest in inferior businesses and you will suffer the same low returns the business is generating. Remember Qantas? Businesses with poor economics and a reputation for poor returns on equity will erode your wealth. Airlines are just one example.

There you have it – three simple steps that will reinvent the way you invest. Turn the stock market off, think about shares as pieces of businesses in which to invest and know how to value a company.

Whether you are a full-time, part-time, first-time or sovereign investor, I wrote my book *Value.able* to show you that there is a simple and more successful way to invest in the stock market. Your portfolio does not need to be beholden to its intoxicating and frequently wealth-destroying influences.

'Value.able – How to value the best stocks and buy them for less than they're worth' is available exclusively online at www.rogermontgomery.com/bt