Finding value in volatile times

By Roger Montgomery

Today I would like to talk to you about something simple. You can do it well and it will improve your returns over the long-term. It will also reduce the amount of anxiety you endure when market volatility makes bungy jumping look serene.

In this article you will discover how I uncover investment opportunities in a variety of market conditions and how I quickly evaluate companies worthy of further effort. Finally, I ask: Is anything cheap right now?

Firstly, a framework; at The Montgomery [Private] Fund we think of the market not as a venue for betting on 'stocks', but as a venue that enables us to purchase pieces of attractive businesses. Thinking about businesses rather than stocks, is the first step to turning your back on speculating and becoming an investor. Further, we focus on value rather than price. At Montgomery Investment Management we use Skaffold to help us do this. Its benefits are significant and obvious once you make it your daily habit.

Importantly, it is only when all the conditions I'm about to outline are met that we buy and only for as long as all the conditions continue to be met do we continue to hold.

First, we define quality using many ratios. They include debt, capital expenditure, cash flow and return on equity but perhaps unconventionally, Skaffold also measures the rate of change of these to produce a quality score from A1 to C5 and they are available with up to ten years of history for every listed company. They are also automatically updated daily without any human intervention so you can be sure of consistency across companies and across time.

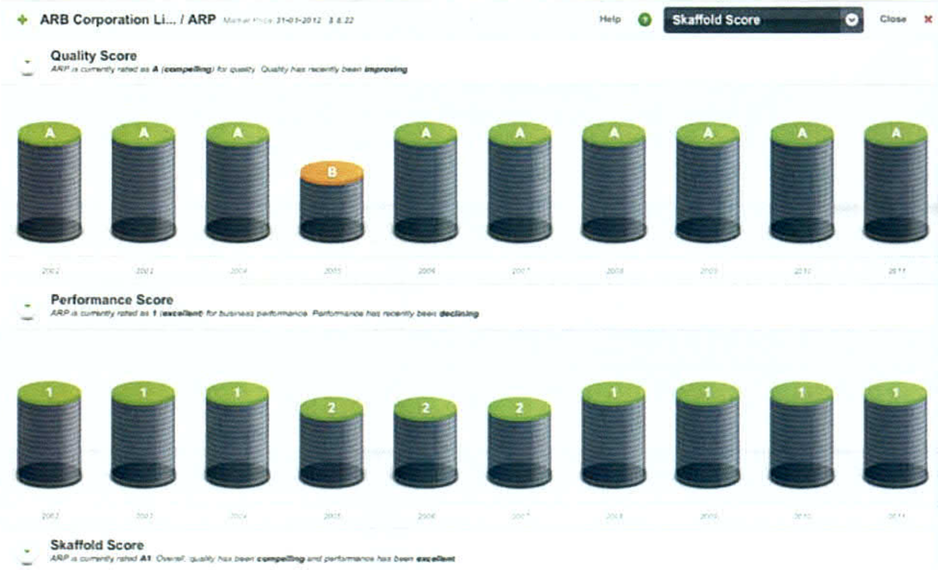
Our investment universe is those companies that receive a score of A1, A2, A3, B1 or B2. Any company that receives a score of A4, B4 or C remain outside our investment universe.

Warren Buffett speaks of the importance of a company with a 'demonstrated track record', so we like to see a solid history of performance. Skaffold's history of Quality and Performance for ARB in Figure 1demonstrates what we are looking for whereas Lend Lease in Figure 2 does not. How do you check that the companies in your portfolio have a demonstrated track record of quality and performance?

We also look for companies with little or no debt. Quite simply, that is our preferred stand on the subject of borrowings – unless a company is in a rapid growth phase, in which case we look at cash flow given changing revenue and profit margin scenarios.

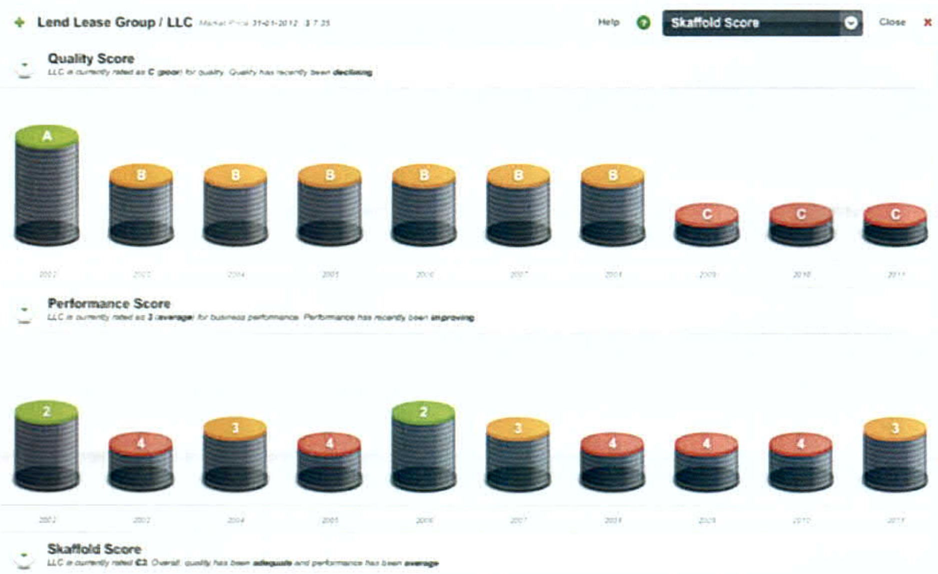
We also look for companies whose profits are cash-based and not the result of an accounting trickery. Last year Billabong

Figure1 ARB (ASX: ARP) Skaffold Quality Scores 2002-11*



*International Patents Pending

Figure 2 Lend Lease (ASX: LLC) Skaffold Quality Scores 2002-11*



*International Patents Pending

reported net profit of $119 million however its cash flow from operations was a mere $24 million! Despite this unhappy occurrence, dividends of $78 million were still paid and capital expenditure and investments of $266 million were made! Think about that for a minute.

We also look for high rates of return on equity (ROE). While we have become conversant in many esoteric aspects of ROE, even with a foundation understanding, you can produce a superior selection of companies towards which your research efforts should be directed. ROE measures the rate of return on the equity contributed by the owners of the business. I confess to a 'special' way of calculating it that makes Skaffold able to identify companies earlier.

Finally, we are interested in businesses whose intrinsic values are expected to rise at a good clip. Figure 3, shows Myer's (ASX:MYR) share price since listing, plotted against Skaffold's intrinsic value estimates since it listed and for the next three years (based on two scenarios occurring). While Myer's intrinsic value is rising the rate of gain is only 6% per annum.

Benjamin Graham was right when he said; 'in the short run the stock market is a voting machine…but in the long run the stock market is a weighing machine'. I believe that short-term share prices are governed by popularity, which is unpredictable. In the long-term however share prices tend to track intrinsic values – provided of course you have a clever way to estimate them. Figure 4 reveals Skaffold's intrinsic value and price chart for ARB – the world's biggest manufacturer of after-market bull bars. You will notice that in addition to the fact that ARB's intrinsic value estimate is rising at about 12% per annum, there has been over the last decade a very close relationship between price and value, demonstrating that Benjamin Graham was indeed right and prices tend to follow intrinsic values.

Once the company meets the quality criteria, I buy businesses that are trading at substantial discounts to their current value. In essence I am looking for the share price to be well below the Skaffold intrinsic value lines (ARB is not) and for those values to be rising at a good clip (ARB is). This approach is the same as predicting share prices - but provided the intrinsic value keeps rising and the company remains a high quality company, Ben Graham should generally be proved correct and price should follow value in the long run.

Look for businesses that meet all of the above criteria. You can do this manually with spreadsheets and read a decade of annual reports for 2000 listed companies, or you can use the same Skaffold service that we use.

So here's a list of companies that I believe are worthy of investigation of the competitive advantages that drive their returns on equity and of their prospects for increases in their intrinsic value. The companies are Silver Lake Resources, Seymour Whyte, Maca Limited, Norfolk Group, GR Engineering, Flight Centre, Credit Corp, Breville Group and Think Smart. If I narrow the field a little differently including expected growth in earnings per share, there are just two out of the universe of 2000-odd companies, that are close to being described as possible 'value' (Figure 5).

And so I leave you with the seed of value investing which I hope will germinate and help you generate superior long-term returns.

Figure 3 Myer (ASX: MYR) Intrinsic Value and Price

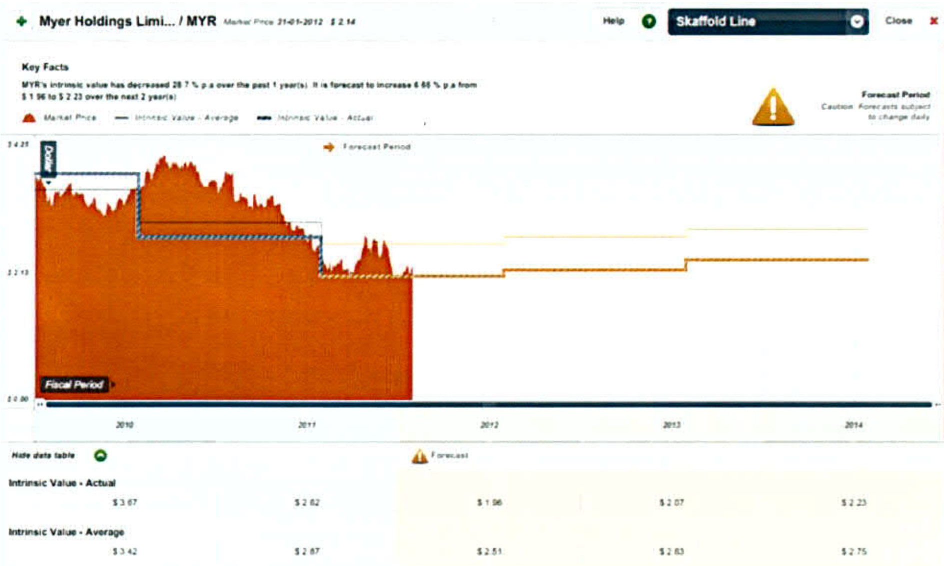
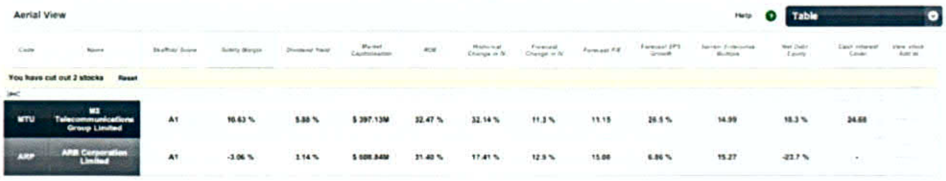


Figure 4 ARB Corp. (ASX: ARP) Intrinsic Value and Price

Figure 5 Results of a search of 200 companies for Growth and Value



Roger Montgomery is the founder of Montgomery Investment Management www.montinvest.com and the Chief Innovation Officer (CIO) at Skaffold (www.skaffold.com). The Montgomery [Private] Fund may own some or all of the companies mentioned in this article. Be sure to seek and take personal professional advice before dealing in the securities of any companies mentioned in this article.