

A Montgomery Thought Piece
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Why the Stockmarket Doesn't Work: Investors Return? It depends on Investor Returns

What is ailing the stock market and why have investors deserted it in droves? Founder of Montgomery Investment Management and author of value-investing bestseller *Value.able* reveals the steps he is taking to ensure investor returns and investors return.

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By Roger Montgomery

There are many lessons worth taking away from the writings of Wall Street Dean Benjamin Graham. While his 'net nets' strategy, for example persistently outperforms - albeit with limited scalability - it remains his observations about the behaviour of markets - those that both precede and partly contradict the efficient market theory - that have a special place in Montgomery's investment thinking. More importantly this somewhat prosaic observation should also be a beacon for the funds management industry, which is fast discovering their offerings have not been attractive enough to prevent a mass exodus from the stock market.

In Security Analysis Ben Graham wrote:

*"...the market is not a weighing machine, in which the value of each issue is registered by an exact and impersonal mechanism, in accordance with its specific qualities. Rather we should say that the market is a voting machine, whereon countless individuals register choices which are partly the product of reason and partly the product of emotion."*¹

Some decades later this was paraphrased by his student Warren Buffett, whose own epochal fortune germinated from the teachings of Graham;

*"In the short-run, the market is a voting machine - reflecting a voter-registration test that requires only money, not intelligence or emotional stability - but in the long- run, the market is a weighing machine."*²

As time passes, the implications of this observation of market behaviour become more important if only because the industry has headed so far in the opposite direction.

Short-term share prices are driven by factors that may or, more likely, may not reflect the performance of the underlying business they represent a part of. This is because the market tends to move from fad to fad and so for some periods of time, prices can 'disengage' from their long-term drivers.

We witness this more than occasionally when, for example a take over offer is received for a retail company causing the prices of all retail companies to rally. We see it when a business with appalling economics and already high levels of debt announces it has secured further debt financing and we see it when the appointment of a reputable manager causes the shares to jump even though the appointment is to a company in an industry with a reputation for poor economics and the manager has yet to prove their ability to turn the company's performance around.

Indeed speculation is often construed as investing. This is not obvious to the untrained or inexperienced eye and the appearance of science-like rigour applied to the study of information-free price action with names like beta, CAPM and WACC or descriptors like explanatory power, makes misguided endeavours even more likely.

Vast forests have been felled since the late 1950's to produce white papers, PhD's and other research giving credit to the study of price action but at its core the research is the

¹ B Graham & D Dodd, Security Analysis: the classic 1934 edition, McGraw-Hill, 1996, p.23.

² Berkshire Hathaway Inc., Chairman's letter to shareholders, 1993.
www.berkshirehathaway.com/letters/1993.html

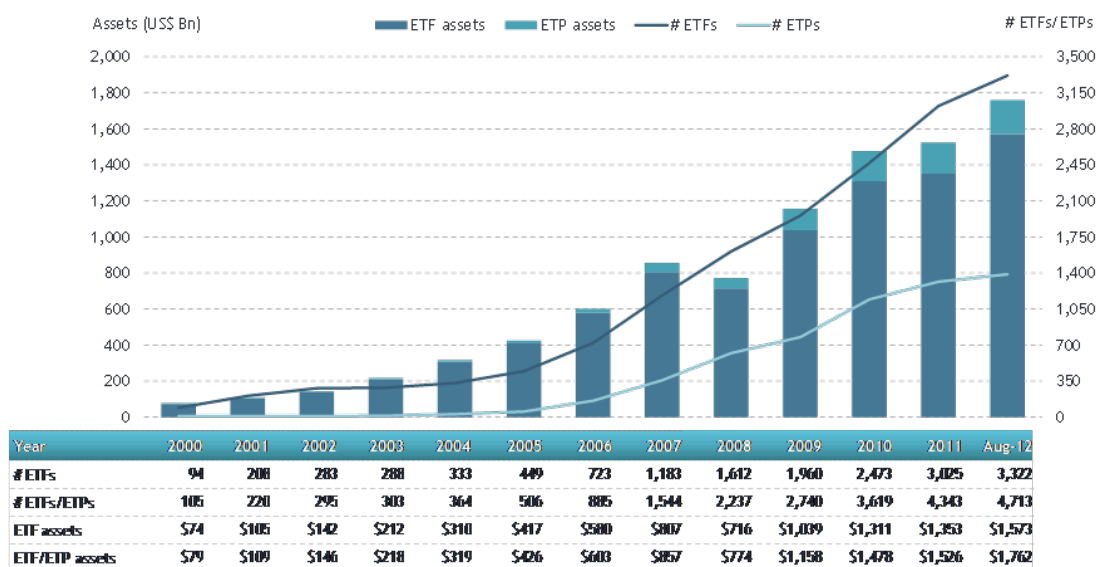
study of betting on 'up' or 'down'. And this is no different to betting on black or red – for which there is also a flotilla of research and findings.

Buying into this research and promoting its 'results' has hitherto been to the advantage of the financial services industry because it complicates and obfuscates investing in equities, rendering it both unappealing and impossible for private investor customers to replicate. As was once observed; what witch doctors gained fame and notoriety by prescribing two aspirin?

But the study of price and the resultant generation of the efficient market hypothesis, efficient frontiers and modern portfolio theory, along with the requirement for publishing quarterly, monthly and even daily returns, has produced mostly mediocre, if not miserable risk-adjusted results for investors, who have now reached the 'event horizon'.

The event horizon is the point beyond which there is no return and investors have instead opted to leave the market altogether or given up on active management's failed promise to deliver index beating returns, admitting defeat and turning to passive index funds and ETF's, the overall growth of which is illustrated in Figure 1.

Figure 1. Growth in global ETF assets under management.



Source: ETFGI, Bloomberg, ETF/ETP providers, Bank of Israel

Importantly the growth in equity ETFs has been the fastest in recent years.

The active funds management industry, by using the tools developed from the study of price have sowed the seeds of their own client dissatisfaction.

There is however a solution and investors are not lost forever, however a new approach to the stock market must be forged and explained to educate investors rather than mystify.

Admittedly this is the only approach we know at Montgomery Investment Management and irrespective of whether it produces fund inflows, it will be the only approach we apply. It simply makes sense.

Talk of beta, alpha and tracking error or stock portfolios must be replaced with talk of a business's revenue per square foot, competitive advantage and product development pipeline.

The stock market can be approached two ways. The first and hitherto more popular path is to bet on price action, unwittingly reducing the stockmarket's role to that of a casino facilitating bets, be they on cards, rolls of dice or black and red.

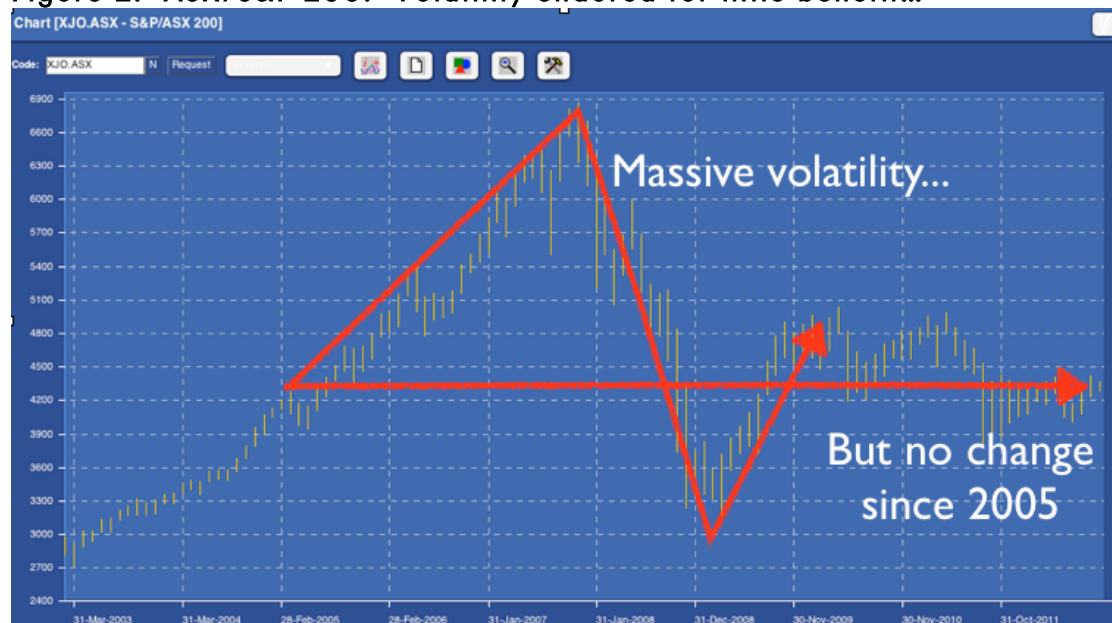
The other more boring but infinitely more rewarding path, is to approach the stock market as a venue through which portions of businesses can be acquired. And thanks to the regular habit of the majority whether professional or otherwise, to operate without 'emotional stability' or 'intelligence', the patient investor is sometimes able to acquire these businesses at prices that would be unavailable in a negotiated trade sale environment.

But before we consider an alternative, and in our own experience, much more rewarding approach, let's reflect on an earlier observation; investors are leaving the stock market in droves.

This is evidenced by massive outflows for many fund managers – the Australian industry lost \$9bn to outflows this year, forcing some like Wallara and Constellation to close their doors. Others like Platinum saw funds under management decline from \$17.8 billion at the start of the 2012 financial year to \$14.9 billion, with net outflows representing \$1.7 billion of the decline. Brokers too are succumbing to the pressure. The 30% reduction in natural volumes through dark pools and high frequency trading is forcing brokers to respond in a variety of ways. Some who have been around for more than a century such as Bailleus and F.W.Holst are consolidating - merging to reduce duplication. Others are cutting staff en masse or simply hoping for a return to the good old days. But the good old days may be a distant memory as the proportion of disinvestors (natural stock sellers) overwhelm investors who are of accumulation age.

Investors generally are tired of lousy returns and heightened volatility as shown by Figure 2.

Figure 2. ASX/S&P 200. Volatility endured for little benefit...



Even the institutional investors are jack of the poor returns. AustralianSuper head of equities Innes McKeand was recently quoted as saying the group is "in the process of putting a platform in place"³ to manage in-house a part of \$15bn it has allocated to Australian equities. This will put even more pressure on fund managers who have built businesses that rely on a few large clients and in turn pressure broker margins as the larger AustralianSuper seeks volume discounts on its deals.

One response to the poor returns and higher volatility has been to leave equities altogether and move towards income securities and annuities. Challenger's advertising - telling boomer investors what they want to hear; that they're no longer young enough to be able to afford to wait for a stock market recovery, has been very effective. The campaign makes leaving the stock market look like a mature decision rather than a mad panic to protect what is left and jump into the latest fad.

The ads have helped Challenger become one of Australia's largest ten fund managers, enjoying six half years of strong net inflows to push funds under management to \$31 billion.

The financial services industry participants, and particularly brokers, fund managers, asset consultants and rating houses, are collectively responsible and the solution is a complete and total rethink about what works in the stock market.

The solution for investors retiring and requiring funding for another 15 to 30 years of spending, lifestyle and health care is not to leave the stock market for it is only through the ownership of businesses with pricing power that the investor's purchasing power can be maintained.

The chart in Figure 2. simultaneously reveals why the stock market has become unpopular and why large institutional funds are shifting to ETFs and index funds.

It's easy to push Figure 2. in front of an investor and show them that they should not be in stocks if they want to sleep well at night and avoid the risk of serious or even permanent capital impairment.

But the reason for the poor returns of the index and those investors who follow its path - ensuring they minimise their 'tracking error' - is not because of China, a recession or Greece. The reason is far more simple than that. It is the index itself that is the problem. More about that in a moment.

Rating houses have correctly rated fund managers on their ability. They provide an essential service for investors to gauge the relative merits of those that seek to be stewards of the life savings of their customers. Unfortunately, one of the tools to measure this 'ability' is tracking error. Tracking error is a measure of how far the fund manager strays from the index - yes, the very same 'index' that has the problem I will discuss momentarily. The best fund managers are supposedly those who have the ability to keep their tracking error within defined ranges.

But it's a case of giving a man a hammer and every problem becomes a nail.

³ *The Australian*, September 10, 2012. **Warnings of industry shake-out as AustralianSuper takes \$46bn in-house**
MICHAEL BENNET and ANDREW WHITE

Retail investors don't care about tracking error, they care about loss and a small deviation from an index that has declined 30% is not something the investor can buy they're friends a night out with. They want to make money and protect their capital. Rating a manager more highly for their ability to stay within a defined band around an index that itself has no ability or desire to preserve a retiree's savings is a huge flaw and another reason investors are fed up and leaving.

Further, asset consultants are the parties that are asked about whether to be in stocks or in cash even though the fund managers are at the coal face and arguably best positioned to decide whether a business is either an extraordinary one and or cheap.

The customers however have fallen for the idea that when one surrounds themselves with economists, strategists and studies of correlations and volatility – further euphemisms for nothing more than historical price action, the ability to forecast which asset class is going to outperform is improved. The result is that fund managers are allocated capital 'from above' and required to be fully-invested even if they don't like the stocks they are forced to buy or the price they are forced to pay.

There is any number of fund managers who would have loved to have been in cash – like us – over the last twenty months. They aren't allowed. If they want to keep their funds under management, their revenues and their kids in the schools at which all their friends attend, they toe the line and stay fully invested, even if they are 100% convinced that a 'dislocation' of epic proportions is in the offing.

A desire to reduce business risk while simultaneously qualifying for professional indemnity insurance will ensure that any change to the status quo will occur at the same glacial pace as turning the Titanic. Passing the responsibility of decision making to someone else spreads the risk so no individual party is to blame when things go wrong or returns don't meet expectations. And fund managers, irrespective of their preferences, comply because complying is the path of least resistance in ensuring food on the table.

But an exodus is in train and dissatisfaction reflected in the examples given earlier. Only a significant shift in thinking will ensure that investors get the best from the stock market which includes maintaining purchasing power over a decade or two – something bonds, annuities and cash cannot hope to achieve at current rates.

Using the index as the base measure of stock market returns is the first thing that must change. The stock market has actually been a very good place to invest if you avoided the companies that have damaged returns. That is self-evident but the point is that the companies to avoid are relatively easy to spot.

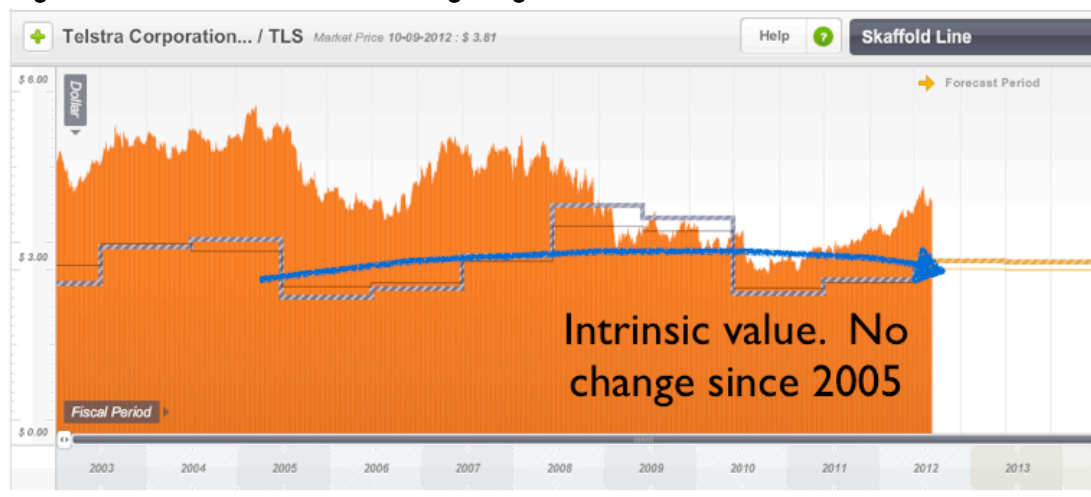
The index upon which all arguments are mounted for and against investing in shares is itself not invested in the very best stocks. It is invested in the very big ones. And the very big ones are not necessarily the best.

Companies like NAB, Wesfarmers, Leightons, Lend Lease, Telstra, Boral, Qantas, Transpacific, BHP and Rio have added little or no intrinsic value for several, if not many, years. And if you believe, as Benjamin Graham did, that in the long run the market is a 'weighing machine', then you know share prices follow a sensibly calculated estimate of intrinsic value. Provided that intrinsic value is based on business performance, then any business with poor or mixed business performance will see its share price produce only

modest long-term returns at best. It comes as no surprise to us that BHP trades at little more than \$30 – that has been our estimate of BHP's intrinsic value for a long time.

Figure 3. illustrates what I am referring to - little or no increase in the intrinsic value of Telstra over the past several years.

Fig 3. Telstra's intrinsic value going nowhere fast.



Using our internally-developed software, Scaffold, Montgomery estimates the intrinsic values of every single listed company and these are automatically updated every day. What we are able to see are those businesses that enjoy rising intrinsic values over the years (CBA, ARB, SEK, REA and WOW, for example) and separate them from those that have not and will not.

More importantly, many of the very best businesses – those enjoying the fastest expected growth in intrinsic value – are not constituents of the major indices. That index I have been referring to is made up of the 'big' companies, but it is not made up of the 'great' companies and those big companies carry a heavy weight and influence over the index direction.

The secret to safe returns for investors and the secret to investors returning to shares is simple. Put together a portfolio of *businesses* not a portfolio of *stocks*. Ensure the portfolio of businesses is populated by the best quality companies and those whose intrinsic value is rising not merely plodding along sideways.

Next, give fund managers the ability to decide whether to be in cash or shares. And finally, ensure new indices are created that are based on quality rather than size. Fund managers may never grow to be as big again but returns to investors are not determined by the size of a fund.

Doing these things will produce returns that must beat the major conventional indices over time and investors will return.

As Figure 4. and Table 1. illustrate, beating the market using an approach that is both rational and patient is possible. Both the Montgomery Fund and The Montgomery [Private] Fund are beating the market and while this can reverse, the point is made.

Figure 4. The Montgomery [Private] Fund Performance since inception⁴

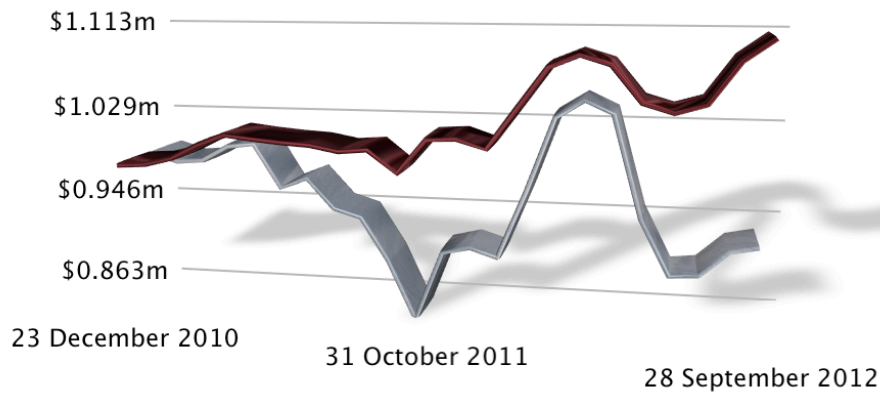


Table 1. The Montgomery [Private] Fund Performance

Relative Performance			
Code	Name	Change [#]	Outperformance
MPF	The Montgomery [Private] Fund	11.25%	-
XNJAI	ASX 200 Industrials Accumulation Index	-6.22%	17.47%
XTOAI	ASX 100 Accumulation Index	0.50%	10.75%
XJOAI	ASX 200 Accumulation Index	-0.53%	11.78%
XAOAI	All Ordinaries Accumulation Index	-2.26%	13.51%
XKOAI	ASX 300 Accumulation Index	-1.21%	12.46%
XTLAI	ASX 20 Accumulation Index	2.64%	8.61%
XMDAI	ASX Midcap 50 Accumulation Index	-13.01%	24.26%
XSOAI	ASX Small Ordinaries Accumulation Index	-17.02%	28.27%

[#] Since inception on 23 December 2010

Investors interested in applying for unites in The Montgomery [Private] Fund or The Montgomery Fund may do so at www.montinvest.com

Doing these things will also result in only the best companies raising capital and an efficient allocation of capital will mitigate the risk to investors of permanent capital impairment. In turn this reduces society's and the government's financial burden of social security, permitting more generous tax regimes and attracting even more productive uses of capital while firing up a virtuous cycle that raises the government's revenue base with which it can provide the infrastructure upon which society can prosper.

And it all comes back to a rational but unconventional approach to managing investor's money by acquiring the best *businesses* rather than the biggest *stocks*. What investor's need is a return to common sense that has hitherto been uncommon.

⁴ Inception date of The Montgomery [Private] Fund; 23 December 2010.

To preserve purchasing power, investors must return to the stock market and when they do, it is the very obligation of fund managers to make sure that they are respected as people with a very heavy burden of stewardship over their family's life savings.

To this very day when I am greeted by our peers in the street I am not asked 'what is your performance?' Instead, I am asked, "how much do you have under management?" This revealing question must be changed and the focus redirected squarely on returns.

Genuine long-term returns will then eventuate and investors will return for the genuinely long term.

Roger Montgomery
October 2012

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