

Play it safe by adding custard

BY: **ROGER MONTGOMERY** From: [The Australian](#) December 08, 2012 12:00AM

PUDDING and custard. At this time of year, there are no two food combinations I am less resistant to. For me, all investing is like pudding and custard: two ingredients that must be combined. In investing, it's quality and value.

Regular readers of this column will know that quite often I focus on the attributes that constitute an extraordinary business. That's the quality. But there are two parts to the investing equation: quality and value.

Identifying the best stocks is half the challenge and buying them for less than they are worth is the other half. In all investment decisions the margin of safety will determine the return. Although a company may have stunning fundamentals, the decision to invest should be made only when the company's share price is trading at a steep discount to its intrinsic value. This way, investors will mitigate some of the risks while ensuring their exposure to potential profit is maximised.

Let me illustrate the point using Austbrokers, which manages a network of insurance brokerage and underwriting businesses. Since 1985, management has employed a stable business model that has led to organic growth and involved acquisitions. This strategy is well suited to the insurance industry.

Historically, Austbrokers' earnings have grown at 15 per cent a year even though most of the earnings from previous years are paid out as dividends and shareholders have not been required to stump up further capital. The company is net cash positive, although it maintains a conservative level of debt on the balance sheet to fund acquisitions.

Austbrokers has all the trademarks of a quality business but this does not necessarily make it a wise investment. The company may get a tick for quality, but are its shares trading at a sufficient discount to intrinsic value? According to Skaffold.com, intrinsic value for this business has been growing at about 12 per cent since 2007 but the share price is now 28 per cent above its value. There is no margin of safety.

Even if I look at conventional measures we can get a sense of the diminished margin of safety. In 2009, the share price was 12.5 times Austbrokers' earnings per share, while this year its share price has been trading at more than 17 times its earnings per share. The multiple of earnings investors are willing to pay has grown 50 per cent in just three years. It is reasonable to conclude the recent share price rally has extinguished much or, if not, all of the value.

At Montgomery we always rely on a margin of safety, and so should you. A conservative margin of safety will protect you when your estimate of a company's intrinsic value is too optimistic. It will minimise your exposure to a

fall in the company's earnings and can turbo-boost your returns. For more about margin of safety, pick up a copy of Value.able for Christmas.

There are two essential ingredients to a happy Christmas dinner and the investing equation, and at this time of year I can't resist the combination.

Roger Montgomery is the founder of Montgomery Investment Management and the author of Value.able: How to Value the Best Stocks and Buy Them for Less Than They're Worth, available at www.rogermontgomery.com.