Think like a business owner …

… And leave the speculation for traders and other investors who focus on price instead of value.

By Tony Featherstone

In my former life as a magazine editor, I once ran a cover story, "*Best blue chips to build wealth",* in the then *Shares* magazine. The reader response was a gigantic yawn. So the next issue screamed: "*10 hot stocks under $1 to buy now*!" Sales skyrocketed and the issue sold out.

I learned two valuable lessons from those coverlines: too many people think like traders rather than investors; and novice investors wrongly equate value with the share price. I could add a third lesson: never chase a quick sales boost -- but that's another story!

The classic value investing book, *Value.Able*, says sustained sharemarket success begins with thinking like an owner of a business, rather than a trader of stocks or a punter on short-term share-price moves. Chapter two, "*Buy businesses, don't trade stocks*", should be mandatory reading for anybody who has bought or sold a stock based on rumours, hunches or headlines.

We've all been there. A colleague tells you about a hot stock he or she owns, and you buy it. A newspaper story makes a compelling case for buying or selling a stock, and you follow suit. A sharebroking firm publishes an aggressive research note on a stock and you buy. Perhaps you have a hunch that China will grow faster than expected, so you punt on quick gains in commodities and resource stocks.

The result is what I call a "cocktail portfolio", which comprises seemingly glamorous stocks that people at cocktail parties told you to buy, but nobody ever told you to sell. The focus was all about price rather than value, the short term rather than long term, and trading rather than investing. The portfolio became a mish-mash of stocks, with poor diversification and terrible returns.

A market full of speculative stocks

Sound familiar? Don't despair: many investors have lost money on stocks by thinking like a trader or speculator, rather than a part-owner of businesses. In fact, by listings volume, the sharemarket is far more geared towards trading than investing, and to speculative rather than investment-grade stocks.

I ran a simple search on listed Australian companies that earned more than $1 in their latest profit result for this story: about a third of the 2188 ASX-listed companies made a profit (even a large number of those were barely in the black). Put another way, two in every three listed companies could not cover their costs; many will have to rely on capital raisings to stay alive. Owning such stocks requires a leap of faith that the firm will eventually be profitable, and a speculator's mindset.

There's nothing wrong with experienced day-traders punting on loss-making companies, provided they understand the risks of speculation, and have enough skill to overcome the enormous odds stacked against them: notably, the impossibility of properly valuing loss-making companies; the potential for higher price volatility in such stocks; and the huge dangers of low stock illiquidity that make it hard to sell quickly if needed. Clearly, loss-making companies do not suit most investors.

And don't get me started on the dangers of using borrowed money to trade speculative stocks. Too many Australian companies already have enough debt without investors borrowing more to buy them.

The proliferation of margin loans, instalments, options and over-leveraged products was partly responsible for the rise in stock trading and speculation over the past decade.

You don't need to trade the two-thirds of loss-making companies on ASX to boost your portfolio's value over time. Leave them for traders and other speculators. There are more than enough opportunities in the universe of profitable companies to make double-digit returns from the sharemarket each year, without excessive risk. It's here where you should truly start to think like an owner of a business rather than a renter of sharemarket scrip. It's here where your find, 'exceptional companies at bargain prices', which is a key line from *Value.Able*.

Many of the best fund managers, including Montgomery Investment Management, have outperformed the sharemarket by holding exceptional companies for long periods, and buying more of them even when prices rise. They know the rising price is tracking the company's rising intrinsic value. Rather than chase rubbish companies, they aim to buy exceptional ones and hold them for as long as the forecast intrinsic value remains sufficiently above the share price.

Become an informed investor

Sustained investment success requires three core skills: asset allocation, stock valuation, and an ability to assess and take advantage of market "noise". Asset allocation is simply how one allocates a portfolio across the main asset classes – stocks, fixed interest, cash, property and commodities – and how one changes that allocation over time as investment needs change.

Myriad investment studies have shown that asset allocation is a bigger driver of overall investment returns than picking the right securities: that is, getting the big picture right and knowing how to make subtle asset-class changes (for example, holding more cash and fewer shares when the market is overpriced) can make a huge difference to long-term investment returns. Share-valuation tool Skaffold can help you understand when stocks are under- or overvalued at an aggregate level.

Asset allocation is too big a topic to be covered here. Suffice to say that having a disciplined long-term asset-allocation plan encourages you to think like a part-owner of businesses or other assets, rather than a trader of stock prices on a screen. A good asset-allocation plan will show you don't need to trade stocks all the time, and take huge risks, to make attractive, sustained returns.

Don't be an unwitting speculator

Success within the equities component of your portfolio starts and ends with stock valuation. As *Value.Able* notes: "If you don't have an estimate for the value of a business and you buy its shares, you are, by definition, speculating and betting someone will be willing to pay more than you just did."

That is a critical point. Speculation is not just owning an unprofitable exploration or biotech company and hoping it will one day make money. It also occurs when investors buy a profitable company, perhaps even a so-called blue-chip, without having a view on its valuation, or how that valuation is changing over time. In effect, the person is unwittingly speculating rather than investing.

Imagine if a friend or colleague asked you to invest in his or her private company. Your first question would probably be: "What are the chances of the business going bust?" That is, is the business profitable, how much debt does it have, and can it comfortably meet its interest repayments?

Your second question might be: "Is it a good business?" Does it operate in an attractive industry, sell a good product, have an excellent reputation and client list? Does it have a long-term record of rising

profits and, more importantly, a rising return on equity (ROE) or shareholder funds? Do you believe the ROE will continue to rise over time and lead to a higher company valuation? And will the ROE be sufficiently high to compensate you for the risk in this investment?

Your third question is probably: “How much do I have to pay to own X per cent of the company?” Having gauged all of the above, you determine what the company is worth, and assess that against the asking price. Having a firm view of the company’s worth (its intrinsic value) helps you make astute decisions when prices rise or fall because you understand the difference between value and price.

Compare that with an investor who buys a profitable listed mining services company on a whim because he or she expects stronger Chinese growth and more activity in the resource sector.

Having not considered the company’s intrinsic value, or compared it with the market price, the investor is speculating that the price will go higher and that another speculator will pay more for the stock than he or she did. When the share price falls, the investor inevitably follows the herd because he or she has no yardstick of value. In turn, this investor cyrstallises heavy losses because decisions to buy or sell are based on price alone, rather than assessment of price versus value.

Don’t be swayed by market noise

So what stops us thinking like a part-owner in a business when it comes to listed companies, and instead act like a trader or speculator? Market noise plays a big role. We get seduced by media headlines, magazine stories on “*hot stocks under a $1”*, pay-TV finance channels, and broking reports. We latch on to supposed expert views and succumb to ever-larger waves of stock commentary.

As the previous feature in this series suggested, investors need a quiet, controlled detachment from the sharemarket. Follow it, but don’t base decisions on what the market is saying, for it is so often wrong in the short term. Don’t let market noise turn you into trader of speculative assets.

Market noise amplifies those two great investing emotions: greed and fear. We punt on low-quality companies hoping to make a quick buck, and sell high-quality companies because we did not realise the rising share price was following the company’s rising intrinsic value. Having a clear yardstick for company value helps you know when to be greedy and fearful, usually well in advance of the herd that uses sharemarket noise as its decision-making trigger.

Another reason why too many investors focus on price rather than value, and trade rather than invest, has been the absence of high-quality sharemarket-valuation tools. So many online sharemarket products are based around charting software, trading systems or other “black box” tools that use market price as their guide, even though this is fraught with danger (Yes, I know that comment will irk chartists, but I strongly believe in using fundamental analysis to value companies).

New tools such as Skaffold make it easier than ever to understand company valuations, and track them against the market price over time. Other sharemarket-valuation tools are also available, but understand how they calculate value. Any software program can spit out a valuation; it’s the methodology that makes the difference.

Other Value.Able gems from Chapter 2:

“The focus on price movement, and the expectation of profit from it, rather than from business performance, is pure speculation, not investing.”

“Instead or renting bits of paper and hoping they will go up in price tomorrow or next week or next month, investing involves buying a slice of a business after considering the facts and applying common sense.”

“Buy shares in order to own businesses. Don’t buy shares merely to sell them.”

ENDS

- *Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at January 22, 2013.*