ROGER MONTGOMERY

Re-inventing the way you invest

For What It's Worth

A Montgomery White Paper

AUGUST 2013

Understanding sensible value investing

In this first part of our Value Investing Series, we explain how to lay down the foundations for a sound approach.

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PART 1: You the Speculator

Unwittingly, you are probably a speculator rather than an investor and I'm making it the role of the first section of this paper to encourage you to turn your back on speculating forever and to become an investor.

Sustained sharemarket success begins with thinking like a business owner, rather than a trader of stocks. Betting on the next 'up' or 'down' is tantamount to betting on black or red at the casino. It's not investing. Further, when someone says, "I just 'invested' in a tech start up," it's incorrect. Speculating is not investing.

When colleagues tell you about a hot stock they own and you buy it, or a newspaper story makes a compelling case for selling a stock and you sell it, you are not acting like an investor. When a broker publishes an aggressive research note on a stock and you buy, or maybe you have a hunch that China will grow faster than expected, so you punt on quick gains in commodity and resource stocks, you aren't investing either.

Not only are the above approaches a common way to construct a portfolio, but the one that results is a hotchpotch of ideas and beliefs that will usually amount to little. Worse, when something inevitably does go wrong, you have learned nothing from the experience because none of it was systematic, replicable or repeatable. Not only was the focus on stocks rather than businesses but it was also on price rather than value.

In fact, by listings volume, the sharemarket is far more geared towards speculation than investing. A simple search of listed Australian companies that earned more than $1 in their latest reporting period reveals that only about a third of the 2,188 ASX-listed entities made a profit and a large number of those were barely in the black.

Two in every three listed companies could not cover their costs, and many will have to rely on capital raisings to stay alive. Owning such stocks requires a leap of faith that the company will eventually be profitable and while faith may prove beneficial spiritually, there is little place for it in investing.

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, including:

- the impossibility of properly valuing loss-making companies
- the potential for higher price volatility in such stocks
- the huge dangers of illiquidity

You don't need to trade the two-thirds of loss-making companies on the ASX to boost your portfolio's value over time. There are more than enough opportunities in the universe of profitable businesses to make double-digit returns from the sharemarket without excessive risk. Montgomery has achieved this as a manager of other people's money.

Become an informed investor

It's among the profitable companies where you should truly start to think like an owner of a business rather than a renter of pieces of paper that are represented by wiggles on a screen in some broker's office. And it's here where you'll find extraordinary businesses at bargain prices.

Arguably, the best long-term risk adjusted returns come from buying exceptional businesses and holding them for as long as they remain exceptional, continue to have bright prospects for intrinsic value growth and share prices do not diverge too far above forecast intrinsic values.

Sustained equity investment success requires two core skills and the right temperament – the latter is up to you and your parents. The two core skills are the ability to identify a superior business and the ability to value that business.

While myriad investment studies have shown that asset allocation is also a meaningful driver of overall investment returns, my view is that the top-down approach is fraught with errors from which little can be learned for the purposes of future exclusion. However, the ability to value businesses produces a list of those that are expensive and those that are cheap. When the vast majority of companies are expensive and there are few securities worthy of investment, the only conclusion is that more funds must be allocated to cash. In one sense, a bottom-up approach, such as the one contemplated here, produces the only sensible asset allocation.

Don't be an unwitting speculator

Without an estimate for the value of a business buying its share is, by definition, speculating and betting someone will be willing to pay more at a later date than you just did.

This 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 a 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 return on 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 for the risk in this investment?

Your third question would probably be, "How much do I have to pay to own X% of the company?"

From the answers, you determine what the company is worth, and assess that against the asking price. A 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.

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 part of a herd? Market noise plays a big role. We are seduced by media headlines, magazine stories on "hot stocks under $1", television finance channels, and broker reports. We fear missing out more than we fear losing money. We latch on to supposed expert views and succumb to ever-larger waves of stock commentary, failing to realise that the entire machine has been set up to promote noise and activity.

Investors instead need a quiet, controlled detachment from the sharemarket. Step number one simply involves turning the sharemarket noise off.

Market noise amplifies those two great investing emotions: greed and fear. Market noise triggers the purchase of low-quality companies in the hope of making a quick buck, and market noise triggers the sale of high-quality companies because there was no appreciation that a sharply rising price was simply following the company's rising intrinsic value or was all occurring well below that 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.

Having discussed the subject of adopting the right mental framework, lets now look at how to assess a business's quality. As we move on however remember the following:

- the focus on price movement, and the expectation of profit from it rather than from business performance, is pure speculation, not investing
- instead of 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

PART 2: Is Growth Always Good?

Many years ago the world's wealthiest man Warren Buffett said that growth was not always a good thing. What? Aren't companies of the western world doggedly pursuing growth? If our economy has two quarters of negative growth, we call it a recession and recessions are bad. More sales, more profits, more products. It is all about 'more'.

But growth is not always good. They might not know it but for some investors, growth has destroyed wealth both quickly and permanently.

Remember ABC Learning Centres? It's April 2006 and the shares are trading at more than $8.00. Profits are growing at a fantastic rate - rising from about $11 million in 2002 to over $80 million in 2006. Brokers and approved lists have the stock rated a 'buy' or 'strong buy'. The problem however is return on equity is declining.

Return on equity contraction foretold the demise of the company, which was accelerated by the increase in debt. It is return on equity that will help you identify the great companies to safely invest in. And it is return on equity that will save your portfolio from permanent destruction.

To understand what Warren Buffett was talking about when he said not all growth is good. You need to know something about return on equity.

Imagine you have a business, even a good one. You invested $1 million dollars in it, bought a shop and in the first year, produced a real cash profit after tax of $400,000. That's a 40% return. Now suppose another shop came up for sale in another area for $400,000 and you decided to buy it. As it happens you are really good at running the first store you bought but you have found running the second store a little harder. Traveling between them has been challenging and so you decide to bring in a manager for the second store. The result is that after a year of owning the second store it produces a profit of $20,000. Meanwhile the first store produces another $400,000. The second store has generated a return of just 5%. Many business owners – and I know one or two – would say this is still satisfactory, because profits have gone up. In the first year your business made $400,000 and in the second year, profits have gone up to $420,000. Profits of your new 'group' grew by five percent.

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WELCOME TO THE BOUTIQUE INVESTMENT MANAGEMENT OFFICE OF MONTGOMERY

Since its inception The Montgomery [Private] Fund has meaningfully outperformed.

How?

Unlike funds managed by much larger institutions, The Montgomery [Private] Fund is not forced to be fully invested at all times.

So when markets are volatile and preserving wealth is paramount, Montgomery can turn to cash.

Returns to 30 June 2013

Code		Change	Outperfomance
MPF	**The Montgomery [Private] Fund**	**35.05%**	**-**
XNAJI	ASX 200 Industrials Accumulation Index	4.65%	30.40%
XTOAI	ASX 100 Accumulation Index	14.89%	20.16%
XJOAI	ASX 200 Accumulation Index	12.18%	22.87%
XAOAI	All Ordinaries Accumulation Index	9.00%	26.05%
XKOAI	ASX 300 Accumulation Index	10.74%	24.31%
XTLAI	ASX 20 Accumulation Index	18.40%	16.65%
XMDAI	ASX Midcap 50 Accumulation Index	-3.39%	38.44%
XSOAI	ASX Small Ordinaries Accumulation Index	-26.75%	61.80%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested.
Past performance is not indicative of future performance.

MONTGOMERY

To find out more about how Montgomery aims to find the best stocks and buy them for less than they're worth, and to find out whether you are eligible to invest in the Montgomery [Private] Fund, visit www.montinvest.com today.

Investment Manager Montgomery Investment Management Pty Ltd | ABN 73 139 161 701 | AFSL 354 564 | GPO Box 3324 Sydney NSW 2001 | 02 9692 5700 | www.montinvest.com | office@montinvest.com Trustee Fundhost Limited | ABN 69 092 517 087 | AFSL 233 045 # Portfolio Performance is calculated after fees and costs, including the Investment management fee and Performance fee, but excludes the buy/sell spread. All returns are on a pre-tax basis. This report was prepared by Montgomery Investment Management Pty Ltd, AFSL No: 354564 ("Montgomery") the investment manager of The Montgomery [Private] Fund. The Trustee and Administrator of the Fund is Fundhost Limited (ABN 69 092 517 087) (AFSL No: 233 045) ("Fundhost"). This document has been prepared for the purpose of providing general information, without taking account your particular objectives, financial circumstances or needs. You should obtain and consider a copy of the Information Memorandum ("IM") relating to the Fund before making a decision to invest. While the information in this document has been prepared with all reasonable care, neither Fundhost nor Montgomery makes any representation or warranty as to the accuracy or completeness of any statement in this document including any forecasts. Neither Fundhost nor Montgomery guarantees the performance of the Fund or the repayment of any investor's capital. To the extent permitted by law, neither Fundhost nor Montgomery, including their employees, consultants, advisers, officers or authorised representatives, are liable for any loss or damage arising as a result of reliance placed on the contents of this report. Past performance is not indicative of future performance. Applications to invest in The Montgomery [Private] Fund are only considered from wholesale investors or investors willing to commit $1 million (or by invitation from Montgomery Investment Management).

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Thinking about this situation another way reveals what a poor investment the second shop is. You first have to remember that you gave your business more money, so profits should have gone up. A rocking chair and a bank account is all you need to make profits go up. Invest $1 million in a bank account and then put in another $400,000 the year after and the interest you earn in the second year will be higher than in the first. You have grown the profits and it has been no effort at all.

So when a company increases its profits it is nothing spectacular if the owners have invested more money in the company. This is purchased growth. Shareholders have funded the opportunity for the directors to look good. The situation is even worse if that additional money generates a return that is less impressive than the rate available from a bank account. And if a higher return can be earned for the same risk or the same return for less risk, somewhere else, then the reality is that you don't want to put more money into the business. You don't want it to grow. It is better that the $400,000 is taken out of the business, rather than employed to purchase another shop. The $400,000 should be invested elsewhere at a higher rate or even at the same rate in a bank account, which has a lot less risk.

If, each year, you invested the $400,000 from the original shop into a new one that produced a return of five percent, the business would eventually have many more shops earning five percent. And each year the business would be worth less and less even though profits would be growing.

Many investors don't understand this – that there is growth that will destroy wealth. They happily allow the management of a company to keep the money "to grow the business" and willingly accept a low return. That low return is actually costing you money because you could have earned a better return elsewhere. It is called opportunity cost. Investing the money in the business at a low rate of return has cost you the opportunity of earning more or earning the same, but with more safety, elsewhere.

For those who are visual, Table 1. shows that an investor in a company that generates a five percent return on equity and that keeps all the profits for growth rather than paying those profits out as a dividend, will lose half their money.

Table 1.

	Year 1	**Year 2**
Equity at Beginning	$1,000,000	$1,050,000
Return on Equity	5%	5%
Net Profit	$50,000	$52,500
Dividend	$0	
Equity at End	$1,050,000	
Price Earnings Ratio	10	10
Market Capitalisation	$500,000	$525,000

Let me show you precisely how a company that is growing its profits but generating a low return on its owner's equity, loses your money. Table 1 shows a company listed on the stock exchange and whose shares are trading on a price earnings ratio of ten times. The price earnings ratio is simply the share price divided by the earnings. So if the share price is $5 and the earnings are 50 cents, the price earnings ratio will be ten ($5.00/$0.50 = 10). If the price earnings ratio is ten, it means

that buyers of the shares are happy to pay ten times the profits for the company.

In Year 1 when the company earned a profit of $50,000, the stock market was willing to pay ten times that profit or $500,000 to buy the entire company. Another way of thinking about it is that the stock market thinks the company is worth $500,000. What the stock market thinks the company is worth and what it is actually worth are very often two different things. Don't listen to what the stock market thinks.

The company begins Year 1 with one million of equity on its balance sheet and in the first year, generates a 5 percent return on that equity or $50,000. Management decide that they need that money to "grow" the business and so decide not to pay any dividends. As you are about to discover, that decision has cost shareholders a small fortune.

By keeping the profits, the equity on the balance sheet grows from $1 million at the start of the year to $1,050,000 at the end. In the second year, the company again earns 5 percent on the new, larger equity balance. A five percent return on $1,050,000 is a profit of $52,500.

So on the surface things look rosy. The company is growing. The equity has grown, the profits have grown and management are no doubt drafting an annual report that reflects their satisfaction with this turn of events.

But not all is as it first appears. Indeed management have, perhaps unwittingly, dudded shareholders.

As a shareholder your return is made up of two components – dividends and capital gains. If two dollars is earned and you don't receive one of those dollars as a dividend, then you should receive it as a capital gain. If, over time you don't, it has been lost and management may be to blame. Every dollar that a company retains by not paying a dividend should be turned into at least a dollar of long-term market value through capital gains.

The company in Table 1 has not achieved this and unfortunately lost its investors money. Even though the company appears to have grown – remember equity and profits are indeed growing – the reality is that as a shareholder you have lost money. How? The company 'retained' all of the $50,000 of the profits it earned in Year 1. You received no dividends. All you got was capital gain but the capital gains were only $25,000. In other words the company failed to turn each dollar of retained profits into a dollar of market value. And so investors have lost $25,000. If the situation were to continue, you should insist that the company stop growing and return all profits as dividends and if that is not possible, the company should be wound up or sold.

Capital Allocation and Management Ability

Table 1. showed us that by retaining money, the company was hurting investors as it expands. The financial pain occurs because some of the profits were retained. The reason for retention of profits is largely irrelevant because, either the money needs to be retained which makes it a poor business or management choose to retain which makes them poor decision makers.

Many investors don't understand this very real way of losing money even when the company is reporting profits. But investors aren't the only ones upon whom this lesson is lost. A very large number of company directors don't understand this 'loss' either or, if they do, they apply their knowledge with a dose of schizophrenia.

The above example demonstrates that a company with a low rate of return on equity will lose money for its shareholders if profits are unwisely retained and as Warren Buffett further observed, if profits are unwisely retained it is likely that management have been unwisely retained too.

There are four steps to investing successfully in equities over long periods of time. The first step is to have the right framework. Done. The second step is to understand the economics of a business. Done. The third step, and one that seems to be over emphasized by many investors, is the calculation of estimated intrinsic value. Its tendency to distract the investor's attention away from understanding a business's quality and prospects is the reason I have deliberately left it out of this paper. The final step, and arguably the most important one is a lesson that cannot be taught; applying the right temperament to the execution of the investment strategy – being patient and having the fortitude to swim against the status quo – are necessary investing qualities that we have observed not everyone has.

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