A handy **framework** to avoid investment pitfalls

BY ROGER MONTGOMERY

KNOWING the investment industry, its players and its products as well as I do, I cannot imagine how an inexperienced individual or family might navigate the minefield that is 'investment advice' in Australia. Where does one start? Who does one trust?

Of course, there's a conga-line of 'helpers' ready to take your hand but how do you identify the talented individuals and separate them from the rest? Unless you 'know someone who knows someone', most investors simply hope and pray that they'll be taken care of rather than taken for a ride.

It's quite common to simply hope for the best but there are some simple concepts that can help sift the wheat from the chaff.

The first step is to zip up your wallet as soon as you hear jargon. Most of the jargon is designed to make the teller sound intelligent or superior and leave you with the impression that you need their help.

Back in 1657, in his work *Lettres Provinciales*, French mathematician and philosopher Blaise Pascal wrote: "I have made this longer than usual because I have not had time to make it shorter."

There is intelligence is understanding complexity, but there is wisdom in the ability to simplify it for others. Be sure to go with someone who shares their knowledge with you rather than protects it from you. (I should say at the outset, we aren't advisers so don't take the above as imploring you to seek us out as advisers.)

Investing involves conducting a little due diligence – but that cannot be undertaken without some understanding of what to look for.

The basic principles of investing aren't altered by the passage of time – that's what makes them 'principles' - and today's column is about providing you with the principles, the framework, through which opportunities and individuals can be assessed.

Ideally, an understanding of the basic tenets of investing will allow you to navigate not only the inevitable changes in economic and market conditions but also the inevitable changes in the individuals who advise you.

Before we begin, a little note on the objective of investing: investing is about preserving and growing purchasing power. By that, I mean to say it is not enough that your investments rise in value by the rate of inflation. They must beat inflation over a long stretch of time for you to be better off.

DIVERSIFICATION AND TIME

Another important aspect of investing is diversification, but like all things, humans usually take it too far.

Diversification is the process of distributing investment dollars among different asset classes or different assets within those classes. The theory says that because you cannot pick the best performing asset class each year, you are best served by having a bit in each.

Looking at the *Australian Financial Review* Rich 200 list, the first thing you will notice is that each individual or family has achieved their ranking by investing in a business. Nobody has become wealthy by

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investing in cash or bonds. They each have started a business and been very focused about the way they run it over many years.

When you invest in the stock market, you are buying a piece of a business.

Diversification is not something you see very much of in the *AFR* Rich 200 list. Diversification is important when you are a passive investor, but it is also what people do when they don't know what they are doing.

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>
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Invest instead in a focused portfolio of businesses whose earnings you are virtually certain will be materially higher in five, or 10, or 15 years from now and you will do just fine. And if you don't feel qualified to do that, then interview a range of advisers and find one that does know what they are doing.

SHARES ARE PIECES OF BUSINESSES

Perhaps even more worryingly, part-time investors buy shares in companies without proper due diligence and in the simple hope they'll just go up. It's not unlike gambling.

Indeed, John Kenneth Galbraith, in his book *The Great Crash*, wrote that one of the key ingredients of a bubble was the replacement of considerations of an asset's long-run worth, future income and its enjoyment, with base hopes of rising prices next week and next month.

Shares need to be treated as pieces of businesses rather than bits of paper that wiggle up and down on a computer screen. But few investors do this. Buying shares in the basic hope they will rise, is not the same as buying a piece of a business.

Over time, the value of a business changes slowly, and much slower than its daily prices on the stock market. The purchase of shares without reference to the quality or value of the business is no different to punting on ups and downs. Similarly, the focus on daily quoted prices of shares encourages the treatment of the stock market as a casino. Gamblers and those who frequent casinos tend to lose. In contrast, treating shares as pieces of a business helps investors outperform those who don't.

FOCUS ON THE FEW EXCELLENT BUSINESSES

Excellent businesses have high rates of return on their equity, little or no debt, bright prospects and sustainable competitive advantages. The chart shows the 10-year share price change of BHP in yellow and the 10-year share price change of REA Group. What is clear is that while BHP is regarded as a blue-chip investment, it is anything but. Over 10 years, its shares have risen no more than 18 per cent. That's not better than inflation. Meanwhile REA Group has risen almost 16-fold. The difference is that REA has had the ability to raise prices without a detrimental impact on unit sales volume – one of the most valuable competitive advantages. BHP does not have that ability. If BHP raised the price of its iron ore above the global price, its volume would be severely disrupted.

As the chart shows, over the short run, the stock market is a voting machine, but in the long run it is a weighing machine. Over the long run, the share price reflects the underlying performance of the business. If the business performs well, so will the shares.

A sustainable competitive advantage is the intangible thing about a company that competitors cannot replicate or imitate. It's the reason people will cross the street to get the product even if the guy on this side of the street has an alternative with a lower price. It's a barrier to entry or a barrier to imitation. Ultimately, it generates the high rates of return on equity that we seek. Over time such business should retain profits at a high rate and increase in intrinsic value at a similar rate to the rate of growth in their equity or book value.

And if I told you that company XYZ's intrinsic value would rise substantially over the next five or 10 years, would it matter if the shares fell today? You should be looking forward to it.

CHOOSE QUALITY AT THE RIGHT PRICE

The higher the price you pay, the lower your return. Don't ever forget that.

It's all very well identifying a great asset. But paying too high a price won't make it a great investment. Take the case of an asset with a low rate of return on your purchase price and little prospect of improving dramatically in the near future. It should be excluded from your consideration regardless of the price. What about a stock market-listed business with bright prospects for its product or service, no debt and 10 years of stable returns on its equity of more than 30 per cent? Include it in your list to consider.

Eventually you fill a corral with opportunities showing a demonstrated track record of superior economic performance. No longer will you be tempted to dabble in the unknown, punting on whether the market or interest rates, employment or inflation will rise or fall in the next few days, weeks or months. Instead, you will keep a protective eye over a short list of great businesses, any of which are candidates for your portfolio if they become available at a discount to value.

We'll have to leave it there for now. Investing is a pretty simple activity. Your job is to ensure it isn't complicated by things like jargon and economics. Next time we'll talk about value investing and how one might determine if an asset is truly cheap.

Roger Montgomery is founder and chief investment officer with Montgomery Investment Management. You can read more insights at rogermontgomery.com