Quality at the right price

Companies with a strong competitive advantage should be on an investor's radar

When it comes to stocks, the term "quality" has many definitions. Some investors adopt a flexible approach to the definition, being satisfied if quality management is running the business, a quality customer base exists or they can identify quality assets on the balance sheet. The most pragmatic investors will be satisfied if a company, even in an industry with poor economics, is good quality relative to its peers.

At Montgomery we adhere to a very specific definition of quality: a company must be able to sustainably generate high rates of return on its incremental equity. We look for a company with a business that can not only retain a large proportion of its profits each year but can also generate a very high rate of return again on its now larger amount of equity.

Obviously, high returns are bound to attract competitors who would normally enter the market offering lower prices, cutting margins and profitability for all players. So to achieve very high returns sustainably, the business must possess a competitive advantage. A competitive advantage puts a company in a favourable or superior business position and the most valuable competitive advantage is the ability to raise prices without a detrimental impact on unit sales volume.

There aren't many companies that have this ability. However, there are enough in Australia to build a portfolio, provided patience is applied to the purchase, which must also be at an attractive price.

Roger Montgomery is founder and CIO at the Montgomery Fund. For his book, Value.Able*, see rogermontgomery.com.*

Reece Plumbing share price

❶ Reece Group

ASX code REH
Price $10.80
52wk ▲ $12.95
52wk ▼ $8.24
Mkt cap $6bn
Dividend 20.25¢
Dividend yield 1.88%
PE ratio 24
BUY

Despite being in the business of supplying bathware and plumbing products to the cyclical building industry, Reece is arguably one of the highest-quality listed businesses in Australia. It has tripled profits in just over a decade despite having raised virtually no new capital (until a very recent acquisition) and while paying off any debt.

Cochlear share price

❷ Cochlear

ASX code COH
Price $175.45
52wk ▲ $221.40
52wk ▼ $161.79
Mkt cap $10bn
Dividend $3
Dividend yield 1.7%
PE ratio 41
HOLD

The manufacturer of hearing implants has been able to sustain very high rates of return on equity and has also been able to reduce gearing. While its shares are currently expensive compared with most estimates of intrinsic value, a recent intellectual property ruling against it, which will be appealed, may provide an attractive buying opportunity.

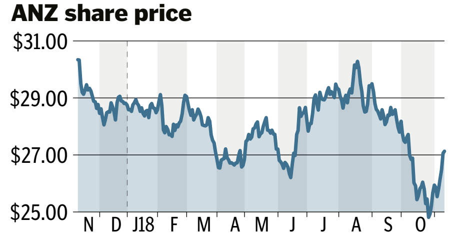
ARB share price

❸ ARB

ASX code ARB
Price $17.11
52wk ▲ $23.94
52wk ▼ $16.97
Mkt cap $1.4bn
Dividend 37¢
Dividend yield 2.16%
PE ratio 27
HOLD

With no debt, ARB has tripled its profits over a decade, averaging a return on equity of over 20%. The manufacturer of after-market 4WD accessories has seen its share price rise more than 500% over the decade. The recent fall from circa $23 to under $17 is not steep enough to bring it below estimated intrinsic value of $12-$15. However, it is getting closer.

ANZ share price



❹ ANZ

ASX code ANZ
Price $26.33
52wk ▲ $30.40
52wk ▼ $24.68
Mkt cap $76bn
Dividend $1.60
Dividend yield 5.9%
PE ratio 12
BUY

Their oligopoly structure, combined with a population that will double over the next 35 years, will ensure the banks write many more mortgages than they do today. Recent steep falls related to slowing credit growth, property price declines and the royal commission have provided a rare opportunity to enter at an attractive price. However, further falls cannot be ruled out.

Prices as at close of business, 12-Nov-18. Charts as at close of business, 9-Nov-18.