MONTGOMERY INVESTMENT MANAGEMENT

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Three timeless lessons for long-term investing

With the market well off its highs, it's a wonderful time to buy shares in high quality businesses at beaten-down prices. And as I make my purchasing decisions, I like to bear in mind a few timeless lessons to help me avoid common investment mistakes. Let me share them with you.

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1. Think like an owner of a business

Many, many years ago, back when magazines represented rivers of gold for their publishers, my good friend Tony Featherstone was the editor at Shares Magazine. I'll never forget the following story he shared with me.

"I once ran a cover story, 'best blue chips to build wealth'. 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."

With inflation, the war in Ukraine, China, recessions and interest rate rises to contend with, today's investors must confront many uncertainties. But is that any different to the past? 'This time is different' are arguably the four most dangerous words in investing, preventing investors from taking the actions at precisely the time that could set them up for the next bull market and for the rest of their lives.

I believe sustained market success begins, not with buying or selling stocks based on rumours, hunches or macroeconomic headlines, but with thinking like an owner of a business.

If you're young and haven't invested in equities much, it could be valuable to appreciate any investors have come before you and have lost money on stocks by thinking like a trader or speculator, rather than a part-owner of businesses.

And it's an easy trap to fall into. As at September 2022, even amongst the top 300 companies listed on the Australian Stock Exchange, 50 of them generate no profit. To put that in more useful terms, 50 companies worth about $60 billion in market value are supported by zero profit, zilch, nada.

If a company is worth the value of all its future free cashflows discounted back to today, then there is $60 billion of market value based on nothing more than vapour. And according to our friends at stockbroker MST, a $100 model portfolio that backed these loss-making ASX companies since 2000 is worth just 24¢ today. That's a 99.8 per cent loss over 22 years.

Despite this, the average sell-side equity research recommendation on these stocks is… you guessed it…a BUY.

And the numbers just keep getting worse. If we expand the universe of companies to all 2144 ASX-listed companies, less than a third make a profit. The rest don't. Two of every three listed companies cannot cover their costs, relying on future capital raisings to remain afloat. And keep in mind, those capital raisings tend to be dilutionary, reducing your ownership of the company.

Another friend of ours, Ashley Owen, produced some handy insights back in 2019. He found there have been about 37,000 companies that raised money from investors and listed on one or more of Australia's stock exchanges since the early 1800s. In 2019 only 2,300 companies remained listed. And of those 2,300, nearly half of their combined total profits and dividends came from just six companies – the big four banks, BHP and RIO.

Nevertheless, just six per cent of the total number of companies ever listed since the early 1800s, remained listed in 2019.

If 37,000 companies were listed and only 2,300 remained where did the other 94 per cent go?

Owen noted three per cent were taken over by other local companies, including the 35 banks that amalgamated into the big four today. The vast majority of those companies taken over however were mining explorers that were mopped up at very low prices "by promoters with high hopes of dressing them up again to take another shot at the next round of gullible investors".

Elsewhere, approximately 200 were taken over by foreign companies, leaving 33,000 (or so) companies that disappeared, for example through bankruptcy (Bond, Qintex, HIH, ABC Learning, Babcock & Brown, Allco, MFS, Timbercorp). But most simply ran out of money and de-listed, worthless.

Owning such companies is easy to do. Sometimes it's a tip from a friend but often it's a fad that captures the imagination of many 'investors' at the same time. Such bets, being in unprofitable companies, often require a leap of faith the firm will eventually be profitable. Without hard evidence, that is, by definition, speculation not investing.

There's nothing wrong with day-trading or punting on loss-making companies, provided you have the proven skills (or the algorithm) to overcome the enormous odds stacked against you including the impossibility of properly valuing a loss-making company; the potential for higher 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.

Many of the best investors, those with sustained outperformance, have outperformed by thinking like owners, holding exceptional companies for long periods, adding to their holding when prices fall on the back of news unrelated to the performance of the underlying business, or buying more of them even when prices rise alongside rising value.

Rather than speculate on the plethora of profitless hopefuls, they aim to buy exceptional companies and own them for as long as they remain exceptional.

2. Turn your back on speculation

Success within the equities component of your portfolio starts with a quality assessment of the company, and a valuation, which includes an assessment of the company's prospects. 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's a critical point. Speculation is not only 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 or quality is changing over time. In effect, the individual is unwittingly speculating rather than investing.

3. Don't be swayed by market noise

So, what stops us from thinking like part-owners in a business when it comes to listed companies, and instead acting like a trader or speculator? Market noise plays a big role.

We are seduced by media headlines, magazine stories on "hot stocks under $1", trading social media stars on Tik-Tok, Instagram, Discord and Facebook, and broking reports. We latch on to supposed expert views, especially those that reinforce decisions already made.

Investors need to separate themselves from the daily distractions of market reports and the noise accompanying the trading day. As Ben Graham once advised, it is important to take advantage of the market's moods rather than be swayed by them. You may watch the market, but don't base decisions on what it is saying, for it is too often wrong in the short-term.

According to my friend Tony, "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 share market noise as its decision-making trigger."

As I wrote in Value.able some years ago, speculators *"…focus on price movement, and the expectation of profit from it, rather than from business performance…"* and *"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."*

Applying timeless lessons to today's market

As I pen this note, fear is at an historic extreme. I have rarely seen sentiment towards the stock market this glum. But it is times such as these that investors, rather than speculators, can begin to build a portfolio of extraordinary businesses, confident that as sure as night follows day, sentiment will change and that which was rejected will again be feted.

Investors buy shares to own businesses. Speculators buy shares merely to sell them. The latter is much riskier, and today's market conditions favour the former. The lessons of the past, and the refined techniques for investing they forged, are more valuable today than ever.

Do you want to get in contact with the team at Montgomery?

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