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# VALUABLE

*Second Edition*

HOW TO VALUE THE BEST STOCKS AND  
BUY THEM FOR LESS THAN THEY'RE WORTH

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# CHAPTER 1

## *The Right Mindset*

**H**ave you made money in the recent post Global Financial Crisis recovery? Congratulations may be in order, but back-slapping is only truly due if your investing logic and framework is such that you are no longer destined to a lifetime of returns and emotions that rise and fall with the market.

Currently there are almost 1,900 companies with active securities trading on the Australian Securities Exchange (ASX). There are, however, more than 4,000 that are delisted. In other words, there is a quantum of companies that have failed and, at any given time, there are a bunch still listed that are on their way to joining the 4,000.

If you could simply avoid those companies that are on their way to the exit, you should substantially beat the market. If you can isolate the very best, you should beat the market by a whole lot more; and if you can buy the very best at the right price, you are most certainly going to do reasonably well.

**What dismays me is that despite frequent crashes, there has been no trend towards a rational approach to investing. Perhaps surprisingly, this lack of logic is true of both seasoned professionals and part-time investors.**

Shares need to be treated as pieces of businesses, rather than lines that wiggle up and down on a graph. This seems pretty

Finally, a great benefit of thinking long-term is that you can lower risk. Not the risk as measured by beta or standard deviation, but real risk – the risk of loss. If you bought shares in a bank in 2009, during the world's worst financial crisis, with a view to owning them for the next 20 years, I would argue that was a very low risk thing to do. To buy the same bank shares, with the expectation of making a profit in the next few days or weeks, however, is significantly more risky, despite the fact we are talking about the same bank.

The widely accepted practice of always equating the volatility of a share's market price with risk is meaningless for long-term owners of businesses. While volatility may be an acceptable measure of short-term risk, such measures are useless for the long-term investor whose strategy is to buy an asset at a sensible price and hold it long enough to reap the stream of benefits that accrue from that business's economic performance.

**Thinking and trading short-term and predicting the stock market's immediate direction is as Christopher Browne said; a 'fool's game'.<sup>7</sup> It is risky, extremely difficult, speculative and in the experience of most people engaged in it, loss generating.**

Some things simply take time. The benefits of compounding require time to weave their magic on the market value of your portfolio; it takes time for businesses to increase their economic value.

Accept that the market is not always efficient in the short-term and grasp the long-term opportunities. Even though sometimes excellent profits will accrue quickly, you must approach investing in businesses with a long-term perspective, expecting and allowing the performance of the business to produce your returns. Put together a portfolio of businesses with excellent characteristics, that can be sustained over the years, and the market value of the portfolio will take care of itself.

<sup>7</sup> CH Browne, *The little book of value investing*, John Wiley & Sons, Inc., 2007, p. 125.

## CHAPTER 4

### *You Don't Need to Know Everything*

**T**he hard part of investing involves modifying your temperament. The easy part of investing is recognising those companies that have better businesses than others. This is your guide to the easy part.

You can simplify your investing life by reducing the number of companies you ever have to think about. Imagine trying to follow the development of every company listed on the stock market. The enormity of the task surely means that many would-be stock market success stories go unwritten.

At the time of writing *Value.able*, my data tells me there are 1,874 companies listed on the ASX and tens of thousands more globally. Imagine needing to know enough about each company so that you would be ready to invest in any one of them at a moment's notice. It's not possible.

Of course there are those who purport to know a lot about every company. They don't, and their track record bears this out, so don't worry about trying to emulate them.

It is actually not that hard to be in a position to say for example, 'I would like to buy Fleetwood if it falls below \$5.95' or 'buy me 5,000 JB Hi-Fi shares if they fall below \$9.00', and to be right about the business and the valuation.

Frequently the market overreacts to events unrelated to the companies you wish to own, and serves them up at prices that

will be tax to pay – which is always painful – and it is not every day that an extraordinary business is available for purchase at an attractive price. Being difficult to replace something does make it challenging to let go of it. But let go you must when the return on equity begins to decline; the competitive advantage is destroyed or begins to erode; or the once-bright prospects lose their lustre.

When the attractive economic characteristics of the company begin to fade it is time to exit the investment.

## DECLINE IN VALUE

In Chapter 11, I listed some of the changes that can result in a destruction or reduction of intrinsic value. If you notice any of these changes and the intrinsic value declines, then it pays to listen to Ben Graham's 'weighing machine' analogy. Generally, prices converge with intrinsic values. If Graham was right on this score – and it has been my observation that he was – then it is nonsensical to own companies whose intrinsic values decline. The price will eventually follow.

**So when management makes an overpriced acquisition, adopts an imprudent capital management strategy – retaining capital at low rates of return or raising capital in a dilutive way – or it borrows too much or otherwise acts incompetently or dishonestly, it's time to sell. This is particularly so if the concerns voiced by shareholders fall on deaf ears.**

Continuing to own shares in businesses with declining intrinsic values, is stubborn ignorance, not wise investing.

So even if the dividend yield looks good, earnings are rising, or there is some other factor that renders the issue attractive on a conventional score, make sure you sell when the intrinsic value of the company is falling. This is doubly necessary when the share price is well above the intrinsic value.

In Buffett's 2003 annual Chairman's letter to shareholders, he wrote:

*...I made a big mistake in not selling several of our larger holdings during The Great Bubble. If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I.<sup>47</sup>*

47 Berkshire Hathaway Inc., Chairman's letter to shareholders, 2003. [www.berkshirehathaway.com/letters/2003.html](http://www.berkshirehathaway.com/letters/2003.html)