

Value Line: The Reject Shop, Westpac



By Roger Montgomery

PORTFOLIO POINT: *Westpac and The Reject Shop have been good investments, but now it's time to cash in.*

Since I was a young boy I have enjoyed fly fishing and archery, hang gliding, cross country mountain bike racing, rock climbing, canyoning and paragliding – with a little sailing and kayaking thrown in.

Where are the engines and petrol sports? Looking back at my hobbies it occurs to me that I am a bit of purist. As an adult that approach has informed the way I apply my investing philosophy, too.

Following the news that the government is looking to separate Telstra, a lot of analysis will focus on how cheap the company is now and yet I won't buy Telstra even if it seems cheap and a mountain of research echoes that conclusion.

Some people can be convinced that a company is a good

investment on the basis of a single indicator. If you are a true value investor then Telstra needs to meet all parts of the value investing philosophy, not just one. But I digress.

With this in mind, I am no longer satisfied that Westpac is the best bank to be invested in, nor am I satisfied that The Reject Shop offers a sufficient level of capital protection. And so it is that with little else to jump into, I will be increasing the level of cash held by Value Line.

Let's start with The Reject Shop. This is a business I think I know reasonably well. Indeed, through the funds management business I founded, I was The Reject Shop's biggest shareholder but I have since sold that business and I am about to sell my Reject Shop shares as well.

You might ask why. Nothing is especially wrong; earnings are heading in the right direction, as are dividends. There is only modest debt and the company has many more stores to roll out. Perhaps most importantly, its new chief, Chris Bryce, is someone I like and trust and someone I believe is qualified and capable of doing an excellent job for shareholders.

So what is my problem? Well, it is that purist inside me. I can't stop thinking that the value of the business just cannot rise at a fast enough clip to justify the current price. I really don't like trading things that I have bought but I don't think the value of the business can continue to rise indefinitely. With a share price of \$13.45 (intraday today) and a valuation

The Value Line portfolio, as at September 15, 2009

Company	July 1 price	Price today	Est value	Margin of safety	Bought	Invested (\$)	Capital value (\$)	Divs rec	Total return	Total return	
JB Hi-Fi	14.8	19.13	21.7	11.8%	845	\$12,500	\$16,157	0.29	\$3,902	31.22%	
Cochlear	56.36	65.26	58.7	-11.2%	102	\$5,744	\$6,651	0.95	\$1,004	17.48%	
CSL	31.81	34.05	28.99	-17.5%	163	\$5,197	\$5,563	0.4	\$431	8.30%	
The Reject Shop	11.62	13.4	11.27	-18.9%	513	\$5,959	\$6,871	0.23	\$1,031	17.30%	
Woolworths	26.16	28.8	26.7	-7.9%	206	\$5,377	\$5,920	0.56	\$658	12.23%	
Westpac	19.68	24.41	18.13	-34.6%	295	\$5,811	\$7,208	0	\$1,397	24.03%	
Reece	17.8	22.2	13.7	-62.0%	236	\$4,209	\$5,250	0.33	\$1,119	26.57%	
Platinum Asset Mgt	4.06	5.57	2.84	-96.1%	854	\$3,467	\$4,756	0.12	\$1,392	40.15%	
Since July 1											
Security Value										\$58,377	
Cash Value										\$52,556	
Total Value										\$110,933	
Total Return (\$)										\$10,932.80	
Return Invested (%)										22.65%	
Total Return (%)										10.93%	
XAO Change										15.20%	
* Outperformance (I): Outperformance of invested portion										7.45%	
* Outperformance (T): Outperformance of total portfolio										-4.27%	
*adjusted for buyback											
Under observation											
iSoft	0.635	0.86	0.19	-352.6%							-35.43%
Amcor	4.79	5.61	2.84	-97.5%							-17.12%

of \$11.27 the shares are 24% above their intrinsic value. This combination of factors tells me that we are safer in cash.

So I will be selling my Reject Shop shares. I might just wait for the dividend, which I am entitled to only after September 22. Browsing through the aisles just won't be the same.

The other change I would like to make is to Value Line's holding in Westpac.

For years the quality of the banks, in terms of their economic performance, were all the same. They looked the same, they move up and down the same. They even lend to the same clients. As a result, their returns on assets and equity were all about the same. But after some arithmetic pilates and a little thumb-sucking, there now appears to be a very clear winner in the performance stakes.

Valuation Changes

Name	Date	Prev	New	Change
The Reject Shop	26/08/09	\$11.45	\$11.27	-1.57%
Amcor	26/08/09	\$2.66	\$2.84	6.77%
CSL	26/08/09	\$25.18	\$28.99	15.13%
JB Hi-Fi	19/08/09	\$18.10	\$21.70	19.89%
Cochlear	19/08/09	\$48.70	\$58.67	20.47%
Platinum Asset Mgt	26/08/09	\$2.18	\$2.92	33.94%
iSoft	26/08/09	\$0.04	\$0.19	375.00%
Woolworths	02/09/09	\$22.86	\$26.70	16.80%
Westpac		\$18.13		
Reece	02/09/09	\$12.81	\$13.70	6.95%

That winner is Commonwealth Bank. How? Well it's all to do with the capital that was raised by the banks. Every bank except Commonwealth now faces a substantial drop in return on equity as a direct consequence of raising capital by issuing shares.

The Commonwealth also raised its fair share of capital but it used the \$2 billion it raised to purchase BankWest from a distressed seller at what appears to be a very good price. The result was that the bank was able to maintain the rates of return on equity that were recorded prior to the financial crisis.

In fact, the bank should record returns on equity of greater than 20%. For the other big banks, it would now not seem likely that their previous returns on equity can be sustained. Westpac is likely to record returns of about 13%, the NAB 12% and ANZ 11%.

As I mentioned earlier, I would never buy Telstra because it's cheap. Similarly, I would never buy NAB or ANZ for the same reason – especially while Commonwealth Bank is the clear leader on such an important metric.

Value Line is thus selling The Reject Shop and Westpac after returns for which I am very grateful. There's nothing

really compelling at present to replace these holdings. So I'll put the proceeds of the sale of The Reject Shop in an interest-bearing cash account. But I will be replacing Westpac with the Commonwealth Bank, which is now superior from both a performance and valuation perspective. ♦

Roger Montgomery is an independent analyst and investor, having previously founded and listed a boutique funds management investment firm.

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