

ValueLine: Only the best will do



By Roger Montgomery

PORTFOLIO POINT: Rising interest rates make it more important than ever to invest in those companies with the best returns on equity. a

Interest rates are going up. Fast. This week's 25 basis point rise was the third in three months ... something the Reserve Bank has never managed until now.

Those little increments, which took the official cash rate from generational lows of 3% to 3.75%, pack more of a punch than many realise. As interest rates go up, the value of shares goes down. The market average dividend yield of 4% or so is not quite so attractive.

Even while looking for opportunities in a market that is no longer cheap, the high rates of return on equity mean that I am still happiest finding opportunities in the stockmarket rather

than sheltering in the safety of a government-guaranteed bank account.

Arguably, interest rates are the most important economic variable that affects share values. Just as gravity pulls down everything in the real world, rising interest rates – even the slightest rise – pull down the value of every other asset in the financial world. And nothing on earth can escape gravity's effects.

It's easy to see that a 10-year bond bought for \$100 with a semi-annual coupon (or interest payment) of \$2.50 and therefore a 5% yield, will fall in price when interest rates rise. Remember the face value of bonds falls when interest rates rise because – after all – who is going to buy a bond when they can get a better rate at call?

What may be less clear is that rising interest rates have precisely the same impact on the value of every asset: wheat in a silo, income-producing land, shares and every other financial asset. And the effects on values can be significant.

If interest rates are, say 3.5%, the present value of the \$1 million that you're going to receive in 10 years' time from an investment is \$708,918; or to work the other way, \$708,918 invested now at 3.5% would compound to \$1 million over 10 years.

The present value of \$1 million that you're going to

The ValueLine portfolio, as at December 1, 2009

Company	Buy price	Price today	Est value	Margin of safety	No of shares	Invested	Capital value	Divs rec	Total return	Total return
JB Hi-Fi	14.8	23.1	25.76	10.3%	845	\$12,500	\$19,510	0.29	\$7,255	58.04%
CSL	31.81	31.73	32.87	3.5%	163	\$5,197	\$5,184	0.4	\$52	1.01%
CommBank	46.51	53.85	52.81	-2.0%	215	\$10,000	\$11,578	0	\$1,578	15.78%
Woolworths	26.16	28.22	26.85	-5.1%	206	\$5,377	\$5,801	0.56	\$539	10.02%
Cochlear	56.36	64.09	56.3	-13.8%	102	\$5,744	\$6,532	0.95	\$885	15.40%
Platinum Asset Mgt	4.06	5.13	3.95	-29.9%	854	\$3,467	\$4,381	0.12	\$1,016	29.31%
Reece	17.8	23.2	14.83	-56.4%	236	\$4,209	\$5,486	0.33	\$1,355	32.19%

Since July 1

Security Value										\$58,472
Cash Value										\$56,635
Total Value										\$115,107
Total Return (\$)										\$15,106.72
Return Invested (%)										31.30%
Total Return (%)										15.11%
All Ordinaries change										19.90%
Outperformance of invested portion										11.40%
Outperformance of total portfolio										-4.79%

Negative Watch

Company	July 1 price	Price today	Est value	Margin of safety	Divs rec	Total return
ISOFT	0.635	0.75	0.19	-294.7%		-18.11%
Amcor	4.79	5.88	3.63	-62.0%		-22.76%

receive if rates are 3.75% is \$692,020 – a decline in value of almost \$17,000. You can thank yesterday's interest rate rise for that \$17,000 loss. Increase rates by more – say 1% – and there's a \$65,000 difference in value over just 10 years.

The three ValueLine portfolios I am running are sensitive to interest rates because the shares they hold represent claims on the long-term profit generation of businesses. And yesterday, the present value of those claims fell.

But ValueLine has not bought any “shrinking violet” businesses or shares solely for income. With an average yield-on-acquisition of just 4.8%, you might think income wasn't a consideration at all.

Instead, ValueLine has selected businesses with earnings power that trounces even the post-rate-rise returns available from a bank account. The shares held by ValueLine produce an average return on equity of 35%. And I want more of these businesses if I can get them at the right price.

Remember that a dividend yield at 4% is only the return on your shares – a decision made by the board of the company – while the return on equity is what the underlying business is making out of the money invested in it, and the key signal to the rising value of any business.

Thankfully, one portfolio is fully invested and this focus on quality businesses bought at the right price produces returns that beat even the stock selection models that focus only on dividends. Many investors don't think about this dimension to investing. But you must, especially once interest rates start rising.

What happens instead is that investors buy into the idea of an income portfolio or a growth portfolio: phrases designed by the financial industry to help differentiate one approach from another.

Trying to squeeze round shares into square incomes is like forcing a business to fit in with your spending needs. But there isn't a better business to buy for holidays or a better one for the kids' high school fees.

There are simply good businesses and mediocre ones. There are cheap prices and there are foolish prices. It is black and white.

“Going for more income” as you get older is the sort of conventional thinking that deserves a place next to other silly inventions, such as Leonardo Da Vinci's water-walking shoes and Alexander Graham Bell's six-nipple sheep.

From here on in, be selective about equities you are about to jump overboard from. Some businesses are generating vastly superior returns to those available in bank accounts and, provided their share prices are not significantly above their present valuations, it would be folly to trade them for something “cheaper”.

Recently I estimated that based on present earnings power the ASX 200 was worth about 4000 points. At 4762 today it's trading at a 19% premium to that valuation. That premium, however, just went up because interest rates just caused my valuation of the market to decline slightly.

While interest rates cause the real values of my shares to decline, the returns the best companies can achieve on their retained profits causes their values to rise, by a magnitude that more than offsets any decline associated with increasing interest rates.

As you know there are three investment strategies running concurrently: the fully invested strategy, which owns all the stocks; the pure Buffett model, which now only owns JB Hi-Fi and Commonwealth Bank, with the remainder in cash; and the one that is partly invested in all of the stocks listed with about 50 percent in cash.

In the kind of market we have witnessed over the past nine months, the portfolios that are fully invested in superior companies will always outperform cash, and they have. But the gap has been closing between the partly invested portfolio and the index as rising interest rates dampen the performance of the shares of inferior businesses, which are in the index but not on ValueLine's radar.

As a result, the gap between the market and the performance of the partly invested portfolios will benefit from their higher cash weighting and the absence of inferior businesses in the portfolios.

And of course as Mae West said: “Too much of a good thing is ... wonderful”. So bring on any stockmarket decline. I have cash to invest and more keeps piling up. ♦

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