

ValueLine: Expensive times



By Roger Montgomery

PORTFOLIO POINT: Most companies are not cheap and some are downright expensive, making value harder to find.

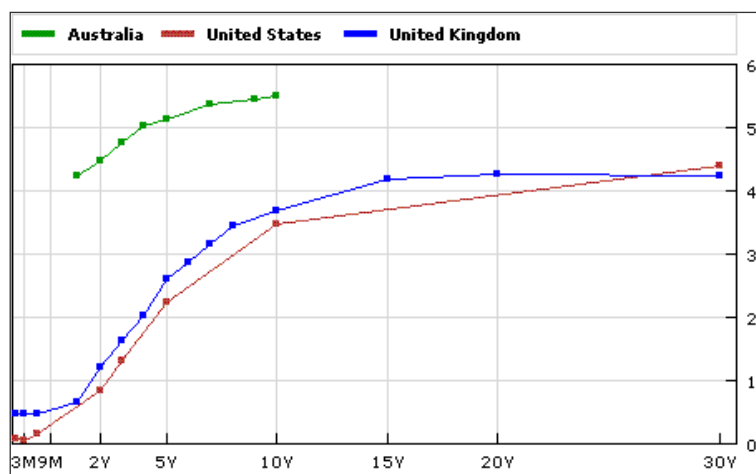
Stocks in aggregate are no longer cheap. They were much earlier in the year, but based on the present levels of profitability they are not cheap any more. Those buying today are doing so in a patently perfunctory manner or are simply motivated by the fear of continuing to miss out.

Before you go selling your holdings in a fit of panic, remember there are always at least two views about the market's short-term direction.

In one corner are the bulls, who say that the equity market's recent strength is the beginning of a multi-year rally that owes its ongoing support to the fact that looming inflation will deliver negative returns from cash, which, combined with the massive expansion of the monetary base, represents a free, low-doc loan from the government.

In this environment many suggest that asset class inflation is assured. Indeed, just under \$20 billion a week has been creeping out of the bomb shelters and into assets such as shares and gold.

In the other corner sit the economic bears, such as Nouriel Roubini, David Rosenberg and Marc Faber, who say the same inflationary and expansionary balance sheet policies of the West have given the US dollar an intrinsic value of zero, which will bankrupt America and produce a complete horror show that makes the last downturn look like a picnic.



So who was it that said two people looking at the same set of facts could not arrive at vastly different conclusions? Listening to and reading the apologetics and protestations of these extraordinarily successful investors must make the morning chat with your broker about whether AMP is paying too much for AXA seem inane.

Perhaps more importantly, to whom do you listen? You cannot base that decision on who is smarter because both groups have geniuses in their ranks; nor can you base your decisions on previous successes because both groups have extremely wealthy proponents.

The answer does not lie with replicating the financial and reputational bets taken by the economists, strategists and traders. Indeed, it lies in not taking a view at all but allowing an entirely different group of facts to dictate your actions.

Those facts are the book values or the equity of companies on a per-share basis, the anticipated profitability of those book values, the manner in which profits are currently retained and distributed (in others words, capital allocation by management) and a reasonable required rate of return.

On these measures most companies are no longer cheap and many are downright expensive. This has occurred for two reasons, that combined, reflect the typical short-term focus of both professional and amateur investors.



The first reason is that share prices have obviously risen. They have risen because Australia has sidestepped a recession, interest rates remain accommodative, our output is in demand and overseas markets have recovered.

The second reason is that shareholders who may have stayed on the sidelines, have pumped money into attractively priced dividend reinvestment plans, placements and rights issues as many of Australia's largest companies collectively raised \$90 billion in the 2009 financial year.

And who can blame the investor who bought shares

in Wesfarmers at \$29 for wanting to bring down their average price and participate in an entitlement offer to buy three more shares at \$13.50 when the rest of the shares they own are trading at \$16?

But while the reduction of debt, associated strengthening of balance sheets and stag profits are attractive, there is a nasty downside to all of this.

If I have a company with \$100 of equity on the balance sheet and 100 shares on issue, each share is entitled to \$1 of the net book value of the assets. If, however, my company's shares are trading at 10¢ because of the global financial

crisis and my bankers ask me to reduce my \$100 of debt to \$50, I may choose to issue 5000 shares at 10¢ to raise the required \$50.

The first thing that happens of course is that company equity rises by \$50 but more disturbing is that there are now 5100 shares on issue. Where once each shareholder owned \$1 of equity for every share they held, they now own just 3¢ worth of equity.

And if you are a small shareholder from whom the company couldn't conveniently raise money, your holding has just been diluted because the institutions got the lion's share of the placement.

Further, the money raised went to pay down debt rather than investment, so the earnings will only increase by the post-tax interest saved. As a result, the return on equity declines as well and because the true value of a company is inextricably related to the profitability of its book value, company valuations decline.

Valuations have thus declined and yet share prices have risen. As Benjamin Graham said, in the short term the market is indeed a voting machine. And I am not talking about one tiny or obscure corner of the market. Rights issues and placements, according to Paterson's research, now account for more than 6.5% of total market capitalization: the highest level in more than 20 years.

In the current environment, many value investors will succumb to temptation and their lack of discipline and reduce their discount rates. In doing so they try and keep their valuations from looking out of touch with ever-increasing share prices but really they're playing catch-up. And when share prices fall slightly, value apparently and suddenly appears.

But the margin of safety is illusory and with returns from stocks unlikely to sustain returns so far out of whack from everything else, real value is some distance below. Only a demonstrated track record can prove otherwise.

The market appears to be a little expensive. The ValueLine portfolio doesn't have to do anything: its outperformance due not as some would suggest to "sector selection" but to good old stock picking and lethargy. ValueLine certainly won't be buying shares whose prices are now at or above valuations.



Postscript: I note that McMillan Shakespeare, a salary packaging specialist many readers know I have followed for some time, saw its founder sell a significant number of shares. You should know that it is not the quantum of the sale that should pique your curiosity or set off alarm bells, but the timing, coming as it does ahead of the findings of Dr

Ken Henry's first major overhaul of Australia's tax system in 50 years, which could include potentially adverse changes to fringe benefits tax and thus salary packaging demand. ◆

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