



When Share Price Falls Make Headlines

and

How To Avoid Them.

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Introduction

Suppose a medium sized or large company has exposure to an economic sector that does not have significant representation in the stock market. The company may be involved in surf wear or day care centres. While there are lots of banks and mining companies listed on the stock market, there just aren't many day care centres or surf wear labels. The company also has enormous growth potential because at present it only sells to 4% of its potential market. If the company can just capture 10%, its sales will...

The story is a familiar one and it is almost guaranteed that at some point the share prices for companies displaying the above characteristics will rise. But as we will see in a moment it is also almost guaranteed that the shares will subsequently fall in a massive heap, burning the fingers of those that mistakenly believed they were investing when in fact they were speculating.

The recent falls in the share prices of companies like Billabong, Globe and Mayne are testament to the fact that the promise of growth is not enough to generate profits from buying shares. Indeed when the promise of growth causes the share price to rise significantly, subsequent buyers may lose money or make very little.

On March 20, 1999, the legendary billionaire investor and the second richest man in the world today – Warren Buffett – was quoted as saying;

“I like a company I can understand, management that I like and trust and a price that is sensible. But with the Dow near 10,000 points, I will have trouble finding No. 3.”

San Antonio Express-News.

When prices are high, an important element of successful investing is missing. The price you pay must necessarily dictate the return you will receive. The higher the price you pay, the lower the return. Successful investing, as opposed to speculating, is the business of finding outstanding businesses and then buying them at cheap prices.

Between October 1, 2001 and October 1, 2002, 244 companies or 20% of the 1181 listed on the Australian Stock Exchange fell by 30% or more. Table 1. **Heavy Falls**, highlights the spectacular falls in the prices of shares for a number of well-known companies in the three years between November 1999 and November 2002.

Table 1. **Heavy Falls**

Nov 8, 1999 - Nov 4, 2002

Company	Code	Subsequent		
		High	Low	Fall
Computershare	CPU	\$9.90	\$1.39	-85.96%
Energy Developments	ENE	\$14.49	\$2.32	-83.99%
Globe International	GLB	\$2.50	\$0.45	-82.00%
Newscorp	NCP	\$25.85	\$8.44	-67.35%
Mayne Group	MAY	\$7.56	\$3.12	-58.73%
Neverfail	NEV	\$4.43	\$1.95	-55.98%
Macquarie Bank	MBL	\$41.03	\$18.75	-54.30%
AMP	AMP	\$21.65	\$10.73	-50.44%
Cochlear	COH	\$52.40	\$27.00	-48.47%
Seven Network	SEV	\$7.90	\$4.63	-41.39%
Billabong	BBG	\$10.00	\$6.24	-37.60%
Coles Myer	CML	\$9.00	\$5.70	-36.67%

Table 1. above, shows that investing for the long-term, does not mean 'buy at any price'. As we mentioned previously, the price you pay determines your return. It may appear to make more sense to own Macquarie Bank at \$18.00 than at \$41.00 – the business business perhaps hasn't changed as much as the perception about its future and its share price has. Similarly it makes sense to avoid Cochlear at \$52.40. Perhaps most importantly, those who subscribe to the dollar-cost-averaging approach would immediately see the benefits of only buying when prices are relatively low. While the advising community may see this as an application of 'market-timing', which is widely frowned upon in favour of 'time-in-the-market', we see it as 'investing' in the most logical and sensible way.

Clearly as Table 1. reveals, history has provided us with a valuable lesson - never pay a high price for a stock, no matter how exciting the story. Unfortunately this is easier said than done for two reasons. Firstly, it is only when prices are high, that the market can see the unlimited potential of a company. When the market is high, the recommendation is to buy but as Table 1 above reveals, buying shares at high prices will result in poor returns. Secondly, when prices have dropped substantially, the news that caused the fall is almost always bad. It is when bad news abounds however that the best time to buy often presents itself. Successful investing therefore is a matter of doing the opposite of what appears to come naturally.

Buying the lows and Avoiding the highs.

It was US billionaire John Paul Getty who once quipped "buy when everyone else is selling and hold until everyone else is buying." Without the benefit of hindsight, how can we know that the price is high and avoid a loss? Conversely, how can we know that the price is low and buy confidently in the face of panic?

The “High Price” column in Table 1 above, highlights actually-traded prices. That means someone bought shares at that price. In hindsight those buyers made an incorrect decision but so did many of the buyers before and after them. To avoid the mistakes of the past, a new approach needs to be adopted.

Separating the business from the market.

A business that consistently generates high and increasing useable cash returns to its owners, compared to the investment made by those owners, while employing little or no debt, has some of the elements of an outstanding business.

List this business on the stock exchange however and the price of its shares will fluctuate wildly. Initially they may rally strongly. Eventually however the share price will overshoot and although the earnings increase, they may not increase by as much as the market expected. The market participants therefore become ‘disappointed’ with the ‘slower-than-expected’ growth in earnings that they had previously priced-in to the shares and so the shares are sold down. Now the shares are cheap, previously they were expensive. This pattern repeats itself over and over in the stock market and speculators, believing they are investing, react to either the slightest variation to earnings expectations or a result that differs from those expectations. Meanwhile, the outstanding business keeps plodding along.

At any given moment the price of the shares reflects many things, not just the underlying fundamentals of the business. In the short term, the price of a share in an Australian company may reflect not just the economics of the business but the broader economy, wars in far off countries, interest rates in the United States, last night’s move in the Dow Jones and expectations about the outlook for the stock market in general. Many of these things are completely irrelevant to the business upon which the shares are based, yet they can have a dramatic impact on the share price of the business.

Benjamin Graham, founding father of security analysis, said that in the short term, the market is a voting machine. In the short term, the market is a popularity contest and the latest fashion can cause participation to reach a fever pitch. It is with the benefit of hindsight however, that one is often able to view past fashions for what they are. Thus in the long term the market, as Ben Graham put it, is a weighing machine.

The key to successful investing, if there is such a thing, is to wait for either temporary factors that are engineered by management or the economics of the industry or for systemic factors that have absolutely no influence on the business, to affect the share price in a negative way. The time to buy shares in an outstanding business is when the share

price is down and so-called 'investors' are treating a short-term set back as a long-term problem.

When is it cheap?

Owning a business entitles you to the net profits of that business and, upon winding up, the equity in the business. The profits appear in the profit and loss statement and the equity appears as shareholders equity in the balance sheet. Equity grows at the rate of return on equity less any dividends paid out.

A company with a high rate of return on equity is a business whose equity will grow at a faster rate than a similar business with a lower return on equity, all else being equal, because it is the rate of return on equity that drives earnings growth. And a business with a rate of return on equity that is higher than the rate an investor can obtain elsewhere, and a business that can continue to generate such high returns on expanding amounts of capital, should not pay those earnings out as dividends. By paying a dividend this business is preventing the investor from generating significant capital gains.

For example, suppose a business consistently generated 20% return on its equity each year. The equity per share in the first year is \$10.00 so the first year's profit is $\$10.00 \times 20\% = \2.00 . Also assume the shares always trade at a Price Earnings (p/e) ratio of 20 times those earnings. Now suppose the company pays out \$1.00 of its earnings as a dividend. Next year the company could have earned a 20% return on \$12.00 instead of 20% on \$11.00 which is the new amount of shareholder's equity. By accepting the dividend the investor is unwittingly foregoing $\$12.00 - \$11.00 (\text{Equity}) \times 0.2 (\text{ROE}) \times 20 (\text{p/e})$ or \$4.00 of capital gain in a year's time, to receive \$1.00 today as a dividend. For each \$1.00 the company pays out, the shareholders are missing out on \$4.00 of capital gain. A company with a high return on equity should retain as much as possible, if management believes it can continue to generate those high returns on increasing amounts of retained earnings.

Conversely a business that generates lower rates of return on owner's equity than that which an investor can obtain elsewhere, should pay all of its earnings out as a dividend to that investor.

We are therefore interested in companies that generate high returns on equity. These companies are able to grow their equity (that part of the company that the shareholders own) at a faster rate. Companies that have a high return on equity are therefore 'worth' more in terms of growth, than those companies that have a low return on equity.

Through some simple mathematics and conservative assumptions, it becomes fairly easy to calculate a current value of the future equity, retained profits and dividends. By discounting

these future values back using a risk-adjusted rate of return, we are able to arrive at a price that we would be willing to pay for the shares today.

In this research note, we adopt a formula for calculating intrinsic value that uses values provided by the company in its final or half yearly report. The data we need is;

- Equity per Share
- Adjusted Return on Equity
- Payout Ratio
- Rate of Return

A description of the model looks like this:

$$I.V. = \frac{roe \left[eqps \left(1 + \frac{re}{eqps} \right)^n \right]}{R \left(1 + \left[R - \frac{eqps}{eqps(roe)} \left(\frac{dps}{eqps} \right) \right]^n \right)}$$

Using this information we can arrive at a theoretical intrinsic value of the companies listed in table 1 above. Table 2 reveals the intrinsic value of each company according to the model described above, the price the shares were trading at when intrinsic value was calculated and the price the shares subsequently fell to.

Table 2. Whats the Value, What's the Price?

When Macquarie Bank	was trading at	\$38.00	, intrinsic value was	\$18.20	. The shares subsequently fell to	\$18.75
When AMP	was trading at	\$18.00	, intrinsic value was	\$10.00	. The shares subsequently fell to	\$10.73
When Computershare	was trading at	\$5.00	, intrinsic value was	\$1.03	. The shares subsequently fell to	\$1.39
When Cochlear	was trading at	\$50.00	, intrinsic value was	\$14.50	. The shares subsequently fell to	\$27.00
When ENE	was trading at	\$8.00	, intrinsic value was	\$1.03	. The shares subsequently fell to	\$2.32
When Mayne	was trading at	\$7.60	, intrinsic value was	\$1.32	. The shares subsequently fell to	\$3.12
When Globe International	was trading at	\$2.00	, intrinsic value was	\$0.18	. The shares subsequently fell to	\$0.45
When Coles Myer	was trading at	\$7.90	, intrinsic value was	\$2.23	. The shares subsequently fell to	\$5.70
When Neverfail	was trading at	\$3.50	, intrinsic value was	\$0.74	. The shares subsequently fell to	\$1.95
When Billabong	was trading at	\$8.00	, intrinsic value was	\$1.77	. The shares subsequently fell to	\$6.24
When Seven	was trading at	\$6.80	, intrinsic value was	\$1.02	. The shares subsequently fell to	\$4.63
When NewsCorp	was trading at	\$14.00	, intrinsic value was	\$1.23	. The shares subsequently fell to	\$8.44

As you can see from Table 2. above, you are not investing when you pay a price for a share that is significantly higher than its intrinsic value. Indeed you are flirting with danger and are likely to suffer significant loss.

By first calculating intrinsic value and then waiting for the price to get close, you are more likely to avoid the headline-making plummets in the share price and are more likely to pick up a bargain. In the above examples losses avoided varied from 39% to 77.5%

The numbers above for intrinsic value are not precise, indeed they are quite rubbery. As a rule of thumb, the investor may elect to add 5% or 10% to these numbers to come up with a theoretical price that represents intrinsic value.

Wouldn't it make more sense to buy Macquarie Bank at \$18.75 than at \$38.00? Wouldn't it make more sense to wait to see if Computershare comes anywhere near \$1.03, before even considering buying? And wouldn't it be prudent to see AMP around \$10.00 or \$11.00 before buying, rather than at \$18.00?

The basic premise of the approach outlined here is; first find outstanding businesses (high return on equity with little debt – many of the above companies don't fit that criteria) and then, wait for the price to approach intrinsic value. Once price is very close to, or preferably below intrinsic value do as Charles Munger and Warren Buffett say;

Buy a Meaningful Amount!

Organised Chaos

Now that we understand the method we can view much more objectively the high prices being paid today for some companies, with great expectations. The company we will highlight today is ABC Learning Centres (ABS).

Trading at a price that is more than 25 times earnings indicates that buyers, are willing to pay over eight times more for a part-share of a child care business called ABC Learning Centres, than the price they would pay for a whole childcare business anywhere in Australia. Childcare centres or long-daycare centres change hands for about three times earnings in Australia, but shares that represent a portion of the same type of business change hands for 25 times earnings on the stock market. A daycare centre in NSW with earnings of \$300,000 could be purchased for \$900,000 and the buyer would also gain complete control. If ABC Learning Centres had earnings of \$300,000 you would have to pay \$7.5 million to gain ownership and control of the entire business. And remember, when most participants buy a share or two, they don't obtain a controlling interest. Generally a premium is paid to obtain control of the business. In the case of shares in ABC Learning Centres, you are paying a dramatic premium above the industry average for no control whatsoever. So who do you think is wrong? Is it the buyer who carefully assesses and patiently buys a whole childcare centre or the excited share speculator who simply sees the shares going up?

The answer is that they may both be right. The shares, representing a portion of the business, may keep going up, but you can be almost certain that the individual who pays 3 three times earnings will ultimately generate a return that has a greater degree of certainty. The buyer at three times earnings is an investor, the buyers at 25 times earnings is a speculator. Make sure you know the difference.

At the time of writing, ABC Learning Centres is trading at \$12.40 and Intrinsic Value is just \$3.49. The significant premium above intrinsic value is not unlike the premiums for some of the companies outlined in Table 2 above. ABS is trading on a p/e of 25 times and has dividend yield of just 2.25%. Conversely take a look at another company, Adtrans Group (ADG). Adtrans Group sell cars and trucks and consistently generate very high returns on equity. Their share price is \$2.65 and their intrinsic value is, according to the method adopted in this article, \$2.48. ADG is trading on a p/e of just 8.4 times and has a fully franked dividend yield of 7.44% or a grossed up yield of over 10%. If you buy ABC Learning Centres at current prices, the price may indeed rise, but you are speculating, just like the buyers of telcos and technology stocks during 1999. If you buy Adtrans, the price may indeed fall, but the risks are lower and you are genuinely acting like a long-term investor.

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November 5, 2002

