

EQUITIES

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INTRODUCTION

By Alison Harrington

The core strength of AIA is its foundation on the premise of "Investors helping Investors". This sharing of knowledge and experience, in a fun and empathetic style, is an immensely valuable tool in the development of an individual investor's confidence and skills. AIA is, more and more, also becoming acknowledged as the "trusted gateway into investing."

This equities bulletin provides examples of these unique roles of AIA.

Anthony Caneva of Australian Unity has given what initially looks like a mathematical discussion but turns out to be commonsense advice on how to make those crucial decisions - when to buy and when to sell.

The three experienced investors who have provided the reviews of these extremely valuable investing information resources have used their depth of knowledge to high light how **all** investors can benefit from using the written material of Colin Nicholson, the definitive book on share value calculation from Roger Montgomery and a new research source currently being established. Robert, Jolyon and Scott have provided excellent independent overviews and insights. Enjoy reading them all.

Alison Harrington is the National President of the AIA.

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RATIOS AND FUNDAMENTAL ANALYSIS

By Anthony Caneva

The most fundamental concept of valuation analysis is the risk-reward relationship. If you want a greater expected return you must expose yourself to greater risk. This is not a two-way street. You cannot select risky investments and then claim to have a greater expected return. A risky asset also has a greater probability of performing poorly.

The additional return above the risk-free rate (government bonds, overnight cash rate, etc) is best known as the risk premium, and for the infinite number of risk factors that can impact the riskiness of an investment there is an equally infinite range for risk premiums.

How is this relevant to valuation and the application to security selection? Well, if we can quantify the level of risk we can quantify the required rate of return. Two of the most common means by which risk can be quantified are beta and standard deviation.

Beta is a measure of volatility relative to the market. If beta is 1.5 then for every point the market moves up, the individual security moves up 1.5, and vice-versa. The greater the beta, the greater the risk.

Standard deviation is a measure of volatility relative to the average return of that particular security. The average return plus or minus one standard deviation represents a range of returns that hold a 66% probability of occurrence. For example, if company XYZ has an average return of 11% with a standard deviation of 4% there is a 66% probability that the return will be between 7% and 15% (i.e. 11 ± 4). The greater the standard deviation, the greater the risk.

One way of calculating the expected rate of return is the Capital Asset Pricing Model (CAPM). This formula is the risk free rate plus beta times the risk premium, which looks like this:

Expected Rate of Return

$$E(R_i) = R_f + B_i (R_m - R_f)$$

The diagram shows the CAPM formula with four labels and arrows pointing to specific parts: 'Expected Rate of Return' points to $E(R_i)$, 'Risk-free rate of return' points to R_f , 'Beta' points to B_i , and 'Market-wide Risk Premium' points to the term $(R_m - R_f)$.

There are significant assumptions and shortcomings in both measures of risk. Firstly, both beta and standard deviation are based on historical data and the risk profile of a company can change over time. The value of a security is a reflection of future returns, which do not always correlate with historical data. Furthermore, beta and CAPM can be seen as an over simplified approach to risk because it summarises all risk factors into one – the market risk premium.

The resulting required return from a factor model such as CAPM is a very specific one. It does not come with a range or an associated probability. It is therefore unrealistic to expect this formula, or those similar to it, to predict year-on-year returns with any certainty.

So where else can we look for answers?

As an investor it is important to understand why you buy a company's stock. Do you try to forecast returns based on historical data (technical analysis)? Do you analyse financial statement and ratios (fundamental analysis)? Do you like large cap, small cap, contrarian or momentum approaches? Do you favour macro or micro factors? You should build an investor profile on yourself so that you have a strong idea of what you think makes a good stock.

One approach to investing is to buy those companies that have fallen the greatest. The idea is that today's losers are tomorrow's winners. This is referred to as contrarian investing. It follows the

principal of price mean reversion. Put simply this principal states that in the long run steady growth is achieved, so given the choice between a company that has just fallen dramatically and one that has not, that which has fallen has further to rise before reverting to a price mean and therefore will deliver greater capital growth.

There is a significant risk with this approach, that the reason for the fall in price to begin with is relevant for a long time. This may see the price never fully recover. Always keep in mind that investors invest for the purpose of receiving a return. A company delivers return through growth of earnings. So price is always relative to future earnings, which brings us to the Price-to-Earnings Ratio (PER).

The PE Ratio is one approach of a broader category known as earnings capitalisation methodology, which also includes EBTIDA multiples and EBIT multiples. They are simple means by which prices can be compared. The simplest and most readily available is the PE Ratio, which is calculated by dividing a company's market capitalisation by net profit after tax (NPAT) or stock price by earnings per share (EPS). As an example a PE Ratio of 20 implies an earnings yield of 5% because for \$20 invested you are receiving \$1 of earnings. So, the lower the PE Ratio the greater the earnings yield.

A low PE is a value indicator, as opposed to a growth indicator. But there are other factors to consider when analysing a PE Ratio. Firstly, a highly leveraged company will have a different PE profile to a company with less leverage. Secondly, different industries will have very different averages. So in using a PE Ratio make sure you are comparing companies not too dissimilar in size or gearing and are of the same industry (or revenue streams). You should also endeavour to discover why the market has this company trading at a low value, because it may just be right.

One other extremely important truth that must be understood is that cheap stocks can always get cheaper. Just because you bought something that is under priced (according to your assessments) does not mean the market won't take it further down. You should have an exit strategy and contingency strategy. An exit strategy is commonly referred to as a target price. A contingency strategy is designed to manage when things don't go as planned, so if the price falls significantly will you cut your losses, or do you take advantage of what may be an even more attractive buying opportunity. Making this decision at the point of purchase removes the risk of being swayed by your emotions when in the heat of the market.

The net result is what is important and active trading can increase brokerage fees as well as tax liabilities if the assets aren't held in a superannuation account in pension phase, in which case active trading may be too risky a strategy regardless. When implementing a value strategy care and conviction are important so that you don't incur unnecessary losses or trading costs.

And finally, investing is a discipline and as such, a disciplined approach is required. Whenever making a purchase list the reasons for the purchase, review them on a set frequency and make sure those reasons are still relevant.

Anthony Caneva is an authorised representative of Australian Unity Personal Financial Services Ltd (ABN 26 098 725 145), AFS Licence No. 234459. His can be contacted at acaneva@australianunity.com.au.

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RESOURCE REVIEW: INDEPENDENT INVESTMENT RESEARCH

Reviewed by Scott McKenzie

IIR is a newish research group that provide free information about listed investment companies and some unlisted managed investments. IIR was created from staff who previously worked for Aegis Research and Property Investment Research, both taken over by Morningstar.

It is gradually adding other categories of investments researched: junior mining companies and Australian companies are (it seems) being added to the list progressively. It is quite limited for the present, but looks like it will become a most useful resource in the future.

IIR research is paid for by the investment companies themselves and is thus supplied to consumers free. However this reduces the pool of those researched to companies that seek this and are prepared to pay for it.

Have a look at Independent Investment Research [here](#).

Scott McKenzie is Vice President of the AIA.

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RESOURCE REVIEW: COLIN NICHOLSON'S NEWSLETTER AND WEBSITE

By Robert Vagg

Colin Nicholson is a well-qualified and experienced private investor, author and educator who adopts an active technically-based approach to investing in Australian equities. Through various means, generally free of cost, he endeavours to share his extensive knowledge with fellow investors and traders in order to advance their efforts to achieve similar success. In doing so he shares the same fundamental goal as that of the AIA.

As a member of both the AIA and the ATAA, Colin is well known throughout the Australian investor community as an approachable presenter and author. He has been consistently rated as one of the best speakers at AIA conferences and seminars. That presentation material forms a very small part of the mass of valuable information that he makes available to investors in electronic format via his popular website and monthly newsletters. Readers may source this information at www.bwts.com.au.

Website: Building Wealth Through Shares

Colin maintains a comprehensive website that functions as his primary information resource, and embodies a significant amount of material beneficial to Australian investors. The site is divided into two areas, with one requiring prior registration. Access to this paid area involves an initial joining fee of \$44 and an annual subscription of \$55. Both areas are continually updated and extended.

Available from the *Home* page are Colin's brief biographical details and an Adobe PDF file that describes a detailed analysis of the investment returns that he has been able to achieve following his investment methods, as portrayed in his popular book *Building Wealth In The Stock Market*. A signed copy of this, and Colin's other book entitled *The Psychology Of Investing*, are each available for direct purchase from the website.

Free Area

Resources available in the website's free area include an archive of the email newsletters whose distribution began in 1999. Readers are encouraged to request topics for later newsletter coverage

and questions from readers relating to investing are invited. This has resulted in an accessible organised database of more than 1,000 *Ask Colin* brief dialogues in Q&A format. A regularly changed Q&A is featured on the website's home page.

The free area also provides access to a set of data files relating to world stock markets that would be of potential value to readers as a basic research resource. As self-extracting zip files, these data are available either in ASCII format, importable into MS-Excel, or in a format suitable for direct use in the *Insight Trader* software package.

These data files include a downloadable MS-Excel spreadsheet containing Coppock Indicator values calculated for the ASX All Ordinaries, Dow Jones Industrials, S&P-500, NASDAQ, FTSE-100 and Nikkei-225 indices. Although not presented in graphical form, the individual worksheets display the complex moving-average formulae required to calculate the values for each indicator. These calculations are based upon monthly-close data for the ASX, Dow and S&P indices since the beginning of the 20th century, and more than thirty years of similar data for the other three indices, alone a potentially valuable research resource.

Some selected fundamental time-series data relating to Australian financial markets available for download are the 10-year bond yield, 90-day bill yield, and the All Ordinaries dividend yields, P/E ratios and earnings yields (each from 1974 onwards). Grouped together in one file, this allows a convenient form of access to these data. A file containing the monthly number of new floats occurring on the ASX since November 1997 also is available to download.

Also included through the *Resources* tab in this free area is a list of publications as *Recommended Reading*, sectioned according to chosen topic of interest. Individual *Book Reviews* on investment topics are available, as well as details of Colin's speaking program. Finally, an excellent comprehensive *Glossary* of investment terms, particularly those of relevance to technical analysis, is available for reference purposes.

Paid Area

The paid area of the website affords subscriber access to an extensive amount of more advanced material that may be viewed online, printed or downloaded. This includes slides used for each of Colin's many presentations around Australia. A large published library of the more than 750 copyright articles and columns that Colin has authored over the years also is accessible, arranged by appropriate classifications. Data calculated for the Australian All Ordinaries Accumulation Index are available.

Resource support for investors who follow the wealth creation methods outlined in Colin's book also may be obtained here. Subscribers are able to follow Colin's investment decisions in detail through description of any changes in his exemplary portfolio. These include well-discussed case studies on individual stock, thereby explaining the rationale for any buy or sell transaction undertaken on the portfolio. The subsequent results of those decisions are commented upon with honesty. Details of the portfolio are continually updated whenever any transaction is undertaken, and its performance is constantly monitored.

The *Market Case Studies* section describes market phase and trend analyses methods that are undertaken in order to be in a position to make strategic market exposure decisions. These decisions generally rely on basic Dow Theory, and the more esoteric forms of technical analysis are avoided. Examples of *Market Scans* for individual stock selection based on both technical and fundamental analysis methods also are available.

Newsletter

Colin produces a regular electronic newsletter, currently around one each month, that is available by free subscription to members who register their email details via the website. Unlike most others distributed in the industry, its main purpose is intended to be informative and educational rather than commercial. It achieves that purpose by providing a very comprehensive coverage of investment-related topics. Again unlike most others, its content is not solely topical but includes a great deal of information that would be of value if retained for later reference.

Each newsletter generally begins by detailing Colin's upcoming speaking program, recent additions to the website, and often includes responses to questions forwarded by readers. Although Colin is wise enough to avoid any suggestions of market tips or predictions, recent issues have included interesting competitions for members wishing either to attempt to forecast the market's likely direction or to provide a detailed analysis of its current position using technical methods.

The newsletter often includes critical reviews or descriptions of new financial instruments, investment products and investment publications. For example, recent issues have included easily understood explanations of High Frequency (algorithmic) Trading (HFT), Exchange Traded Funds (ETFs), Exchange for Physicals (EFPs), Dark Pools, and the new S&P/ASX Volatility Index (the Australian VIX).

Examples of some recent interesting topics are *"Forecasting and Prediction"*, *"How Asia is different – A view of the future"*, *"Investing versus Trading"*, *"Do investors profit from takeovers"* and *"Managing a portfolio while travelling"*. Two recent topics relating to Colin's *The Psychology of Investing* book, were *"Seeing is believing"* and *"I can't sell the stock for less than I paid!"*. Each addresses the important issue of the mind-set required to be a successful investor or trader.

Book reviews, extracts from investment publications, amusing or pragmatic quotations, and useful hyperlinks to other sources of valuable information are often included. Interaction with members is encouraged, and properly sourced links to information likely to be of value to other readers is welcomed, such as the recent *"Mining Scams and More"* and *"Commodities Website"* contributions. Readers are invited to email requests for topics they might wish to see discussed in future issues. The newsletter thereby acts as a valuable conduit for information exchange between its members.

Conclusion

In combination, Colin Nicholson's website and newsletter represent an exhaustive resource of valuable and enduring information made accessible to the Australian investor. A great deal of that information derives from Colin's own work and hence is unavailable through other means. Its emphasis is almost completely on the Australian market, and hence content is not "borrowed" from international sources. Being non-advisory, its informational and educational purpose distinguishes it from most other more commercial sources of investment information and supports its credibility.

Colin's generous approach to supporting fellow Australian investors is obvious from his participation in the activities of the ATAA and the AIA. A common thread runs throughout his work that is a major contributor to his popularity as a presenter. It is manifest in his writings, presentations, newsletters and website. Plain common sense.

This reviewer recommends the Nicholson Website and Newsletter to all investors without reservation.

Robert Vagg is a member of the AIA and writes a regular article in the AIA's Investors' Voice newsletter.

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RESOURCE REVIEW: VALUE.ABLE

Reviewed by Jolyon Forsyth

Title: Value.able: How to value the best stocks and buy them for less than they're worth
Author: Roger Montgomery
Publisher: My 2 Cents Worth Publishing, Melbourne, 2010
ISBN 9780 6465 25440
RRP: \$49.95
Reviewer: Jolyon Forsyth

The long title of this book covers what Roger Montgomery sets out to do and he does it well. The book is divided into three sections, beginning with our need to think like an investor and not as a speculator. I quote from his prologue. "This is a book for you and your future. Think of it as an investment in yourself. I intend to give you the tools the principles and a framework you need to do better in the stock market than you have done before; and to do it with less stress, more sleep and without worrying about the daily gyrations of the market." I think that Roger has succeeded for us all.

Roger urges us to buy shares in order to own businesses, not to buy shares in order to sell them. If one wants to be on the road to wealth accumulation we should be focusing on value and not price. Price is what you pay, value is what you will own. Valuations do not change nearly as frequently as prices!

To identify extraordinary businesses Roger urges investors to look for:

- bright long term prospects
- a high rate of return on equity driven by sustainable competitive advantages
- solid cash flow
- little or no debt
- first-class management.

These may look familiar to you. That's because they come from Warren Buffett and in Part Two of *Value.able* Roger deals with each of these. He warns us to steer clear of commodities which are when a product or service is selected purely on the basis of price, for example airline seats. And then he introduces investors to the golden rule for picking extraordinary businesses and it is not price-earnings ratio or dividend yield or price to book ratio. It is return on equity. Had one been using this tool alone one could have predicted the demise of ABC Learning Centres two years before it happened. Again using Return on Equity Roger shows that Wesfarmers paid too much for Coles. At that time Coles had \$3.9 billion of equity at the end of 2007 and was earning a return on this of 19.9%. Wesfarmers paid \$22 billion for Coles and the Return on Equity declined precipitously to about 3.5%.

An extraordinary business needs not only a high return on equity but also a sustainable competitive advantage. Roger quotes JB Hi-Fi as having such a competitive advantage when the guy at the Apple store tells you that the cheapest place to get a Mac is at JB Hi-Fi you have to conclude that JB Hi-Fi has some important advantages that keep people coming back.

Roger then discusses why debt is not always good and the importance of cashflow and why Goodwill is not good. He suggests that we should remember the following formula:

Capital Raised + Acquisition + Low Rate of Return on Equity = Write-down.

This is what happens when companies pay too much for the whistle.

After proving to the reader the value of his thesis, in Part Three one gets to "How to Value a Business" and this is made very easy for the reader. Chapter 11 – Intrinsic Value shows how to calculate the intrinsic value of a business. The reader needs to decide what rate of return they are looking for from their investments and Roger suggests the following. A long term real rate of return over 22 years was 3.2% to which he adds 5% for inflation and a risk premium of 4% to give a

rounded figure of 12%. There are two tables here for valuing a company a) when it pays out 100% of its earnings as dividends and b) when it retains 100% of its earnings. One might say most Australian companies pay out a percentage of their earnings as dividends. A little more arithmetic is then needed to arrive at the intrinsic value of the business. There isn't sufficient room in this review to go through the detailed mathematics but Roger gives two examples. One is JB Hi-Fi for which the calculation gives an intrinsic value of \$20.81 and at the time of writing they were trading below \$20.00. The other example Roger gives is Buffett's bid for Burlington Northern Santa Fe Corp at \$100 per share which was a 30% premium to the then market price. Roger calculates the intrinsic value of Burlington Northern to be \$117.28.

The final chapter of *Value.able* is entitled Getting Out and this may be necessary if the intrinsic value of the business declines.

Value.able is an easy to read book and the reader is not blinded by mathematical formulae. It would be ideal if the book was made compulsory reading for all public company directors and management and Chairpersons ordered all their Board to reread it before considering the takeover being proposed by management.

Value.able is available exclusively at www.rogermontgomery.com. The reviewer, Jolyon Forsyth, is a Councillor of the AIA.

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This bulletin is produced by the:

Australian Investors Association
PO Box 7439, Gold Coast MC Qld 9726
Tel: 1300 555 061 Fax: 07 5538 8376
Email: aia@investors.asn.au Web: www.investors.asn.au

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