Roger Montgomery, Montgomery Investment Management

Roger Montgomery is the founder, Chairman and Chief Investment Officer of Montgomery Investment Management. He is a renowned value investor with more than 25 years' experience.

Following a successful career as an analyst and public company Chairman, Roger published the First Edition of his stock market guide, Value.able, in 2010, becoming an Australian best seller in just 16 weeks.

He is an awarded presenter on the subject of investing and appears regularly on the ABC as well as Sky Business and 2GB radio. Roger also writes regular commentary for major financial publications and newspapers.

A FORK IN THE ROAD

Roger Montgomery

We are value investors for many reasons, one of which is that establishing an estimated intrinsic value provides an anchor or a solid point of reference from which the turbulence of markets can be viewed dispassionately. Although, value investing does have its limitations. How, for example, can a value investor win when there is nothing cheap enough to buy in the first place?

During one of my regular ABC interviews, I was asked two questions. The first, why the market had faltered in February, particularly when the outlook for growth is so strong? The second, whether the market falls had us picking up a few bargains. Given the importance of investing to retirement outcomes, it is unlikely my radio host is the only person stewing on those questions.

The short answer to both questions is quite straightforward; firstly, sentiment shifted, and secondly, no, not yet.

Before expanding on the answers however, a little background.

Why value investing?

We are value investors for many reasons, one of which is that over the long-run, it just works. Value investors, including 'Growth at a Reasonable Price' (GAARP) investors, tend to outperform most other 'styles' over long periods. Of course, value investors won't outperform every year, but there is no way to eliminate all discomfort from investing.

For example, we already know the analysis showing that an adviser, who had perfect foresight and picked the best performing Australian domestic fund manager over a five-year period, every five years for 35 years, might have still been sacked along the way.

While this 'perfect' adviser produced a 35-year return of more than 20 per cent per annum and turned an investment of $10,000 in September 1982, into $6.9 million by September 2017 – 14 times more than the ASX All Ordinaries, there were inevitable periods of extended underperformance. For example, over the first five years the best manager failed to substantially beat the market, then there was a three year period that produced 35 per cent underperformance; and there was also a drawdown of 43 per cent at one point.

Even if your prescient adviser had ensured you were invested with the very best manager every five years, for three and a half decades, you were still obligated to endure some excruciating discomfort.

Another reason to support the value investing philosophy is that establishing an estimated intrinsic value provides an anchor or a solid point of reference from which the turbulence of markets can be viewed dispassionately. If we think of our valuation as the lighthouse, and we build that lighthouse on a solid foundation, then no matter how extreme the tempest might be in financial markets (whether extreme pessimism or optimism), we can see it for what it is.

Without the benefit of a valuation, you are simply trading sentiment, or business or market momentum, and relying on either an ability to predict when that sentiment will shift or on the market momentum slowing gently and smoothly.

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The quote

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Recent experience

Calendar 2017 recorded the sixth consecutive year of positive real total returns from all major asset classes for Australian investors – Australian shares, global shares, Australian and global bonds, listed and unlisted commercial property, housing and bank deposits. It was the first time in history that everything has gone up for six straight years for Australian investors.

And since the lows of 2009, the US market has risen with nary a bump along the way. Benefitting from, and subsidised by, the zero-interest rate environment, even inferior companies have risen dramatically, and been lent billions of dollars with few covenants, rather than being pushed out of business.

In such a low risk environment, it is no surprise that investors have poured trillions of dollars into index funds and ETFs and eschewed active management because any risk management has hurt performance.

As the market continued its relentless climb, with minimal volatility, value investing had been relegated to history – an anachronism from a simpler and more innocent time. Observing fund manager peers generating high double digit returns from companies whose prices at the time of purchase weren't even in the same universe as our valuations, I began to question the relevance of value investing myself.

But as interest rates normalise – we have already seen US ten-year bond rates more than double from 1.36% in mid-2016 to 2.92% more recently – active management and value investing comes to the fore.

You see, at their core, active fund managers, especially value investors, are risk managers. Risk managers are always prioritising risk minimisation and particularly the risk of permanent capital impairment. This is reflected at Montgomery through a preference for quality companies purchased at rational prices and through the preference for cash when companies with the aforementioned attributes cannot be found.

But our own analysis shows that the invested portion of the portfolio has outperformed the market since inception, the corollary being that holding cash has been a significant drag.

When interest rates normalise however, risk management becomes not only prudent but necessary and risk-conscious value investors should do well.

Separately, a conversation with one peer cemented my loyalty to value and GAARP investing, despite its inferior recent performance, compared to momentum and growth; I asked my friend how he could have purchased the company under discussion given its price? He offered that my 'problem' was "too much of a focus on value and too little focus on business momentum." According to my friend, one could do just fine picking a business with strong sales or subscriber momentum, in the knowledge that as the growth continued and the story spread, other investors would join the party at higher prices and a profit could be realised.

He had indeed made a substantial return for himself buying stocks this way and he was fully invested. Recent performance did suggest he was right and I was wrong. But my next question revealed a possible flaw in the approach. I asked; "if you are buying well above a conservative estimate of value, how do you know when to exit?" His answer left me uncomfortable; "That's a good question, you'll see it 'rolling over'."

Within a week of this conversation the Dow Jones lost four per cent in a single day, and then sold off further, in a week that had the financial media producing some of the most breathless headlines we have seen in years.

Several of my friend's stocks fell as much as 16 per cent in a month. I wondered whether those falls constituted a 'rolling over' by his definition.

As Warren Buffett has observed, the light can at any time go from green to red without pausing at yellow.

Putting the recent bout of weakness in context

The first thing to point out is that the breathless headlines about the Dow Jones falling the largest number of points in one day ever and about $61 billion being wiped from market values should be ignored.

On February 5, 2018 the Dow Jones fell a total of 1,176 points, from 25,521 the day before to 24,345. This was indeed the single largest daily point fall ever. But let's put the move, and the media headlines, in perspective and dismiss any notion that something significant actually happened.

First, it is important to realise that as the market climbs over the decades, the falls – in absolute points terms – will likewise increase. In other words, percentages are more important than absolute points and the Dow Jones's move represented only a 4.6 per cent fall.

By way of comparison, back in October 1987, the Dow Jones fell 505 points in one day, less than half the move registered in early February this year, but that move represented a 22.5 per cent decline.

Second, over the previous year, the Dow Jones rallied as much as 32.9 per cent, and in January alone it had rallied as much as 7.6 per cent. A 4.6 per cent fall, in this context, is relatively minor.

Third, since 1980, there have been 37 days – an average of one per year – where the market fell by more than four per cent.

All of this simply demonstrates that such moves should be considered regular and a normal part of long-term investing in the stock market. While the market's moves may yet prove to be significant, there is very little of significance in the recent one-day fall for the long-term investor to consider.

What happened?

For several years now, the stock market has been rallying as investors migrated away from the punitive returns offered on cash deposits – returns which themselves were synthesised by ultra-low interest rate policies and extended by central bank buying of bonds. Low rates forced investors into other asset classes and further up the risk spectrum. In fact, the stock market is not unique in terms of delivering very attractive returns to investors.

As the period of ultra-low interest rates extended from months to years, the migratory behavior of investors produced record prices across many asset classes. More on that in a moment.

The longer rates stayed low, the more willing investors were to recycle their profits into more esoteric opportunities. Then along came the collective insanity known as Bitcoin.

Putting aside the merits of blockchain technology, which lent credibility and apparent sophistication to the 'investment', Bitcoin and its cryptocurrency alternatives afforded the prospect for individuals to make vast sums of money quickly and effortlessly.

A sure and repeating sign of a bubble is the emergence and development of the belief that everyone can be rich. The prospect of these vast riches lured many to speculate, using the proceeds of the sale of real assets such as property. That a bubble had formed was not in question, the only unknown was how big the bubble grew before it popped.

In another example, investors had piled US$2.5 billion into an index fund that provided the opposite return to the Chicago Board Option Exchange's VIX volatility index. If volatility fell – as it had been for years, and to historic lows – investors in the VelocityShares Daily Inverse VIX Short Term ETN (NASDAQ code XIV) stood to make a fortune (about 150 per cent per annum for the last two years).

According to some reports, this 'shorting volatility' strategy "paid for many a Porsche out of trader bonuses."

But one day after the CBOE Volatility Index (VIX) recently had its largest-ever one day rise of 116 per cent, Credit Suisse announced it would close its inverse VIX note, which lost 96 per cent of its value in one day.

Chat site Reddit's 'Trade XIV' group used to carry posts entitled; "How I made $356k on XIV in two years".

More recently Cuffelinks reported the following Reddit post:

> *"I've lost $4 million, 3 years of work, and other people's money. I started with 50k from my time in the army and a small inheritance, grew it to 4 mill in 3 years of which 1.5 mill was capital I raised from investors who believed in me. The amount of money I was making was ludicrous, could take out my folks and even extended family to nice dinners and stuff. Was planning to get a nice apartment and car or take my parents on a holiday, but now it's all gone."*

Experienced value investors can see when sentiment has migrated beyond optimism to irrational exuberance. And then, on January 31 this year, Alan Greenspan, the 91-year-old five-term former Chairman of the US Federal Reserve, and the man who coined the term 'irrational exuberance', said the stock market was in a bubble.

In recent months, and reminiscent of the dotcom boom, we have seen companies simply change their name or strategic focus towards blockchain, and the market has rewarded incumbent shareholders with 300 per cent plus gains.

On December 21, the Hicksville, New York-based Long Island Iced Tea company announced a "Corporate focus shift towards opportunities strategic to blockchain technologies". The loss-making company's shares rallied from just under US$3 to over US$15 during the day of the announcement. At their peak the shares were trading 411 per cent higher than their lows only a week or two earlier.

On January 9, Kodak jumped on the buzzword, launching its own cryptocurrency, KodakCoins – tokens for use in the blockchain-powered KodakOne photography rights management platform. Within days of the announcement Kodak's shares were trading 390 per cent higher.

Then eCigarette company Vapetek changed its name to Nodechain and said it would 'explore' Bitcoin, Ethereum, and other cryptocurrencies. The thinly traded shares jumped over 360 per cent.

These recent name changes are reminiscent of the adoption of names ending with '.com' during the tech boom of 1999 and early 2000. Back then, investors mistakenly believed that new technology – technology that can admittedly change the world – would render all companies involved profitable. It is a common mistake to believe all companies involved in a new technology will make it. They simply cannot.

Australia is far from immune from this irrational exuberance. Perfectly valid arguments are being proffered for companies with revenues of barely $1 million and market capitalisations of nearly a billion dollars.

The US stock market

Three and a half decades of declining interest rates has fueled an investment migration that has devoured the implied returns of every asset class. As investors migrated away from cash and into shares and property, prices rose and yields fell. Such was the size and length of the migration that the yields on CCC-rated junk bonds, corporate bonds and emerging market bonds fell to their historically lowest premiums above those yields offered by bonds issued by the US Government. Eventually the migration found its way to increasingly riskier investments and ended up at auctions for art, wine, rare coins, collectible cars, number plates and stamps – none of which earn any income and all of which achieved new world-record prices.

Importantly, these records were being broken across the globe, confirming the hitherto success of Sydney Brisbane and Melbourne property investors had nothing to do with skill and everything to do with a global narrative of very cheap money over a very long time.

Of course, by now you should be thinking these returns aren't normal…

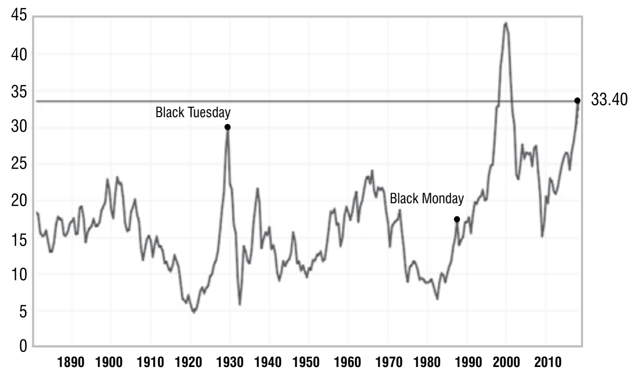
Over the very long run asset markets like the stock market might be expected to deliver real returns much lower than those that have been achieved recently. For that long run average to remain undisturbed, the recent strong gains will have to mean-revert. And given most market's tendencies to overreact, it is quite likely the markets for many assets could decline to levels well below those representing the long-run average growth.

As Figure 1, illustrates there is no question the US market is expensive.

The CAPE ratio sits at over 33 times ten-year cyclically-adjusted earnings for the S&P500. Therefore, we know that the CAPE ratio takes into its calculation the negative earnings of the December quarter 2008, which boosts the current level of the CAPE ratio, but a simple calculation that grows this year's earnings by as much as ten percent, and simultaneously drops out the 2008 earnings, reveals the CAPE ratio is still at 30 times. At 30 times it is still higher than at any time since the late 1800's with the exception of the tech boom.

While Robert Shiller himself warns that the CAPE ratio does a relatively poor job of predicting corrections, he notes it does an excel-

Figure 1. S&P500 CAPE Ratio to February 2018

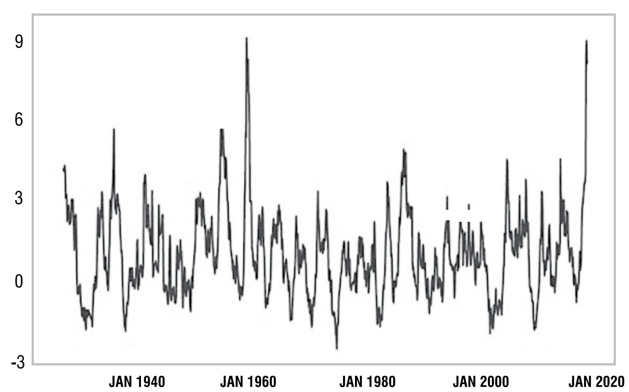


Source: Multpl

Figure 2. S&P500 Sharpe Ratio rolling 100-month periods

Source: Bloomberg

Figure 3. S&P500 Sharpe Ratio 12-month annualised to Dec 31, 2017



Source: Global Financial Data from 1926 – 2015, CSI Data for VT ETF

lent job of predicting future returns. The aphorism 'the higher the price you pay, the lower your return' sits well with Shiller's findings.

With the CAPE ratio at record highs – even after we grow earnings for 2018, and drop off the poor 2008 numbers – we can see future returns at very unappealing low single digits for many years.

We note Berkshire Hathaway reported it had rejected nearly all deals presented to it in 2017, due to prices hitting all-time highs.

The question is whether those low returns will be smooth or accompanied by volatility? As Figures 2 and 3 show, the US S&P500's Sharpe Ratio, when measured across most time frames, is at near record highs and at a level history shows has rarely been sustained. This suggests that even if the overvaluation, as measured by Robert Shiller's CAPE ratio doesn't lead to a correction, volatility is quite likely to pick up.

And if heightened volatility is a real risk, and prospective returns are in the low single digits, don't the returns offered by cash offer a superior risk-adjusted alternative?

It certainly makes sense to us, to be holding some cash, even if it means that our returns are dragged back in the short term.

For Australian investors, the domestic market might not seem as expensive as US indices, but you can be sure of a very high correlation if the US market turns down.

What could happen next?

The rally in the S&P500 over the last few years, has not been unique in terms of its length. It has however been unique in terms of the very low accompanying volatility.

On any measure of volatility, investors have experienced an extremely low level of it. This has lulled many into a false sense of security and comfort believing good returns and very few negative days is normal. The resultant record levels of applications being experienced by index funds and margin lenders is a reflection of this (and both could have a central role in adverse changes to liquidity in the future).

In the first instance however, we believe the combination of high returns and low volatility cannot continue indefinitely. Importantly, the recent market falls have not corrected the two major imbalances in the market; bond yields remain elevated and are rising, and equity prices remain stretched. Generally, and in aggregate, equity prices both locally and internationally do not offer yields or implied returns that warrant the risk being assumed to own those assets.

As previously articulated, Australia has not been immune to the exuberance that has gripped global markets. There are profitless companies, and those being described by analysts as "pre-revenue", with market capitalisations approaching a billion dollars.

In some of these 'concept' stock examples, we have calculated that their share prices imply earnings growth of more than 40 per cent annually for a decade and without interruption. This is rarely achieved, but of course most investors believe it is a capital loss that will be rare.

Aggressive quantitative easing has deliberately manipulated the price of risk-free capital in global markets and corrupted investors' appreciation of risk. This has progressively pushed investors out along the risk curve in search of higher returns and driven up the price of equities first and then all manner of non-income producing assets.

Indeed, some asset classes with higher risks of capital loss than cash, have been offering lower yields than cash. This is an irrational and unsustainable situation, fortifying our preference for higher levels of cash even as shares have run hard.

During these periods, you can be forgiven for succumbing to the temptation of chasing optimistic and apparently easy returns, especially when your friends (and our peers) are seemingly doing much better, but patience is all that is required.

> *"What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential."* W. E. Buffett

It is abnormal to see so many generating returns of 30 per cent or 40 per cent per annum with apparent ease. Abnormally high returns however are just that, abnormal…and in the not-too-distant-future, negative numbers of equal magnitude may be just as common.

We have not forgotten how to value companies nor how to identify those of sound quality. But we have not been willing to chase momentum.

Of course, we cannot tell, with any useful accuracy, when or even if, the US market will turn down more meaningfully than it just did, but we do know some things:

- We know that there is little to no absolute value available in the Australian market for quality companies.
- We know that irrational exuberance has emerged in some small pockets of the market.
- We do know that ultra-low volatility and ultra-high returns (the S&P500 rose almost 20 per cent in just the six months to December 2017) are not a combination that lasts very long.
- We do know that history reveals market corrections to be preceded by the types of shots-across-the-bow that we have just witnessed.
- We do know that on a risk adjusted basis there may be more attractive alternatives to being fully-invested in equities. But we also know that history allows for the recent weakness to be completely reversed and then replaced by a wildly bullish rally that sees caution thrown to the wind and irrational exuberance itself making headlines.

On balance it does seem some caution is warranted and more appropriate than it has been at any time since 2009. Howard Marks – founder of the $100 billion Oaktree Capital – has told clients to stay "defensive or cautious" in the current market environment. Robert Shiller has warned "People should be cautious now." Both investors also said it is not appropriate to be out of the market altogether. Our own process has arrived at rising cash weighting and we're still 70-75 per cent invested. So, you could say we agree.

Study findings

A recent study – led by Tim Kelley, The Montgomery Fund's Portfolio Manager – of the variability of individual stock returns at times of market dislocation, reveals something very valuable.

We can confirm that during steeper market falls, market participants are less discerning than they are during stable periods. When markets become emotional and less considered, stocks tend to display less variability in returns. In other words, they all tend to move down together.

On February 6, when the ASX 200 fell three per cent, we observed half the scaled variability of returns than we observed in previous weeks, when the market was rallying. In other words, all stocks tended to fall in unison and by roughly similar amounts.

All this means that the cash we are holding could indeed prove to be very valuable. Not only could it protect investors during any correction, but it could also produce excellent long-term returns. If quality names are hit just as hard as low-quality names, and that's what our research suggests – we should receive some mouth-watering opportunities.

What has proven to be a recent drag could quickly turn, at any time, into a very powerful option over lower prices.

A quick insight into The Montgomery Fund's recenperformance

We are most comfortable when our investors appreciate that we put the preservation of capital ahead of chasing the last few percentage points of a rally, especially when that rally has produced valuations that require companies to grow at rates that are simply uncommon throughout history.

For the 12 months to December 31, 2017, and comparing "apples with apples," The Montgomery Fund returned 10.51 per cent gross (before fees) against the ASX 300 Accumulation, which returned 11.94 per cent.

Adjusted for an average cash holding through the year of 25.8 per cent, which only earned 2.25 per cent, the equity portion of The Montgomery Fund outperformed the broader market, returning 13.38 per cent.

With our investment process prioritising capital preservation, Montgomery has held a large proportion of cash through 2016 and 2017. Stocks are extremely expensive generally, and indiscriminate speculation is commonplace, so Montgomery concurs with the conclusion that a high cash weighting is prudent. It is better to be 12 months early than 12 minutes late.

It is worth mentioning that the outperformance of the equity-invested portion of the portfolio has resulted despite a zero weighting to the Materials Sector, which was the best performing sector in 2017 and the largest contributor to the market's return.

At Montgomery we are comfortable with a high cash weighting, which we believe will provide an advantage over our fully-invested peers in an expensive market that demonstrates unusual, if not unsustainable, characteristics.

In conclusion

Value investing has its limitations. How, for example, can a value investor win when there is nothing cheap enough to buy in the first place? One ends up holding funds in the safety of cash and watches as prices rise inexorably higher.

When the optimists are winning, as they have been recently, value investing can't hope to beat buying the 'concepts' that are simply going up the fastest or registering the most visitors.

Of course, value investors won't outperform every year, but there is no way to eliminate all discomfort from investing. But that's a limitation that we are comfortable with because the alternatives involve permanently impairing one's capital. FS