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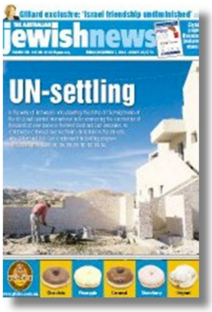
SMSFs: the secrets of highly successful share investing

By Dr John Price



Investment rule number one? Never lose money. Rule number two? Never forget rule number one! This is the mantra of Warren Buffet, Chairman and CEO of multinational conglomerate holding company Berkshire Hathaway, and widely considered the most successful investor of the 20th century.

"Obvious as these rules may seem, they are all the more important in these uncertain times when managing your own super fund," says TeamInvest Co-Director Howard Coleman. "After all, the quality of your retirement years is likely to be determined by your super fund's performance."

Given this need and responsibility to preserve and even grow your wealth, the key requirements for successful investing need to be implemented with even more care and rigour than usual.

When it comes to a share portfolio within your SMSF, how can you be sure that the companies you invest in are what TeamInvest call 'Wealth Winners'®? The answer lies in having a clear, rational and objective basis for developing and maintaining your superannuation portfolio, coupled with a strong focus on preserving your capital.

Buffett made the first of these two requirements clear when he wrote that the basis of his success was having "a sound intellectual framework for making decisions, and the ability to keep emotions from corroding that framework." As even the most seasoned investor will tell you, that's easier said than done!

As an example of Buffett's success, when he started his investment partnerships in Omaha in 1956 his net worth was approximately US$174,000. Today it is around US$50 billion, an average annual return of more than 25 per cent, and one that most of us would be delighted to see our SMSFs achieve!

This "sound intellectual framework" or methodology is even more important for portfolios held by super funds for two distinct reasons. For simplicity let's assume that the super fund is for a couple's retirement, and that one of them takes most of the responsibility of its management:

1. It is easier to properly explain investment decisions to the other partner. Too many times stress and conflict in a relationship are caused by the managing partner not explaining the rationale behind his or her investment decisions.

2. The methodology can be explained to the children or other members of the family, which becomes particularly important if the managing partner dies or is unable to continue in the role.

As for preserving capital, (remember Buffet's two rules with which we began our discussion!), it's essential to note that even though performance is important, more important are strategies that avoid your wealth slipping away through misguided, ill-informed or short-term decisions.

The obvious reason to preserve capital is so that there is no loss of wealth for or during retirement. A second and more important reason is that it prevents an even greater loss of money for future years. A loss of wealth now can become magnified in the future because of a smaller base to take advantage of the effect of compounding. By way of example, think of the people you know who never really recovered financially when their super portfolios were decimated during the crash of 2008.

Even though these methods aim to implement a rational investment methodology and preserve capital, they also provide a foundation for generating not only an attractive return, but one with high safety as well.

Rational Share Selection and Portfolio Management

Let us start by outlining a rational basis for selecting shares and managing a portfolio under the categories of financial requirements, risk analysis, board and senior management, and economic moat.

Financial Requirements

Start with the earnings of a company. Most investors are surprised to learn that over any 12 month period, only around one-third of companies on the ASX make money. Putting it another way, over any 12 months, more than 1,400 companies make no money for their shareholders (their real owners), with most losing money for them.

It is therefore no wonder that the prices of so many shares never meet their touted expectations. Most turn out to be outright Capital Killers™ with huge crashes in share price. Or they are Capital Killers™ by stealth and dribble your capital away. The first financial requirement is a steady strong growth in earnings per share. The same applies to sales per share, the bedrock of earnings per share.

Next look at return on equity (ROE), the earnings of a company divided by its equity. This is an important measure of a company's economic success. "It's like the first line in management's scorecard. Unless management scores well, it makes little sense to invest in the company," says Coleman. With this in mind, a basic requirement is that ROE should be consistently above 10 per cent. Above 15 per cent is even better.

Another requirement is that there should not be too much debt – a four-letter word for safe investing. Remember Babcock and Brown? Just before it collapsed it had a debt to equity ratio of

450 per cent. Almost 80 per cent of the net profit was used to pay the interest bill, yet it was being promoted by most analysts and financial commentators as a desirable investment. You should be wary of companies with debt to equity above 50 per cent, as well as those who use debt in ways that appear to be more for the benefit of management than shareholders.

"At TeamInvest we studied many different software packages before choosing *Conscious Investor®*. It's the only product that automatically applies each of these financial requirements to all stocks on the ASX, around 5,000 US stocks and more than 3,000 Canadian stocks," says Coleman.

Future Risks of the Company

It's easy to find reasons to invest in a company. Simply read any of the press releases by the CEO or chairman who have a vested interest to describe the company in a positive light. It's not so easy to find reasons *not* to invest in a company. Yet from an investor's perspective, knowing about the risks involved could be the difference between a Wealth Winner® and a Capital Killer™.

Teaminvest runs facilitated analysis sessions looking at the risks of key companies on the ASX. These think-tank type workshops and resulting reports differ from the usual analyst reports because they are based on the collective wisdom and expertise of thousands of years of business experience and networking.

The workshops start by developing a list of the risks of a business. Once described, the next step is to gage the likelihood of these risks occurring in the next economic cycle and the severity of the damage should they occur. Frequently lists of 15 to 20 risks are obtained with varying likelihoods and severities.

Trusted board and senior management

About 50 years ago, Philip Fisher, one of the pioneers of investment analysis, wrote that the final question every investor should ask was whether the company had management of unquestionable integrity.

It isn't always easy to assess this from the outside. There are, however, pointers that cause us to shy away from particular companies. One is through a careful reading of the section in the annual report on related party transactions. If there are a large number of related party transactions or if they are of considerable size, it is generally best to move on.

Another pointer can come from the remuneration report. The levels of the salaries and incentives given to senior management, particularly the CEO, are important. Even more important is whether the incentives are properly aligned with the goals of the shareholders. Now as a shareholder, which would you prefer management to be rewarded for, new acquisitions or increased earnings per share?

Companies should be like castles

Just as castles usually had moats for protection from the enemy, so Wealth Winner® investments require economic moats, or sustainable competitive advantages, to protect them from changes in the buying habits of consumers, existing and new competitors, government legislation, and the general economy. Types of economic moats include geographical, location, brand name, licences or patents, cost of entry and management expertise.

We measure an economic moat in terms of its type, strength and durability. It is vital that a company has a strong economic moat and that there is evidence that the company is firmly focussed on maintaining it. Otherwise the company may move from a profitable market leader to an 'also-ran' contender.

While the above measures are by no means exhaustive, they give an understanding of the types of criteria that need to be satisfied as part of a clear and rational investment methodology.

Another aspect that the conscious investor may consider is whether a particular company provides products or services that are aligned to the investor's personal values. By way of example, at a recent TeamInvest workshop members expressed reservations about investing in a large manufacturer of pokie machines even though the company itself passed the Conscious Investor® software filters. They simply could not feel comfortable investing in the gambling industry.

Now you're probably wondering why I haven't mentioned the actual share price in any of the requirements thus far. Let's take a look at preserving capital via stress testing.

Preserving Capital via Stress Testing

The key to preserving capital is stress testing. When an architectural engineer gives approval for the construction of a new building, he or she must give assurances that, not only will the building meet the owner's needs, it will also pass a range of safety requirements. Before a single shovel-full of dirt is removed for the foundations, the design has to be stress tested for everything from the ability of the floors to carry specified loads to the building being able to withstand extreme winds.

Stress testing in the share market is designed to do something similar. Before purchasing, the investment needs to be stress tested in an objective and systematic manner to ensure it will preserve capital and provide a healthy secure return.

There are three areas for stress testing any potential investment: (1) growth of the business, (2) market recognition of the business, and (3) board policy regarding dividends. In each of these areas I have developed computer models to apply stress tests.

However, before describing them, there is something else we can learn from architectural engineers. Layers of stress testing will be of no use if the design of the building or bridge is flawed in the first place. Similarly, in the stock market, we only deal with quality companies that have already passed the stringent requirements described earlier.

Stress Test 1: Growth of the Business

Professional analysts make forecasts of the growth of businesses. Unfortunately, many large scale academic studies show that they are generally not accurate enough for responsible investing.

However as investors we don't need to make accurate forecasts – we just need to avoid negative surprises. In other words, we want to make forecasts so that it is very unlikely that the actual growth rate will be less than the forecasted rate, and highly likely that it will be more.

This is what we mean by a stress-tested forecast. It can be interpreted as a worst-case scenario.

Stress Test 2: Market Recognition

When Benjamin Graham introduced the mythical character Mr Market he wanted to emphasise that stock markets have moods. Some days shares in a particular company will only be available at high prices. Other days, with no further information, they will only be available at much lower prices. The easiest way to see these swings is via the price-earnings or P/E ratio. The P/E ratio tells us how much Mr Market is willing to pay for the projected stream of earnings being generated by a company.

Even for stable iconic companies such as Woolworths, this can vary over each financial year by 50 per cent or more. What we need is a stress-tested P/E ratio at a level we can be confident will be exceeded in the future.

Stress Test 3: Dividend Policy

What have dividends been in the past compared to earnings per share? Has the board given any indication about the future dividend payout ratio? What if the payout ratio was cut back? How would this impact on the expected return on an investment? These are the types of questions that can be included in making forecasts of payout ratios. Once more we are stress-testing the particular forecasts and their outcomes.

It's essential that stress tests are objective. Otherwise it is too easy to get led astray by behavioural biases into thinking that an investment is more robust than it really is.

"Another reason TeamInvest uses *Conscious Investor®* is because it comprises objective computational methods that isolate weaknesses in the historical financials of a company and make these stress-tested forecasts," says Coleman.

Calculation of the Expected Return

Given all that we know about the business from the preceding analysis, what minimum return would be required to compensate for the risks associated with it? For example, suppose the risk-free bank rate is five per cent. What extra return would be required to compensate for the risks associated with investing in a particular company? Without answering this type of question, we really are just speculating in the hope that we'll achieve a profitable return.

After activating the stress-tested forecasts just described, *Conscious Investor®* calculates the return that can be expected with confidence from purchases made at the current price. I call this the expected return valuation method.

If the return that is calculated exceeds the required return described earlier, it may be time to buy since the stock has passed all the requirements of being a Wealth Winner®. If not, further calculations show what the appropriate purchase price would be.

The important point is that we are now in the enviable position of knowing the stock we want to buy, and the price we are willing to pay to achieve with confidence the return we desire. If the calculations show that we would be unlikely to get this return at the current price, we can sit and bide our time, secure in the knowledge that market volatility can be 50 per cent or more over a year even for blue chip companies.

Conclusion

Portfolios held by super funds have special requirements due to their responsibility to maintain wealth for retirement. The investment methodology described above provides a clear pathway using proven rational steps to assist the portfolio manager in selecting the Wealth Winners® from among the many companies listed on the ASX. Moreover, this methodology enables the owner of a superannuation portfolio to manage it with the highest level of stewardship, while at the same time allowing for his or her partner to understand and feel comfortable with the investment decisions made.

Dr John Price is a world renowned academic and author and has published three books on valuation methodology and over 50 academic publications on investing and financial services in the USA and Australia. In addition he has served as a director of companies in both Australia and the United States. John is the creator of the Conscious Investor® Investment Software and one of the founders of Teaminvest, a private membership organisation for those who prefer to control their own money well, rather than paying others to do it badly for them.