Invest in Sound Businesses

When the last big bear market hit us in 2008-09, many investors in Australian stocks lost heavily. Those who were invested in sound businesses and held their nerve came though alright and by late 2013 the market as measured by the S&P/ASX All Ordinaries Total Return (Accumulation) index had recovered the losses.

Another group also came through fine – those who follow the market timing approach that I teach of being in bull markets and out of bear markets.

Unfortunately, there were other investors who were not so fortunate. Many panicked and sold their part ownership of sound companies in the grim days of late 2008 and early 2009. Then they compounded the error by watching frozen as the market roared back in mid-2009.

Even worse hit were those who were part owners of unsoundly financed companies, which went belly up, or who were gambling in the speculative end of the market.

In general terms there are two kinds of private investors in the stock market:

Investors: They buy a part ownership of a business which will yield them an income stream in the form of dividends and franking credits and, if the business prospers over time, an increase in the market value of their investment.

Speculators: They buy and sell shares with the aim of making a capital from favourable changes in the price of the stocks. Typically, they are investing with an eye to the spectacular gains that are occasionally made when the company finds or develops something.

While speculators will be prepared to buy and sell anything that moves in price, investors should know that there are two basic types of businesses that are listed on the stock market:

Investment grade stocks, which can be defined quite easily; they are stocks that have a history of making profits and paying dividends. If possible, investors should seek out the history of earnings and dividends over at least ten years. This is not always possible because the business may not have been listed on the stock market that long. In that case investors should seek to read the prospectus on the ASX website in the section on company announcements. This may provide information on these metrics for the time before the stock was listed. Failing that, and in all cases, the best investments will be in companies that have shown consistency and growth in earnings and dividends with little debt.

The necessity to look at a decade of earnings and dividend history is especially important if the business is cyclical (grows and declines with the business cycle) or is tied to commodity markets, which are notoriously cyclical.

Speculation, which can also be defined quite easily; they are stocks that have not yet been able to make consistent profits and pay dividends. This group will be avoided by investors, but hold out the temptation for the speculators that one or two may hit the jackpot and spectacular capital gains will be made, hopefully offsetting the many others that failed and lost most of the speculator's capital that was punted on them. These speculative stocks come in many forms including:

- New businesses that have raised seed money to try to prove up a business plan
- Resources explorers that have raised money to search for an economic mineral or energy deposit
- Biotech developers that have raised money to try to discover and develop new treatments
- Internet/technology start-ups that have raised money to implement a new and unproven business idea or to make a new scientific discovery

The key thing to remember is that, if an investor buys speculative grade stocks, they are not really investing, but speculating. If they hold these stocks and the management does not make the business work, or they do not discover something, before the money runs out then these stocks will end up worthless and no income stream will have been enjoyed during the process.

Assuming that we want to focus our investing on sound businesses, how might we find them among the over 2,000 securities listed on the Australian Securities Exchange? The first step is to winnow the list down to only those stocks that both made a profit and paid a dividend in the last year. As of Friday 6 November 2015 there were only 431 listed companies that made the grade.

However, some were not very large businesses. If we were to filter that list further by requiring that the market capitalisation was $1 billion or more, there were only 150 companies left to consider.

This list can be quickly reduced well below 100 companies by crossing out those that are in cyclical industries, businesses tied to the commodity cycles, businesses that you do not understand and especially those with high debt.

Once the easy work has been done, the list needs to be worked over, looking for those companies that meet these easily found or calculated metrics:

- Grossed-up dividend yield better than the market average*
- Price earnings ratio less than the market average*
- Return on equity greater than 10%
- Profit growth over 5 and 10 years that is greater than sales growth over those periods
- Likewise earnings per share
- Likewise, dividend growth
- Likewise, free cash flow growth

* The market average is used because it represents the opportunity cost versus investing in an index fund.

Above all, we must be sure that we understand the business and its growth prospects. Here we want to see a business that has a level competitive advantage, with pricing power with respect to suppliers and customers.

Some of this analysis is relatively simple in that it is a matter of accessing and processing readily available data in company accounts. The difficult part is the work needed to understand the business, level of competitive advantage and its growth prospects through wide reading and study.