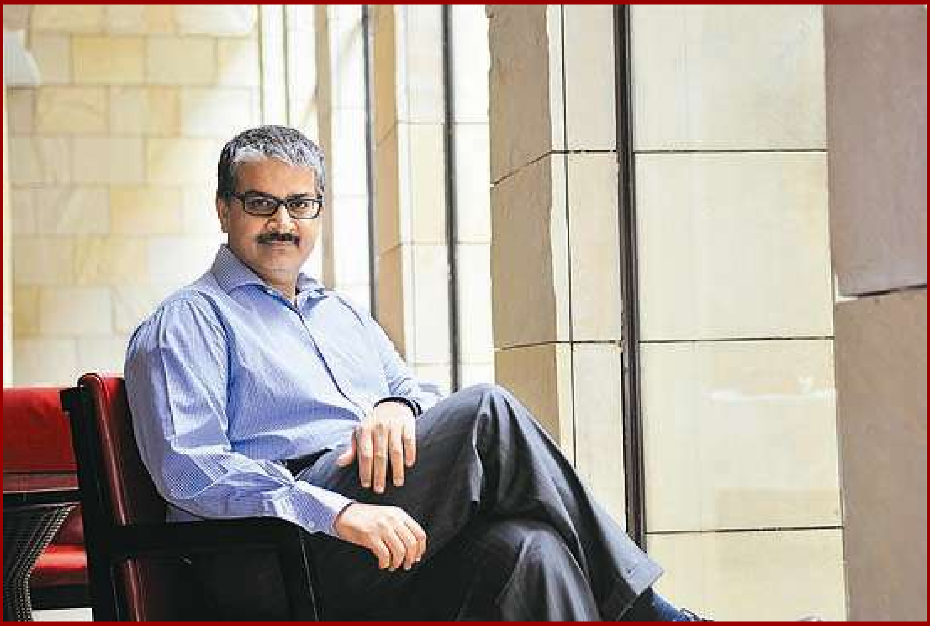
Value Investing

The Sanjay Bakshi Way 2.0



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"We do not inherit the earth from our ancestors.
We borrow it from our children."
~ David Brower

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Value Investing, the Sanjay Bakshi Way 2.0

Safal Niveshak: Let me start with a question I have been waiting to ask you for some time now. Through a comment on a link I shared on Facebook and through a few of your posts over the past few months, you have suggested that your investment philosophy has moved further towards high quality businesses, and great managements. Can you please elaborate on the same? What has been this transition all about? And why?

Prof. Bakshi: I started my career as a value investor in 1994. Over the last twenty years, I have practiced most styles of value investing including as Graham-and-Dodd style of investing in statistical bargains, risk arbitrage, activist investing, bankruptcy workouts, and Warren Buffett style of investing in moats. There have been times when I have owned 40 stocks and times when I have owned just 10.

I teach all these value investing styles in my course at MDI. I tell my students that they need to pick a style which suits their personality.

Some students have a statistical bend of mind and prefer to work with situations that can be evaluated more objectively than others. I tell them to focus on statistical bargains and risk arbitrage. I ask them to practice wide diversification.

Others like to delve deep into the fundamental economics of businesses and are comfortable with dealing with softer issues like quality of management. I ask them to focus on moats and diversify less. It all depends on what you enjoy doing over time and what has worked for you.

I have absolutely enjoyed practicing all these styles of value investing. Over the years, I also learnt a few additional things. One of them was about the idea of **returns per unit of stress**.

You can make a lot of money by being an activist investor, which I've done in the past. But it's stressful. You can make a lot of money by shorting over-valued stocks of companies run by promotional and fraudulent managements. But it's stressful.

You can make a lot of money doing risk arbitrage where you have to monitor — perhaps 20 deals at any given point of time and be ready to react quickly when odds change. But it's stressful.

I found that investing in moats is *not* stressful. It involves a slow and more meaningful understanding of how a business creates value over the very long term. And boy does it work!

I'd argue that if you pick 100 successful value investors who have compounded their capital over the long term (a decade or more) at a very healthy rate, then the vast majority of them would have accomplished that by first investing in high-quality businesses run by great managers at attractive prices, and then by just sitting on them for a long-long time.

Moats are *internal compounding machines*. History shows that you get rich by just sitting on them because they do all the hard work for you. And I realized that over the years. Just as Mr. Buffett did when he too moved from classic Graham-and-Dodd to moats.

Let me give you an example. Many years ago, I co-authored a **paper** on Eicher Motors, which I think your readers would agree is a fantastic company. At the time, in 2008, the stock was selling at a ridiculously low price of Rs 200 per share even though the company had Rs 147 per shares in cash and no debt. That stock now sells at 5,500.

I presented that paper to two investors — both offshore funds. One of them bought it promptly and, over time, Eicher Motors became its best performing position. The other fund bought it too but sold out in less than a year when the stock went up a bit. So, you get two vastly different outcomes from the same stock. The fund that sold out did not have the patience. The other one did. And the fact that I had much more influence over the one which did not, or perhaps could not, exercise patience at the time, tells us something isn't it?

I learnt a very important lesson from that one. Be patient with great businesses. Let *them* do the hard work for you. Just sit there.

So, a few years ago, I decided to increase my focus on moats. I enjoyed the process (and the proceeds) so much that last year I decided to exclusively focus on moats.

In this decision, apart from my own experience of investing in moats over the last 20 years, I was also influenced by two thoughts from two wise men. One of them was Pat Dorsey, the author of a wonderful **book** on moats. He wrote…

Moats can help you define what is called a "circle of competence." Most investors do better if they limit their investing to an area they know well-financial-services firms, for example, or tech stocks-rather than trying to cast too broad a net. Instead of becoming an expert in a set of industries, why not become an expert in firms with competitive advantages, regardless of what business they are in? You'll limit a vast and unworkable investment universe to a smaller one composed of high-quality firms that you can understand well.

And the other one was none other than Warren Buffett. I read something he had said a few years ago and it made a deep impression on me. He said…

The difference between successful people and very successful people is that very successful people say "no" to almost everything.

Twenty years is a long time to learn the importance of extreme specialization! If you work hard to specialize in a niche, and you keep doing it following a certain **process**, you'll get good at it. It works in sports, it works in medicine and it works in law. It works in investing too.

And it isn't that other styles of value investing won't work. They will, if you focus on them.

I chose moats because I wanted to slow down, and not do too many stressful things. And the fact that investing in moats works beautifully if you only let them do the hard work for you, was a compelling argument too.

Safal Niveshak: While they are very critical, moats are also tough to define. I look back a dozen years and have to think that few would have thought a company like Asian Paints or Titan could have any meaningful competitive advantage. Yet with all its growth, there is no meaningful competition to Asian Paints today. My questions are –

- **Can you give us an example of a sustainable competitive advantage in the current times?**
- **How does an investor know whether a moat is sustainable or fleeting?**
- **What are the early signs one needs to look for to identify eroding moats?**

Prof. Bakshi: Actually, *defining* a moat is the *easy* part of the problem. The *tough* part of the problem is to get good answers to four questions:

1. How big and wide is the moat?
2. How enduring is it?
3. Can inept or corrupt management impair your ability to make a good return by owning this business for a long time?
4. How much money you will make by buying it now and holding on to it for a decade or more?

First the *easy* part. Many investors simply look for *quantitative* evidence of a moat relying on the wisdom of these words of Warren Buffett…

A good moat should produce good returns on invested capital. Anybody who says that they have a wonderful business that's earning a lousy return on invested capital has got a different yardstick than we do.

So far so good. But then the investors ignore businesses which may be earning a mediocre return right now but are on their way to earn superior, sustainable returns ("emerging moats").

Investors also don't bother asking the remaining three questions. Instead, they implicitly assume that the moat is an enduring one, management really doesn't matter, and nor does valuation. Those are *big* mistakes in my view.

So your question as to whether a moat is sustainable or fleeting is a very intelligent one.

I tried to answer those questions in a series of lectures on **Relaxo Footwear** which was a case in my MDI course which got over in January.

Relaxo earns a pre-tax ROE of more than 35% a year so there is evidence of moat, but the remaining questions still need to be answered. Using Michael Porter's framework on competitive advantage, we can think about the resilience of a moat from five perspectives –

1. Intensity of competition amongst existing players in the industry;
2. Threat of new entrants;
3. Threat of Substitute Products or Services;
4. Bargaining Power of Customers; and
5. Bargaining Power of Suppliers

I think it's *very* important to have these five forces in mind when thinking about *resilience* of moats. In the Relaxo Lectures (I won't go too much into the details) my friend Ravi Purohit and I showed that the structure of the industry meant that the intensity of competition amongst existing players was low.

We also showed that for a new entrant to enter the market and try to dislodge Relaxo from its current competitive position, the competitor would have to be willing to lose large amounts of money for long periods of time.

The threat from substitute products in footwear is quite low. I mean science is unlikely to deliver a new invention which would make it unnecessary for us to wear flip flops, sandals, and shoes, isn't it?

Similarly we showed that the power of the company over its customers and suppliers was increasing and evidence supporting that was visible by studying the company's improvement in gross margin and also because of the reduction in its working capital intensity over time.

The Relaxo Footwear lectures were offered as a template of course. In some businesses the threat from substitute products can be so high that it could turn a moat into a dinosaur in less than a decade.

See, for example what mobile telephony did to MTNL. Indeed the mobile phone has destroyed or is in the process of destroying or at least causing grave harm to entrenched players in many industries like manufacturers of cameras, scanners, flash lights, board games, and stand-alone mapping devices. Similarly the app store at Apple has ruined many a business model.

Disruptive innovations like the mobile phone and the Apple app store often produce new threats from substitute products and services which come from unexpected sources.

While investors are thinking too hard about *other* flashlight manufacturers or *other* camera manufacturers, they often don't successfully anticipate threats from flashlights and cameras built into mobile phones.

Forget investors, even industry insiders don't catch such threat early enough to be able to adapt. They are simply not conditioned to recognize it early.

People who focus on entry barriers (threat from new entrants) alone may forget that increased power of customers and/or suppliers could also significantly impair a company's ability to deliver high returns on invested capital over time. Life for a towel supplier to Wal-Mart who contributes to most of its revenues is unlikely to be a happy one over time. Is that too hard to comprehend?

And that's precisely why you need to have those five forces described by Porter on a checklist on moat investing. Otherwise, you may not remember them. I recall that famous quote from Robert Rubin – *"Condoms aren't completely safe. My friend was wearing one and he got hit by a bus."*

Risk in world of business too could come from sources you cannot imagine, so having a checklist to help you remember the multiple sources of risk to moats is a good idea for moat investors.

You need to ask yourself questions about how any or all of those Porter's five forces could destroy or impair the moat you love so much right now.

And you need to do it regularly. You need to be *aware* of those forces almost at a subconscious level to be able to evaluate the resilience of a moat.

So there has to be a moat checklist and those five forces form part of that checklist. And you have to keep going back to it and modify it over time as you gain experience.

As Mr. Buffett often says, a moat around a business castle is either constantly improving or eroding.

You ask: How do you get an early warning signal of an eroding moat?

Well, it goes back to those five forces of Porter. Is the intensity of competition amongst existing players increasing? If it is then how will you measure it? Wouldn't it show up in reduced margins, increased battle over market share as reflected in slowing sales and/or increased spending on sales and marketing, increased working capital requirements as industry players offer better payment terms to customers and/or suppliers etc.?

A deterioration in the competitive positioning of a business will eventually be reflected in the numbers through:

1. Reduced returns on invested capital; and
2. Deterioration in the quality of its balance sheet.

But well before that happens, you should be able to pick up enough clues.

You're really looking for clues and patterns like Sherlock Holmes did. I think every investor should read Peter Bevelin's **book** on how to think like Sherlock Holmes and try to apply the learnings to investing.

Another trick to use is to evaluate the quality of decisions made by management. Are they doing things that will increase the size of the business's moat in the long run or are they doing the reverse?

There are all sorts of business decisions which the management can take that will *increase* the size of moat of a business over time but will also *reduce* its near term earnings. And many managers *hate* those tradeoffs because their own compensation is based on the delivery of high near term earnings.

The presence of perverse incentives results in perverse outcomes. But if you want to change behavior, as Charlie Munger often says, change the incentives. Notice, for example, how changes in incentives by a new owner are resulting in delivery of high operating cash flow at Thomas Cook.

I think it's also important for investors to recognize that in a few businesses:

1. Economic earnings *exceed* reported earnings and it's the economic earnings that really count; and

2. Management focusses on growth in per-share intrinsic business value and not immediately reportable earnings.

Investors should *seek* such businesses for obvious reasons.

Safal Niveshak: In an Outlook article last year, you wrote about paying up for businesses with sustainable moats, like Nestle. My questions are:

- **When is a company with sustainable moat attractive, and when it is not?**
- **How to your differentiate between "paying up" and "overpaying"…because people can rationalize any price with a behavioral explanation?**
- **If you find such a stock, when will you sell it?**

Prof. Bakshi: That point about Nestle was perhaps one of the most mis-understood points in my writings and talks!

I wasn't recommending Nestle at *any* price. I was demonstrating that long-term returns for investors who bought it in the past at prices which many value investors would consider to be expensive were exceptionally good. I wasn't talking about the future. I was talking about what factually happened in the past.

The idea was to provide one data point (and there are many others as well) as strong disconfirming evidence against associating “expensive” with seemingly “high P/E” multiples.

I wanted investors to de-anchor themselves from earnings multiples based on recent earnings and reported earnings.

Most value investors understand that leaving the question of price aside, businesses with enduring moats are more attractive as investments than commodity-type businesses which have no low-cost advantages.

I think that point is easy to get. But not-so-easy point to get is that businesses with enduring moats are more attractive as investments than those which don’t have enduring moats *even at relatively higher prices in relation to assets, recent earnings and cash flows.*

In my view, a business with an enduring moat is attractive when:

1. It’s run by an able manager who possesses strong operating and capital allocation skills; and
2. It’s priced such that the expected return of acquiring and holding an interest in it for a decade or more is very attractive as compared to other alternatives available to you.

I think it's important for investors to think in terms of *expected returns* instead of fuzzy concepts like *intrinsic value* even though they may be functionally equivalent.

There are, in my view, significant advantages of thinking in terms of "How much money am I going to make in this business over time?" over "What's the discount to intrinsic business value?" The answer to the first question is what really matters isn't it? Then why try to answer it indirectly?

And the beauty about investing in moats is that you think about expected returns *after* the business passes your business and management quality checks. That means that if you have no idea what the earnings of a business would look like a decade from now and whether or not those earnings will still be growing or not even after ten years, you should not invest in that business.

So the business quality checklist will eliminate a huge number of possible businesses to evaluate. This is what I believe Mr. Buffett meant when he talked about "circle of competence."

Next, the management quality checklist would eliminate many more businesses from consideration. That would leave a handful of businesses which you would like and know pretty well and about which you'd have the ability to estimate a range of expected returns over a decade or more.

Now imagine you had done that exercise and come up with expected returns for about 20 stocks over the next decade. Which ones would be rational to include in your portfolio? And which ones should you *not* include in your portfolio regardless of how much you like the business and management?

Well, I propose that you use AAA bond yield as a benchmark. You may use long-term historical Nifty returns too if you prefer but I use AAA bond yield, which, at this time is about 10% pretax.

Imagine that there are a few stocks in your “investible universe” whose upper estimate of expected return is *less* than AAA bond yield. Would it be rational to own it? Of course not!

Why would you even want to invest in a business where you couldn’t even get a return above AAA bond return? This kind of thinking helps you in cutting down the list further by eliminating stocks which offer sub-par expected returns.

Once you’ve eliminated those stocks, then you could simply rank the remaining ones in descending order of expected returns and then allocate capital based on your conviction (as expressed in terms of expected return) keeping in mind the need to diversify into multiple names as well as other portfolio construction considerations dealing with limiting “aggregation of risk.”

Let’s say you decide to own just 10 names (and it could be 15 or 20 as well and I am not going to get into that debate). Then you’d know which ones to include in the portfolio and which ones to not include in the portfolio. You’d prefer the 10th one over the 11th one because it offers a higher expected return.

If you then stick to your policy of never having more than 10 names then you’d know which ones to kick out and which ones to keep in the portfolio. You’d be forced to take actions that maximize the expected return of the portfolio over a decade by making ideas you love compete with each other without ignoring other considerations relating to aggregation of risk and the need to diversify. And if you did it properly, you’d get quite unemotional about it over time.

So, in my view, thinking in terms of expected returns helps you to choose which stocks to buy and which ones to not buy. It helps you in position sizing. It helps you determine when to not buy and just hold a position. And it tells you when to sell and replace it with something better.

So, conceptually it’s a good idea, no? But there are “behavioral issues” in using a computer model while estimating expected returns. Richard Feynman was aware of the behavioral problem in using computer models when he said:

There is a computer disease that anybody who works with computers knows about. It's a very serious disease and it interferes completely with the work. The trouble with computers is that you 'play' with them!

There are tricks to deal with the "behavioral issues" relating to this approach. One trick I use is to keep expected return calculation hidden while I am working on an opportunity.

I think it's very dangerous to see that number *before* you've finished your work which involves careful thinking about various variables including business volume growth, realization growth, profitability, potential equity dilution, dividend policy, capital structure related issues and earnings multiple expansion/contraction.

Only *after* I have done my thinking about these points and have defined my ranges, the expected return numbers should be viewed. And once they are viewed they won't be changed at that time.

The decision to invest or not invest would be based on that number. That number, of course, is subject to change later in light of new developments such as changes in fundamentals and/or stock prices or simply the passage of time.

There are other ways of dealing with "behavioral issues" in evaluating businesses with a lot of uncertainty but they usually don't end up in moat portfolios so I won't comment on them over here.

You ask about when will I sell a moat business. My answer is I'd sell it regardless of price if I determine that the moat not enduring any more, or if I determine that management is no longer both competent and honest. And you have to keep making those periodic evaluations to determine if you're happy with the business and the management. Remember Keynes:

When facts change, I change my mind. What do you do Sir?

If the moat is still enduring and I still love the management, then I'd sell it only if I found *something significantly better* in terms of expected returns.

That *something significantly better* could be another moat business which has also passed the management quality tests and, at its current asking price, offers a significantly better expected return. Or that something significantly better could be cash or bonds which in a bubble market may offer better returns.

Remember that an increase in price, other things remaining the same, implies *lower* future returns. So, while it feels good to see stock prices of existing positions go up, the expected *future* returns decline.

When it comes to moats, you have to be a *reluctant seller.* Logical reasoning has to *snatch them away from you*. At other times, you should let them do the hard work of compounding your capital for you.

Safal Niveshak: Do you believe in 'Quantitative Value Investing', or Magic Formula Investing? The reason I am asking this is because Graham, in a 1976 interview, said: "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities." So, is the extra effort put into deep security analysis, when simple formulas generate equally satisfactory returns, justified?

Prof. Bakshi: I believe in value investing. Period. 😃

There is nothing wrong in "quantitative value investing" or "magic formula investing." If you follow a *process* which works, you'll do fine.

I think the extra effort is worth it not just because there's money in it but also because it's *enjoyable*. So, even if Graham was right and there was more money in an algorithm-based investing model, I would still prefer what I do because I love it. I agree with MasterCard: *"There are some things money can't buy."*

Safal Niveshak: In your story you shared with an MDI alumnus in 2004, you talked about getting enamored with Buffett's letters and Graham's statistical bargain and starting an investment partnership upon your return from LSE. Then you mentioned that, within the next 3 years, you had shrunk it by 40%. My questions are –

- **What were the mistakes/missteps that resulted in such capital erosion?**
- **What were the lessons you learned in the process? (Because this happened after you had gotten fairly familiar with Buffett's and Graham's teachings which is the same stage many of the new investors may find themselves now. So, your thoughts could be valuable lessons for investors starting out now)**
- **How did you tweak your investment process to avoid the repeat in future?**

Prof. Bakshi: This is way back in mid 1990s when I had just started out. I was young and foolish (and now I am just older.)

I under-estimated the importance of management. I bought a large position in a business which I believed had moat characteristics. In the next bear phase its market value fell well below my cost. Then the management took the company private at a small premium to market but at a huge discount to value and also to my cost and I experienced a permanent loss of capital.

There were no SEBI delisting guidelines then to protect me. The intentions of the management were not good. I now *avoid* partnering with such people.

Investors should read **this** document. This is a *public* document published years before problems surfaced in this particular group. Had people read it and learnt about management intentions they would have kept away.

I now have a management quality checklist (which covers operating skills, capital allocation skills and integrity), which keeps getting tweaked over time. Some of it was published **here**.

As an equity investor, you have no say in management. You have no *covenants* to protect you. The *only* protection you have is *avoidance*. I recall Charlie Munger's famous words about sensible lending:

The first chance you have, to avoid a loss from a foolish loan is by refusing to make it; there is no second chance.

I use the same logic when thinking about making long-term bets in moats. The first chance you have, to avoid a loss from investing in a great business run by a fool or a crook is by refusing to invest in it; there is no second chance.

Safal Niveshak: One of the problems that new or small investors have is that they can't really get their heads around valuation. It seems so complex. A lot of the terminology is complex, the concepts are, and there is a lot of contrary thinking needed to effectively value businesses.

How can valuations be made easier? How have you made it easier? Or can it not be made easier?

Prof. Bakshi: Vishal, that particular problem is equally applicable to large investors!

Anyway, over the years I have dealt with the problem in many ways. As a disciple of Ben Graham, when working on any business and not necessarily moats, I developed my own ways of thinking about valuation.

Graham used to talk about *protection vs prediction*. He used to say that investors should seek protection in the form of margin of safety either through conservatively calculated intrinsic value (usually based on asset value) over market price or superior rate of sustainable earnings on price paid for a business vs a passive rate of return on that money.

That approach works well in many businesses as even though their future fundamental performance is largely unpredictable because one is, in effect, underwriting insurance.

Graham's methods helped investors deal with the unpredictability problem in security analysis. For example, when you bought the stock of a company selling below net cash and the operating business was not losing money, then you were effectively getting the business for free. Even if the business may have been mediocre, it was *free*. And the typical Graham-and-Dodd investor absolutely *loves* freebies.

That kind of approach enabled you to justify a purchase because value was more than price even though one did not know by how much. Poor management quality was dealt with through insistence on an even lower price in relation to value.

For Graham, there were no good or bad businesses, only good or bad investments. And that approach can work if you practice wide diversification and buy out-of-favor businesses which are perhaps not doing very well right now but eventually might.

So there was an inherent belief in the idea of mean reversion i.e., poorly performing businesses would improve their performance over time.

In case of predictable businesses with stable cash flows, I used to talk about "debt-capacity bargains" and still teach that concept to my students. That's because I think the idea of "debt capacity" is a very powerful mental construct in valuation.

The basic idea here was that the value of a debt-free business has to be more than its debt capacity. I discussed it in detail in one of my more popular lectures titled "**Vantage Point**" so I won't get into the details here.

Similarly, buying into businesses where pre-tax earnings yield was in excess of twice of AAA bond yield, and the business had a strong balance sheet was one of the key methods of Graham for identifying a bargain security.

If you had a reasonable degree of confidence that average past earning power will return soon and the business had staying power (that's why the insistence on a strong balance sheet), then sooner or later the market will recognize that the stock had been beaten down too much and there would be a more than satisfactory appreciation in its market value.

And even if you go wrong on a few of these positions, because you had so many, things would work out well eventually.

But as you move towards enduring moats, you move towards *predictability* and *higher quality*. In such situations, the need for *protection* in the form of high asset value or high average past earnings in relation to the asking price goes away.

Of course, that does not mean that you don't need a margin of safety any more. Far from it. It's just that the source of that margin of safety now resides in the quality of the business you're buying into, its long-term competitive advantages, its ability to grow its earnings while delivering high returns on incremental capital without need for issuance or new shares or significant debt.

It also comes from the superior ability of the management to create a moat and to do all things necessary which will widen it over time.

Finally, the safety margin comes from buying the business at a valuation that would, in time, prove to be a bargain, even though today it may appear to be expensive to many investors.

It's obvious that the art of making even reasonable estimates of future earning power of businesses a decade or more from now cannot possibly be extended to most businesses.

But I think — and I've learnt this over the years by studying investors like Charlie Munger and Warren Buffett — you can do that for a *handful* of businesses. And as Mr. Munger and Mr. Buffett like to say you don't need very many.

Then, if that's true, and I think it is true, you can reach out reduce the problem to just a handful of variables that will help you come with a range of potential future earnings and market values and from that you can derive a range of long-term expected returns. And I tried to explain that in my final **Relaxo Lecture**.

So, to summarize, if you are going to invest like Ben Graham, then your sources of margin of safety are different than if you invest like Warren Buffett. You just have to be aware of those sources and also of their limitations.

I also strongly feel that when it comes to moats, it makes sense to think in terms of *expected returns* and not fuzzy *intrinsic value*.

What will *not* work is to apply the same methodology to every business.

For example, in my view there is a **way to invest** conservatively in businesses which are likely to experience a great deal of uncertainty. But you simply can't use that approach when dealing with enduring moats. And vice versa.

You need to have multiple models to deal with different situations to avoid the "to-a-man-with-a-hammer-everything-looks-like-a-nail" trap.

Safal Niveshak: Stephen Penman, in his book "*Accounting for Value*" talks about his dislike for the DCF method of valuing stocks. His reasoning is that FCF, the basis for DCF is calculated after reducing capex/investments, even when investments, if directed well, create immense value for companies. His second grudge is against forecasting cash flows for 5-10 years, which he thinks is speculation.

What are your thoughts – good or bad – on DCF? If not DCF, what?

Prof. Bakshi: Prof. Penman's book is an excellent one and I would recommend it to all value investors.

I completely agree with him when he says that standard valuation models use FCF and FCF is not the same as owner earnings. It's the owner earnings that really count. That's the number you've to focus on.

A business may have low FCF but very high owner earnings simply because the business is growing and a big part of operating cash flow is going into growth capex. Or a business may have low FCF because it has low owner earnings in relation to tangible capital employed and the business has to spend a lot of money to replace obsolete plant and machinery.

The difference between these situations is night and day, even though the outcome in both is the same: low FCF.

I think investors should spend a lot of time thinking about owner earnings in a variety of businesses and look for good reasons which explain situations where owner earnings are materially different from reported earnings.

They should ignore FCF as well, except when they are evaluating the firm's need to access outside capital markets to fund growth. That's the only good reason to look at FCF in my view.

Over the years, Mr. Buffett has written extensively about owner earnings in his letters. See, for example, Appendix to his **1986 letter**. There's also very good book on the subject that I like a lot and I would recommend to your readers. It's titled "**It's Earnings That Count**" by Hewitt Heiserman.

DCF has problems of its own of course. Most of them are behavioral. Investors tend to tell stories quite well using DCF. The most popular software for writing fiction isn't Word. It's Excel. 🙂

DCF models must come with standard warning: *Use with extreme care. This may explode in your face.*

Graham recognized that and warned against such behavior. Prof. Penman does the same in his book as well. While it's easy to fool yourself, there are ways to prevent that.

The first one is to limit its usage to only those businesses which have predictable business models.

The second one is to exercise conservatism while predicting future growth rates and profitability.

Third, one can side-step the issue about making predictions far into the future and think in terms of expected returns over a decade or so (no more playing around with terminal growth rates). While doing that, when determining value a decade from now, one must not assume a high P/E multiple.

And fourth, when facts change, you must change your mind. No matter how sure you feel about your predictions, when you encounter evidence that proves that you were over-confident, you must change your conclusions and not look for new reasons to justify your previous, wrong conclusions.

I think it's also a good idea to use the *inversion* principle which involves taking the current market value of the firm and reverse engineer into the implied assumptions and then objectively question those assumptions. Thinking backwards de-biases you.

Safal Niveshak: Last time we met, you talked about a few behavioral biases that affect investors. This time, can you take us through a few mental models outside psychology that "must" form part of an investor's latticework? How does one go about developing such models?

Prof. Bakshi: Of course you have to step outside the world of psychology. One discipline which you've to read is micro-economics.

Micro-economics is not complete without psychology. They complement each other.

Standard micro-economics textbooks, for example, tell you that there comes a point when a business must be shut down (the "**shut down point**").

However, if you read Buffett and psychology, you'll find that in many businesses the shut-down point comes much *earlier*. Buffett explained that beautifully in his essay titled "Shutdown of Textile Operations" in his **1985 letter**.

Studying micro-economics will provide you with several mental models like opportunity cost, pricing power, creative destruction, Gresham's law, comparative advantage, invisible hand, tragedy of the commons, economies and diseconomies of scale, Tobin's Q, specialization and experience curve, and many more.

Within the field of micro-economics, I think you really have to read a lot on competitive advantage. What creates an advantage? What sustains it? What destroys it?

There are many wonderful books you just have to read on the subject to pick up a few very useful models. For example Pat Dorsey's "**The Little Book That Builds Wealth**" is a superbly written book which helps you create a framework around competitive advantages.

Another excellent book which summarizes Porter's ideas on the subject is by Joan Magretta and is titled "**Understanding Michael Porter: The Essential Guide to Competition and Strategy**".

I think that there's a great need to synthesize the ideas of Munger, Buffett and Dorsey on moats and Porter on competitive advantage.

I also loved "**Different: Escaping the Competitive Herd**" by Yongme Moon and "**The Tipping Point**" by Gladwell. And I absolutely loved "**Abundance: The Future is Better Than You Think**" By Peter Diamandis. All these books will make you think.

Books on evolutionary biology (my favorites are "**The Selfish Gene**" and "**The Blind Watchmaker**" by Richard Dawkins) and quantum physics (read "**Taking the Quantum Leap**" by Fred Wolf) will give you some very useful mental models too.

Read "**The Brain That Changes Itself**" by Norman Diodge to learn about the plasticity of the brain and you then use what you learn from that book along with "**One Small Step Can Change Your Life: The Kaizen Way**" by Robert Maurer to learn how the slow contrast effect works on your brain. Read "**Hooked: How to Build Habit-Forming Products**" by Nir Eyal to learn how businesses condition consumers to choose their products subconsciously.

Read "**Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers**" to ignite your mind about a variety of business models.

You can also pick up a lot of mental models by following and reading blogs like **Farnam Street**.

I could go on about acquiring mental models by reading books but I'll stop here!

Read annual reports of companies with a curious mind always asking how, why or why not questions.

How did Shriram Transport Finance create a low-risk business from giving loans to used-truck drivers? How did Symphony Limited learn from its mistakes to become India's most profitable businesses in its industry in less than a decade? Why is Thomas Cook's integrated business model of travel and forex much more profitable than stand-alone forex and stand-alone travel companies?

As Charlie Munger says you just have to read a lot and relate what you read to what you observe, always with a curious mind.

Try to come up with notions or provisional theories which explain whatever you're trying to explain and then look for evidence that supports or destroy those notions. Peter Bevelin, author of a wonderful **book on Sherlock Holmes** would agree. Here are a few quotes from his book.

"Without an idea of how reality works, a purpose, provisional idea of what is important and what to look for, our observation or collection of facts is of little use."

“A hypothesis is…the obligatory starting point of all experimental reasoning. Without it no investigation would be possible, and one would learn nothing: one could only pile up barren observations. To experiment without a preconceived idea is to wonder aimlessly.” (Claude Bernard)

“You have a theory?” “Yes, a provisional one.” (Holmes; The Yellow Face)

“Nothing can be done without preconceived ideas; only there must be the wisdom not to accept their deductions beyond what experiments confirm.” (Louis Pasteur)

Safal Niveshak: Buffett has said “diversification is for the know nothing investor”. Now if I borrow from Jacobi and invert this, I would think “concentration is for the know everything investor”. The question is – Given the regulatory uncertainties and the extremely large pool of shady promoters, would concentration work in the Indian markets?

Prof. Bakshi: The “know everything” investor is also usually an overconfident investor.

My view is that investors, when they start out, should practice wide diversification and move towards concentrated positions only after about a decade of experience and as they move towards concentrated positions, their propensity to take business risk and management risk will go down but their ability to acquire deep knowledge about a handful of businesses with value creating potential will go up.

As for your question about regulatory uncertainties and shady promoters, I invite you to read a very interesting document I read in the early part of my career. Titled "**Recovery Investment**" it describes a British fund which…

…never invested in successful, well managed companies such as Marks and Spencer, Sainsbury's or Shell. The Fund which is called the "Recovery Fund" invests in companies which are experiencing difficulties such as making losses, weak balance sheets, frauds, natural disasters, or a specific industry downturn.

Recovery Fund has been in existence since 1969 and over 26 years till 1994 (when I read the document) compounded capital at 19.9% a year as compared to benchmark return of 13.2% a year.

While I don't practice recovery investment anymore, that doesn't mean it won't work for someone who is *focussed* on turnarounds. When Buffett wrote that "turnarounds seldom turn," he did not imply that they *never* turn.

India has its share (perhaps more than its share) of businesses run by fools or crooks but that fact wouldn't necessarily prevent a creative, thoughtful, and focussed value investor from making money in them. Such a strategy, however, would require wide diversification.

You’re right about concentration. If you want concentrated positions, you don’t want businesses run by fools or crooks in your portfolio.

Safal Niveshak: Seth Klarman and many others (even Buffett) had mentioned that investors with small amounts to invest should look at things that no one is looking at, the ones that slip through the cracks. Where would these areas be in Indian equities? And given the paucity of data and questionable management that could be running these companies, how does one do the due diligence and get comfortable that the data is correct so that we don’t get blindsided?

Prof. Bakshi: That would be micro-caps. And there are a group of very smart value investors in India doing just that.

They buy stocks of obscure and small but rapidly growing companies run by good managements at very low earnings multiples and then see their market values soar over the next few years. Their excellent returns are a direct result of negligible competition as no institutional investor would want to invest in a company with a market cap of Rs 50 cr. Maybe you should interview some of those guys.

I will give you a list after checking with them. Some of them may provide a better answer to your question than I can.

Safal Niveshak: How do you avoid getting caught with your own reasoning? In other words, how do you look into a business from an

outsider/ bystander's point of view without accepting your internal beliefs about the company?

Prof. Bakshi: Well one way to do that is to have a checklist about the business and the management and keep going back to it to verify if the investment thesis is still intact or not.

Nothing is permanent. Moats get impaired. Managements can make big mistakes which destroy the investment thesis. You also need to keep reviewing your estimate of expected long-term return based on the prevailing market price, and if that becomes mediocre for any given stock, perhaps it's time to replace it with another, more promising one.

One great book I recommend on checklists is "**The Investment Checklist**" by Michael Shearn.

Another way is to pay special attention to disconfirming evidence and views of someone you respect who does not agree with you. But it's also important to not end up in a room full of skeptics. In his latest letter Seth Klarman draws a beautiful metaphor between investing and rowing. He writes:

A good investment team is like a crew team – a mix of talents and personalities that come together to produce a result surpassing what any one individual could hope to muster.

You need generalists, but also some specialized knowledge. You need skeptics, but a room full of skeptics would have trouble "getting to yes." You need good negotiators, and people who can reach closure on a great deal when it's offered. You need deliberators and decision-makers. You need contrarians, but sometimes the consensus view is exactly what happens. You need visionaries and number crunchers, outside the box thinkers, and some who can stay within the box when appropriate.

You need those with the arrogance to shout "buy" and "sell" in fast-moving markets, and those with the humility to consider whether they could, in fact, be wrong. Most valuable, of course, are those with multiple skills, those who can occupy different seats, even all the seats, in the boat at different times.

A third way is to conduct post-mortem about your mistakes. And you wouldn't know the quality of your decisions unless you followed the advice of Shane Parrish, the publisher of Farnam Street who talks about the need to keep a "**Decision Journal**." He is overwhelmingly right on that one.

In his monumental book "**Thinking Fast and Slow**" Prof Kahneman talks about Gary Klein's idea of "pre-mortem" which goes one step further than post-mortem. He writes:

The procedure is simple: when the organization has almost come to an important decision but has not formally committed itself, Klein proposes *gathering for a brief session a group of individuals who are knowledgeable about the decision.*

The premise of the session is a short speech: "Imagine that we are a year into the future. We implemented the plan as it now exists. The outcome was a disaster. Please take 5 to 10 minutes to write a brief history of that disaster."

I have to confess, however, that I haven't conducted pre-mortems yet!

Safal Niveshak: In The Intelligent Investor, Ben Graham gives considerable importance to dividends. In contrast, Philip Fisher does not find anything important about dividends. It would be great to have your views on the same.

Prof. Bakshi: What matters is *total return* on the stock over time and *dividends* are a part of that.

If you're investing in non-moat, slow growing businesses, dividends often become quite important. The dividend stream alone may explain a large part of the company's stock price, and so the rest of earnings which are not being paid out may be acquired at a very low multiple.

It's useful to value that dividend stream like a bond and net off the derived value of that bond from the stock price to determine what the market is paying for the rest of the earnings.

When investing in moats, there are three situations:

1. **Non-scalable moats** which won't grow a lot over the years but will pay a large part of earnings as dividends over time (one current example is Noida Toll Bridge Company).

2. **Scalable moats which can take in capital** i.e., the business can grow rapidly but they need incremental capital for that growth and that capital is usually provided by keeping dividend payout ratio low. So long as returns on incremental capital in such situations are excellent, investors should not worry about low dividends. They will make money though capital gains instead. An example of such a business is Relaxo Footwear.

3. **Scalable moats which don't need a lot of capital for growt**h because the business model is asset-light. Such businesses can deliver excellent returns through growing dividends and capital gains. One example is that of Kewal Kiran Clothing which was a **case** in my class last year.

By the way, I am not recommending any of these stocks and cite them only as illustrations.

Personally, I have moved away from non-scalable moats because I apply a filter by asking a simple question: Can this stock become a ten-bagger?

And there is no way a stock can become a ten-bagger in a rational market unless revenues were to grow rapidly over time. So, for me, high dividends in non-scalable moats are not terribly exciting.

When it comes to scalable moats, the relative importance of dividends as part of total return would depend upon whether the business is capital intensive or not. So the correct answer, in my view, is that investors should focus on total return.

Safal Niveshak: Talking about one concern that seems to be on top of most investors' mind – the currency printing worldwide that's creating bubbles all around, especially in equities.

- **How does an investor deal with this uncertainty of these bubbles bursting?**
- **How does one maintain a "DCF frame of mind" when cash is fast losing value?**

Prof. Bakshi: Bubbles are a function of human nature and human nature hasn't changed much since the days of the **South Sea Bubble**.

We're going to see a lot of bubbles over our lifetimes. But that doesn't mean that there won't be opportunities to make money in stocks.

Investors should be cognizant about bubbles in various asset classes (real estate, commodities, equities, gold etc) and position themselves to not be hurt when the bubbles burst.

That, by the way, is one reason why I like moats. Companies that buy commodities and sell brands, for example aren't likely to be hurt by a commodity price bubble occurring or bursting.

If the business has *pricing power*, then if commodity input prices rise, the business has the ability to pass it on to customers without fear of volume decline or loss of market share.

If the bubble bursts, and commodity prices crash, then the business can either pass all of the benefit to customers to drive volume growth or retain some of it for itself.

That's the thing about moats. They are *resilient*. They can withstand shocks way better than other businesses which don't have moats.

The "DCF frame of mind" is a very useful mental construct. After all, if everyone had perfect foresight, there would be no ambiguity about the value of any productive asset. Simply bring back to present value all its future cash flows.

Of course, no one has perfect foresight and one can have limited foresight about just a handful of businesses out there. Even so, the DCF mindset can help investors deal with understanding other less predictable businesses as well.

Markets can oscillate between extreme optimism and pessimism and having the DCF mindset can be really useful for the thoughtful investors. Stock prices often fall to such low levels that the earnings of the next three to four years alone in a business which is certain to last much longer, start explaining almost all of the stock price.

Conversely, sometimes market valuations go to such extremes that even high earnings growth rate for a couple of decades would not produce earnings sufficient enough to justify a future value large enough to make a commitment today. So, having the “DCF frame of mind” is very useful in my view.

You talk about cash fast losing value because of inflation. Cash is a very hard asset to value. Most people think that a Rs 100 note is worth Rs 100, no more and no less. That would be true if the money was in their hands. But the money is not in their hands. It’s in the hands of a company whose stock they own.

In such situations, what’s the cash worth in an inflationary world? The answer depends on what the company does with that cash. The choices are:

1. Deploy it in assets which would earn a much higher return than AAA bond yield net of inflation. Even if the deployment is a bit delayed, the *prospect* of that happening makes that cash worth more than its face value;

2. Deploy it in assets which would earn a return lower than AAA bond yield net of inflation, in which case value is destroyed and the cash should be valued at a discount; and

3. Hoard it and keep it in treasury with no intention of deploying it anywhere, in which case, again value is being destroyed and the cash on the balance sheet is worth less than its book value.

Safal Niveshak: Do you continue to believe in the long-term India story? If yes, why? If not, why not?

Prof. Bakshi: Do I continue to agree with the long-term India story? Not only do I agree, over the last one year, my partner and I have made numerous presentations to global investors in an attempt to convince them to make long-term commitments through Indian public markets.

In our view, global investors mustn't ignore India anymore. Sure, we'd had our Satyams and NSELs but we've also had our Asian Paints and Pidilites. The number of companies that have created enormous long-term wealth in India for their stockholders is large enough to be noticed.

India has many fantastic entrepreneurs who, under very difficult circumstances have been able to compound capital entrusted to them at superlative rates for long time periods. They have done it without cutting corners. And they have done it with a sense of capital stewardship that should remind the global investors about Rose Blumkin of **Nebraska Furniture Mart**.

Like Mrs. Blumkin, many of these entrepreneurs did not get “proper” education in English-speaking schools. Like Mrs. Blumkin, they too can’t articulate their thoughts very well to the global investment community. But boy do they know how to run a business!

They know how to create brands and how to get a sustainable cost advantage. They know how to distribute their products efficiently. They know how to manufacture efficiently. They know how to implement the best management practices. Cost cutting comes as naturally to them as breathing.

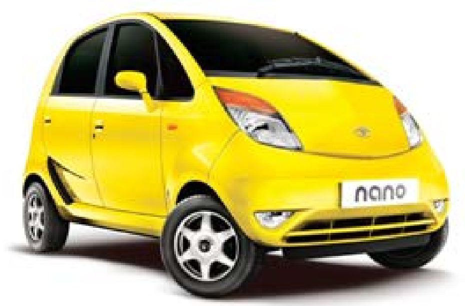
They know how to advertise. They know how to make intelligent capital allocation decisions. They know that “growth for the sake of growth alone is the ideology of a cancerous cell” and they run their businesses for *profitable* growth and not for just taking market share. They know how to focus on long-term value creation and not short-term earnings.

I believe they are the *unsung heroes* of India's capitalism. Partnering with them and showcasing them to the world is something that ought to be done. It's kind of patriotic, isn't it?

And, I am doing it…

Safal Niveshak: Would you tell my readers the Nano vs. Jaguar story that you've created?

Prof. Bakshi: Of course!



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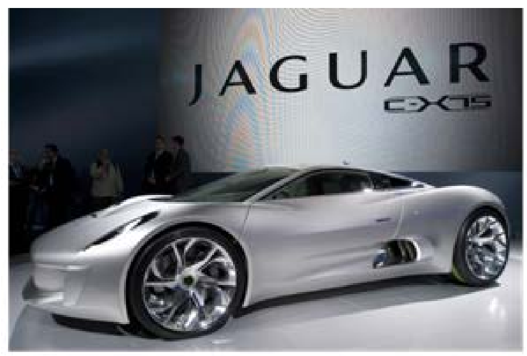

Question: A Nano is about to enter into a race with a Jaguar. Because the faster of the two is Jaguar, to create a "level playing field," the race organizers decide to give Nano an advantage.

They do this by allowing it to start the race 5 km ahead of Jaguar. Which car will win the race when both are allowed to go at their top speeds? Think before reading further!

Answer: It depends on how far is the finishing line.

A scalable commodity-type business without a moat is like the Nano. While it have an advantage of a “cheap” price in the form of a low P/E or P/B multiple, it’s “engine” sputters quite a bit and may die rather unexpectedly. Nano is not going to win a long race against Jaguar.

On the other hand, a scalable moat business is like the Jaguar. The disadvantage it suffers from is the “high” P/E and P/B multiple one has to pay to get into its driver’s seat. In long races, this disadvantage doesn’t prevent Jaguar from beating the shit out of Nano but in very short races, Nano wins.

The moral of the story is this: If you’re going to be making truly long-term bets, you should buy Jaguars. But you should also ensure that they are not too far behind Nanos when the race starts. Because, if they are too far behind, then it will be very difficult for Jaguars to catch up.

Investors should recognize that when they buy poor businesses (Nanos) at below book value, then while their original investment may have been made on a bargain basis, every successive investment made by them in the business through earnings retention happens at book value. That’s because earnings retention is functionally equivalent to a dividend payout of 100% of earnings immediately followed by a proportionate, compulsory rights issue at book value.

In contrast, when investors buy great businesses (Jaguars) at above book value, then while their original investment may look expensive (and often turns out to be too expensive), every successive investment made by them in the business through earnings retention happens at book value.

Over time, the aggregate earnings retention by a business since its acquisition will start mattering more than its purchase price. In poor businesses, it would hurt. In good ones, it would help.

To illustrate, in the short-run, the stock of a poorly run bank which earns a ROE of only 10% a year bought at 0.5 times book value may outperform the stock of a brilliantly run and highly profitable NBFC (ROE of 25%) acquired at 2 times book value. But in the long run, the NBFC will almost always outperform the bank (assuming the qualities of both businesses remain unchanged).

Safal Niveshak: Amidst the rigours of daily life, small investors often find it difficult to devote much time to reading, which is so essential to develop the right investing mindset. So if you were to suggest them just 3-5 books or resources that can provide them 80-100% of their learning, which ones would those be?

Prof. Bakshi: You should read 3-5 books in a month! And if you don't get time to read, then pick some tricks from **here** written by a friend who reads 3-5 books in a week!

But if you put a gun on my head, then I would advise investors to buy a Kindle and then buy all the **letters of Warren Buffett** *(Vishal – You can also download PDF of his 1957-2012 letters from* ***here****)*. They cost just US$ 2.76 (Rs 180) and in my view there is nothing better out there.

Why on Kindle? Because you get access to them all the time. You could be waiting at a traffic crossing in your car waiting for the light to turn green and while you're doing that you could pick a random passage or two and learn something useful.

Before you sleep at night, you could read a few more passages and then by the time you wake up the ideas you read about would get "fused" in your brain because your mind would be thinking about what you read even when you slept. This works for me. It really does!

Read just that one book slowly and you'll become wiser.

I also recommend:

- **The Investment Checklist** by Michael Shearn;
- **The Little Book That Builds Wealth** by Pat Dorsey;
- **Understanding Michael Porter: The Essential Guide to Competition and Strategy** by Joan Magretta; and
- **It's Earnings That Count** by Hewitt Heiserman.

Safal Niveshak: Thank you so much Prof. Bakshi! I also thank you on behalf of Safal Niveshak's readers for taking out time from your busy schedule to answer so many important questions on investing and how one can form the right mindset to become a sensible, long-term investor.

Hope to meet you soon. Thank you!

Prof. Bakshi: This was fun. Thanks for your patience. Keep up the good work you're doing. Let's create some really good investors!

Prof. Bakshi's Book Recommendations

Here are a few books Prof. Bakshi has mentioned in this interview:

1. Moats & Competitive Advantages

- The Little Book That Builds Wealth ~ Pat Dorsey
- Understanding Michael Porter: The Essential Guide to Competition and Strategy ~ Joan Magretta

2. Accounting and Valuation

- Accounting for Value ~ Stephen Penman
- It's Earnings That Count ~ Hewitt Heiserman

3. Mental Models – Thinking

- A Few Lessons from Sherlock Holmes ~ Peter Bevelin
- Different: Escaping the Competitive Herd ~ Yongme Moon
- The Tipping Point ~ Malcolm Gladwell
- Abundance: The Future is Better Than You Think ~ Peter Diamandis
- The Brain That Changes Itself ~ Norman Diodge
- One Small Step Can Change Your Life: The Kaizen Way ~ Robert Maurer
- Thinking Fast and Slow ~ Daniel Kahneman

4. Mental Models – Evolutionary Biology

- The Selfish Gene ~ Richard Dawkins
- The Blind Watchmaker ~ Richard Dawkins

5. Mental Models – Quantum Physics

- Taking the Quantum Leap ~ Fred Wolf

6. Others

- Hooked: How to Build Habit-Forming Products ~ Nir Eyal
- Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers ~ Alexander Osterwalder
- The Investment Checklist ~ Michael Shearn
- Berkshire Hathaway Letters to Shareholders

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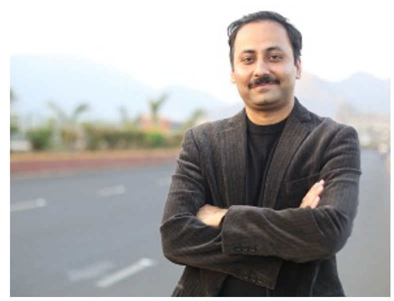
About Safal Niveshak

Safal Niveshak (Hindi phrase for 'successful investor') is a movement to help you, the small investor, become intelligent, independent, and successful in your stock market investing decisions. It's about a new way of thinking about investing that can unleash the smart investor within you, and lead you to prosperity and financial peace of mind.

Who Writes Safal Niveshak?



Safal Niveshak is written by **Vishal Khandelwal**. You can find me on **Facebook** and **Twitter**. I focus on simplifying the art of investing and the causes of human misjudgment when it comes to investing. I also share my experiences as an investor and lessons from some of the greatest investors of all time.

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What Readers Say about Safal Niveshak…

"I am sure that any investor (including experienced ones) in Indian markets would benefit from Vishal's work. I certainly have." ~ ***Prof. Sanjay Bakshi***

*"It means 'Empowerment'. A powerful force that was lying dormant has been unleashed." ~****R K Chandrashekar***

“It is really a treasure trove of information for those who want to utilize the power of equity for wealth creation, for those who are interested in value investing principles, for those who wish to invest on the basis of solid research and not on current fads, rumours or tips from brokers/channels/so-called experts. ~ ***Sanjeev Bhatia***

“Anyone can master the techniques of stock investment and profit from them by following Vishal’s posts regularly.” ~ ***Manish Sharma***

“Safal Niveshak’s simplicity has stunned me.” ~ ***Jayant Nikam***

“…plain speak, no-nonsense view about investing.” ~ ***Indranil Maitra***

“I felt this is my blog.” ~ ***Hari Kumar***

“Vishal’s passion to teach Value Investing is contagious and his informal yet definitive style of teaching is par excellence.” ~ ***Gautamjit Singh***

“…selfless service to the small investor.” ~ ***Samson Francis***

“I have gone through 100s of sites and 1000s of blogs and finally i have found my home. Thank you for this experience!” ~ ***Harshad Parulekar***