Safal Niveshak's

VALUE INVESTING ALMANACK

Wit and Wisdom on Value Investing

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Spotlight: Investing During Uncertainty

If you have chosen to invest money in stock market, accept the fact that there will be times of uncertainty with no clear visibility into near future. Since you can't predict what tomorrow will bring, you must be prepared for whatever it does. If you can't stomach that, perhaps you shouldn't be in the stock market at all.

There's no question about the fact that it's harder to see the future than the present. But the quest for certainty and longing to know the future is an old human endeavour. For centuries, people have been misled by looking for certainties where none existed.

Uncertainty creates acute mental discomfort and there are evolutionary reasons behind it. Before agricultural revolution, homo sapiens lived as hunter-gatherers. In the absence of steady food supply and the constant threat of wild animals, evolution hardwired human brain to resolve uncertainties about its environment. Agricultural revolution resolved the uncertainties about food and danger but opened up new avenues like diseases, famine, and natural calamities. The way the human race has dealt with these problems was to seek answers from authority figures.

Until 500 years back, before the scientific revolution started unfolding the layers that were hiding the secrets of nature, this thirst for certainty was quenched by religion and collective myths. Religion and its CEOs (priests, pope, godmen etc.), who claimed to have a direct connection with God, offered all answers to all the important problems. So, this tendency to equate *knowledge* with *certainty* is an old habit. As technology advanced, it gave birth to methods and tools where it became possible to remove a certain class of randomness from human life, like having more control over deadly diseases and adequate supply of food. Today, modern technologies, from mathematical stock prediction methods to medical imaging machines, have made us more confident about many unpredictable things.

We may have mastered the uncertainty of basic things like where will the next meal come from, or will I be able to survive the next seasonal flu or epidemic, but as scientific progress has pushed us forward, it has also brought extreme complexity in our environment.

If a medieval king in 700 A.D. went to sleep and woke up in 1000 A.D., he wouldn't have found much difference in the world around him. But if a farmer went to sleep in 1700 A.D. and woke up 300 years later in the year 2000, he probably would find himself on a totally different planet.

The half-life of businesses is going down rapidly. Today, a billion-dollar business can completely disappear in less than a decade. The instant availability of information has introduced extreme efficiency in the systems around us. But an easy and constant flow of information has amplified the noise too. The noise doesn't come alone. It brings with it healthy doses of uncertainty. Despite knowing that uncertainty is a norm today, the basic human urge to seek certainty can't be suppressed completely. In the stock market, this primal need for visibility into future results in extreme anxiety. Investing requires us to deal with the future. If the future were knowable by all, investing would be neither challenging nor profitable.

But knowing that businesses are fragile, the fluctuations in stock market prices is hard to ignore. This widespread anxiety about uncertainty ensures that astrologers, crystal ball gazers, and stock market forecasters thrive during uncertain times. Their confidence in their abilities to forecast the future acts like a magic pill. Their prescription is always about doing *something*. Buy, Sell, or at least stay glued to TV channels. In fact, if you think about it, the real cause of worry isn't uncertainty. It's the risk.

It's the Risk, Stupid!

Risk doesn't always equal *uncertainty*. It's a very crucial distinction, the difference between risk and uncertainty, that confuses most investors. Uncertainty is having a possible range of future outcomes because of a present event. Risk is when one of those outcomes possesses a serious threat to your financial net worth. One of the clearest and most accurate definition of risk is what I heard from Howard Marks. He said, *"Risk means uncertainty about which outcome will occur and about the possibility of loss when the unfavourable ones do."*
Of course, there's much more uncertainty in stocks as compared to bank fixed deposits. And that uncertainty is what makes the stock market look riskier. But the thing that needs to be understood is that you get paid better in stocks not because you assume more risk, but because you are willing to stomach the inherent uncertainty.

Many people don't realise that even past, like future, is uncertain (at least in terms of its utility to predict the future) because whatever happened was just one of the many possibilities. Howard Marks writes –

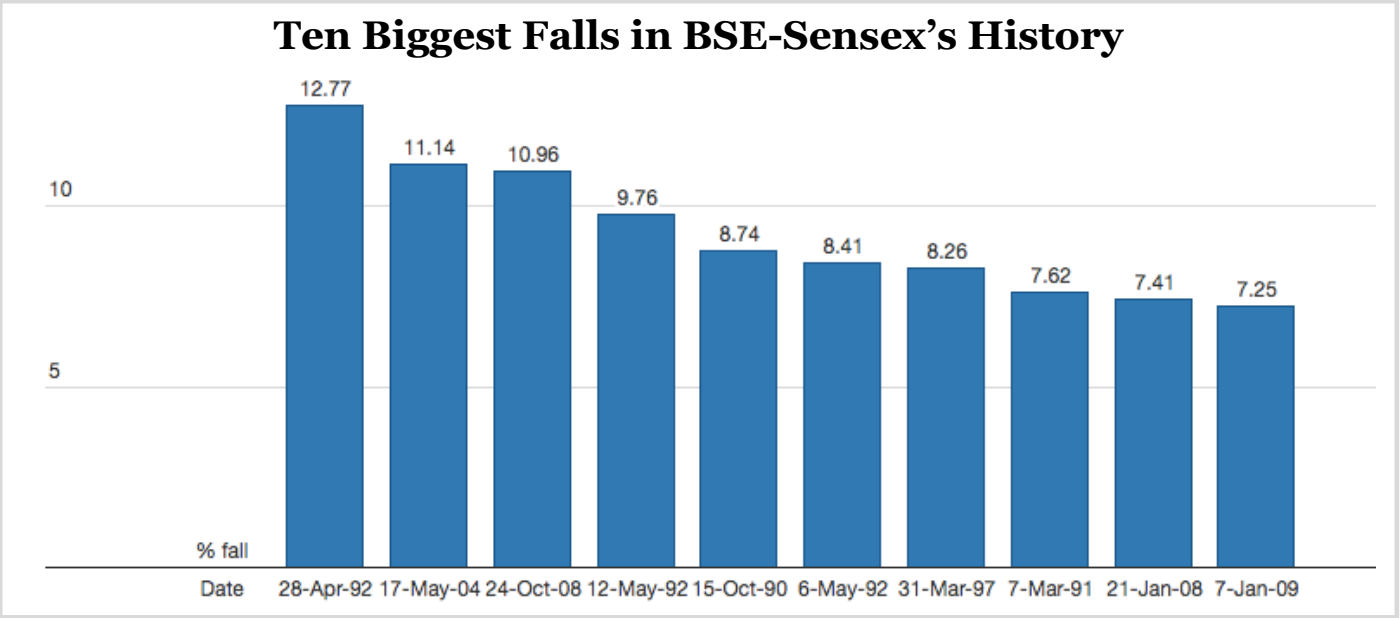
"Most of the people acknowledge the uncertainty that surrounds the future, but they feel that at least the past is known and fixed. After all, the past is history, absolute and unchanging…things that happened are only a small subset of the things that could have happened. Thus, the fact that a stratagem or action worked - under the circumstances that unfolded - doesn't necessarily prove the decision behind it was wise."

How to Deal with Uncertainty?

The first trick is to accept that uncertainty is an inseparable part of this universe. It starts at the quantum level. Quantum physics says that even the behaviour of subatomic particles, like an electron, is uncertain.

Quantum theory states that you can't measure both the speed and location of an electron at the same time. If you measure one, the other becomes uncertain. And this is not because of the limitation of the measuring instruments or lack of technology. It's an objective truth. And despite this lowest level uncertainty, the universe on higher levels seem to behave quite predictably in many areas e.g. the laws of gravity. There is no uncertainty about planetary movements and their locations. So, if you have chosen to invest money in stock market, accept the fact that there will be times of uncertainty with no clear visibility into near future. Since you can't predict what tomorrow will bring, you must be prepared for whatever it does. If you can't stomach that, perhaps you shouldn't be in the stock market at all.

A wise man once said, "God grant me the serenity to accept the things I cannot change, the courage to change the things I can and the wisdom to know the difference." Well, that quote contains an important clue about stock market uncertainty. Once you have accepted that uncertainty is inevitable, the second trick to deal with



it is to understand where uncertainty can or can't be controlled. Once you have developed the mental toughness to weather the uncertainty, the next step is to realise that uncertainty brings a lot of opportunities.

Whenever there's a news about a significant political event or economic policy, markets react to it. In such situations, most investors, including big institutional investors, pull out their investments arguing, "We're going to wait until the dust settles and the clouds of uncertainty clear out." Of course, what they mean is that they're frightened and don't understand the businesses they own.

Do you see the paradox in this strategy? By the time the dust has settled and the clouds have cleared out, there won't be any bargains left. So, uncertainty brings two kinds of opportunity. Firstly, it gives you a chance to practice patience and build your equanimity muscle i.e., keeping calm and being unruffled by the raging storm of panic and irrationality around. Jason Zweig, in his recent article titled "Do You Really Have the Stamina to Be Wealthy?", wrote -

"Between September 1929 and June 1932, the stock market lost more than 83% even after annual dividends as high as 6%. Losses nearly as severe came in 1973-74 and in 2000-02. And sooner or later, they will again. Cultivate your patience now; one of these days, you will need it."

Second, it throws up attractive bargains in the stock market, provided you have done your homework beforehand and have a watch list of great businesses ready. If any of those businesses have become cheaper than your estimate of fair value, back up your truck.

In his 2010 letter to shareholders, Warren Buffett wrote – *"Commentators today often talk of "great uncertainty." But think back, for example, to December 6, 1941, October 18, 1987 and September 10, 2001. No matter how serene today may be, tomorrow is always uncertain. Don't let that reality spook you. Throughout my lifetime, politicians and pundits have constantly moaned about terrifying problems facing America. Yet our citizens now live an astonishing six times better than when I was born. The prophets of doom have overlooked the all-important factor that is certain: Human potential is far from exhausted, and the American system for unleashing that potential — a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War — remains alive and effective."*

What about the Indian stock market? Have a look at the above chart which shows the ten biggest falls in Sensex's history. The worst one (12.7 percent) was at the time of Harshad Mehta scam in 1992. The time immediately after these corrections was considered most uncertain. Quite a few businesses did get wiped out, but if you have even a basic understanding of analysing businesses, it would have been obvious that most of those businesses were sitting ducks waiting to be slaughtered. On the other hand, quality businesses run by able and honest managements weathered the storm and created huge wealth for people who chose to stay put.

Whether it's Brexit, Trump or demonetization, uncertainty will always find an excuse to present itself in some form. And during these times, Mr. Market will throw away the baby with the bathwater. Bigger the uncertainty, more the number of babies.

Warren Buffett's statement is applicable in India also. Irrespective of what happens in the short-term, over the long-term, our country is going to grow economically. Which means businesses will grow and the stock market will show an upward trend. Just like lower level uncertainty in quantum physics doesn't affect the higher-level law, the short-term uncertainty and volatility aren't going to make a dent in the long-term prospects of our country and its resilient businesses.

Behaviouronomics: Diderot Effect

Obtaining a new possession often creates a spiral of consumption which leads you to acquire more new things. As a result, we end up buying things that our previous selves never needed to feel happy or fulfilled.

The manager of a superstore came to know that one of his salesmen sold stuff worth Rs 1 crore to a customer on a single day. He got curious and called the salesman in his office.

"How on earth did you manage to sell so much to a single customer?" asked the manager.

"Well, sir, the guy wanted to buy a smartphone so I showed a mobile that could function as a TV remote also. He liked the idea but he didn't have a TV at home so I sold him a wide screen TV also. Then I suggested to him that a TV without home theatre would be useless so he bought that also. Of course, a wide screen TV and home theatre wouldn't be of much use without an HD cable connection so he took that too. Then I explained to him how cool it would be to connect his TV to his home security system. He agreed and bought our latest state of the art home security system. The security system came with free gift vouchers. To use those vouchers I took him to our furniture store and he picked up a premium TV cabinet. Since his living room wasn't big enough for the TV cabinet, we went down to our real estate department and he ended up booking a new house."

"Wait a minute! So, you're telling me that you sold a house to a guy who just came in to buy a smartphone?" the manager asked.

"No sir, he just came in asking directions to the nearest bus stop. I told him that if he had a good smartphone, he would never have to ask directions again," explained the salesman. "And he's going to come back next week when he moves into his new house since a living room with just a TV cabinet will look quite awkward. Isn't it?"

Well, the anecdote is a good joke among sales professionals but it contains a cautionary message for common consumers like us. When this salesman's customer bought that unneeded smartphone, it was the beginning of what's known as *Diderot Effect*. As you can see that all his purchases were impulse buying. These reactive purchases have become known as the Diderot Effect.

No doubt the salesman deserves some credit for nudging the poor customer throughout the buying spree, but these days you don't even need a salesman to do that. In the era of online shopping, the e-commerce recommendations are doing a job thousand times better than any salesman could ever do.

Diderot Effect

The Diderot Effect states that obtaining a new possession often creates a spiral of consumption which leads you to acquire more new things. Thus, we end up buying things that our previous selves never needed to feel happy or fulfilled. This behavioural anomaly is named after 18th-century French philosopher Denis Diderot, who first described the effect in an essay.

He tells how the gift of a beautiful robe sent him down into debt –

Initially pleased with the gift, Diderot came to rue his new garment. Compared to his elegant new dressing gown, the rest of his possessions began to seem tawdry and he became dissatisfied that they did not live up to the elegance and style of his new possession. He replaced his old straw chair, for example, with an armchair covered in Moroccan leather; his old desk was replaced with an expensive new writing table; his formerly beloved prints were replaced with more costly prints, and so on. "I was absolute master of my old dressing gown," Diderot writes, "but I have become a slave to my new one ... Beware of the contamination of sudden wealth. The poor man may take his ease without thinking of appearances, but the rich man is always under a strain." (Source: Wikipedia)

Notice Diderot's warning: "Beware of the contamination of sudden wealth." The expensive robe, which Diderot neither needed nor desired, changed the way he thought about himself. Which soon led to harmful buying patterns.

Disposable Income is a Misnomer

For the previous generation, especially the middle class in India, the whole idea of disposable income didn't exist at all. Whatever was earned was barely enough to cover the household expenses. But today the consumer class is known by its disposable income. The difference between income and necessary expenses, which ideally should be called as savings, has this new fancy name – disposable income. As if it's meant to be disposed of like waste. And this has resulted in the culture of hyper-consumerism. Today a large part of consumer spending is driven by things that people don't need.

In fact, consumerism is the result of a modern myth called economic growth. The word "myth" shouldn't be interpreted in a negative sense but it's a fact that every economy in the world collectively imagines that the answer to all the woes of society is economic growth. The relentless pursuit of this capitalist myth, at the individual level, translates to consumerism.

Yuval Harari, in his brilliant book Sapiens (which we have reviewed in this issue), writes –

"The modern capitalist economy must constantly increase production if it is to survive, like a shark that must swim or suffocate. Yet it's not enough just to produce. Somebody must also buy the products, or industrialists and investors alike will go bust. To prevent this catastrophe and to make sure that people will always buy whatever new stuff industry produces, a new kind of ethic appeared: consumerism...Consumerism sees the consumption of ever more products and services as a positive thing. It encourages people to treat themselves, spoil themselves, and even kill themselves slowly by over consumption...Consumerism tells us that in order to be happy we must consume as many products and services as possible. If we feel that something is missing or not quite right, then we probably need to buy a product (a car, new clothes, organic food) or a service (housekeeping, relationship therapy, yoga classes). Every television commercial is another little legend about how consuming some product or service will make life better."

Upgrading lifestyle is never ending process and the upgrade doesn't move you forward. It's like trying to climb on an escalator which is going down. That's why it's called the *hedonic treadmill*. There's no end to it. It's a trap.

In Business and Investing

Do you know what's the fastest growing product category for Apple Inc? No, it's not the iPhones, although they still sell like hot cakes. It's not the new Apple watch either. iPad? Macbooks? No.

It's the accessories like chargers, connectors, cables, earphones (you can't use a normal 3.5 mm earphone in iPhone 7) etc. One intentional design decision that Apple took for its products was to make them incompatible with any other hardware. So, when you buy one Apple product, it's just the start of ensuing purchases that you'd have to make to keep using it. From a business point of view, it could be a good strategy because you get an ongoing business even after selling the primary product.

And don't forget the whole business of matching accessories and the constant upgrade cycle of software/hardware. In fact, it's ironical that most consumer durable products are turning into FMCG i.e., fast moving consumer goods. The shelf life of electronic goods has come down drastically. Most mobile handsets become outdated in less than one year of their launch. And within two years most of the apps stop supporting your old hardware. You have no choice but to upgrade and then the cycle repeats with the new device.

Diderot's essay was meant to be a warning about consumerism, but, as we have seen above, it can also be a powerful marketing tactic.

In investing, especially in personal finance, Diderot Effect has huge implications. Every rupee that you choose to save and invest, instead of spending, immediately goes to work for your future. Every single paisa in your investment kitty is like a worker toiling hard to ensure a financially secure future for you. Giving in to the temptation of unnecessary consumption is akin to killing your workforce. And thanks to Diderot Effect, getting started on the path of sacrificing your diligent workers can start a chain reaction and soon you find that whole of your army of workers has been massacred by a monster called consumerism.

Fighting the Diderot Effect

The inspiration for this article came from a post by James Clear on his blog. He writes –

"There will never be a level where you will be done wanting things. There is always something to upgrade to...Our natural tendency is to consume more, not less. Given this tendency, I believe that taking active steps to reduce the flow of unquestioned consumption makes our lives better...Personally, my goal is not to reduce life to the fewest amount of things, but to fill it with the optimal amount of things."

Every habit is initiated by a trigger or cue and Diderot Effect is no exception. For the customer of the salesman we talked about at the start of this post, the smartphone was the trigger. For you, it could be the marketing mailer from popular e-commerce website promoting their Christmas or Diwali sale. Even if there's no occasion those frequent reminders from Amazon are extremely tempting but they are the triggers which will start the avalanche of Diderot Effect.

Planning to meet your friends? Skip the shopping mall and sit on a park bench.

You don't have to start from scratch each time you buy something new, suggests Clear, "When you purchase new clothes, look for items that work well with your current wardrobe. When you upgrade to new electronics, get

things that play nicely with your current pieces so you can avoid buying new chargers, adapters, or cables."

Diderot Effect holds the clue to the question, "How should one deal with newly acquired wealth?" In other words, is there an advice for someone who suddenly becomes rich? I recently found an insightful answer to this question in a post written by Nassim Taleb. In his article, Taleb describes how Ed Thorpe, a mathematics professor, author, hedge fund manager, chose to live a stress free and independent life –

Many successful speculators, after their first break in life, get involved in large scale structures, with multiple offices, morning meeting, coffee, corporate intrigues, building more wealth while losing control of their lives. *Not Ed. After the separation from his partners and the closing of his firm, he did not start a new mega-fund. He limited his involvement in managing other people's money. Most other people do reintegrate in the comfort of firms and leverage their reputation by raising monstrous amounts of outside money in order to collect large fees. But such a restraint requires some intuition, some self knowledge.* ***It is vastly less stressful to be independent – and one is never independent when involved in a large structure with powerful clients****...True success is exiting some rat race to modulate one's activities for his peace of mind. Thorp certainly learned a lesson...*

You can detect that the man is in control of his life. This explains why he looked younger on the second time I saw him, in 2016, than he did the first time, in 2005. [Emphasis mine]

Conclusion

Diderot Effect severely afflicts those who are overly concerned about their so called "status" in the society. Someone rightly decoded the meaning of status – it's buying things which you don't need, to impress people whom you don't like, using money which you don't have (debt).

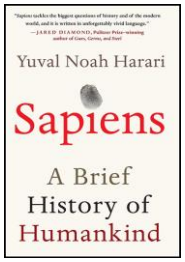
"Let my example teach you a lesson. Poverty has its freedoms; opulence has its obstacles," warned Diderot in his essay.

My take away from Diderot's tale is to exercise caution while acquiring things. The primary purpose of wealth is to give you the independence of pursuing what you love doing. If you forget that, a surplus of money, in no time, can pull you down the whirlpool of mindless consumption.

So, beware of the shiny robe. It could come in any form – a sudden promotion at work, an unexpected profit in stock market, a large inheritance cheque, a lottery. Accept it happily but don't let it become the trigger for financial ruin or loss of mental peace.

BookWorm: Sapiens

The traditional way of learning history in the classroom has always focused on memorising the dates and events. Yuval Harari's book will change that forever. Sapiens provides a sweeping history of human race from 40,000 feet. Harari's observations and insights aren't merely interesting but highly provocative because they will challenge your deepest and dearest assumptions about this world.



The gentleman who taught us history course in school had a strong baritone voice which was in stark contrast to his fragile-looking structure. The only reason I remember him even today is because his voice still echoes in my head. The endless lectures where he would dictate the historical events and we would ferociously note down every single word. I am sure he knew his subject well but never bothered to convince us why studying history was important.

It wasn't until 2015 that I learned the importance of history. And the credit goes to Yuval Noah Harari, who not only made a dry subject very interesting with his unique style of humour and penetrating observation but also because he presents convincing arguments about why one should study history. In his book Sapiens, he writes –

"Unlike physics or economics, history is not a means for making predictions. We study history not to know the future but to widen our horizons, to understand that our present situation is neither natural nor inevitable, and that we consequently have many more possibilities before us than we imagine. For example, studying how Europeans came to dominate Africans enables us to realise that there is nothing natural or inevitable about the racial hierarchy, and that the world might well be arranged differently."

Sapiens was the best book that I read in 2015. And I am not alone in declaring it as the most important book that every knowledge seeker should read. Mark Zuckerberg, Barack Obama, and Bill Gates have openly and strongly recommended Yuval's book.

I guarantee that once you read the book, your worldview about the past, present and future will change dramatically. It's such a rich book that I had to literally stop at every page and marvel at Harari's jaw-dropping insights.

So, without further ado, let's dive into few key ideas discussed in the book.

Species and M&A

Many insights from the field of Biology, especially the Theory of Evolution, have direct implications in investing. But one fascinating insight that I discovered in this book was about how incompatible species produce sterile offsprings.

"Biologists classify organisms into species. Animals are said to belong to the same species if they tend to mate with each other, giving birth to fertile offspring. Horses and donkeys have a recent common ancestor and share many physical traits. But they show little sexual interest in one another. They will mate if induced to do so - but their offspring, called mules, are sterile. Mutations in donkey DNA can therefore never cross over to horses, or vice versa. The two types of animals are consequently considered two distinct species, moving along separate evolutionary paths. By contrast, a bulldog and a spaniel may look very different, but they are members of same species, sharing the same DNA pool. They will happily mate and their puppies will grow up to pair off with other dogs and produce more puppies."

When two companies with different culture and values merge, they end up creating a sterile offspring i.e. an entity which fails to create value for the shareholder. Warren Buffett's Berkshire Hathaway is a brilliant example of how this evolutionary insight can be exploited to create a stronger business. Buffett chooses only those companies which meet his criteria of business quality and management culture. He knows that the future prospects (offspring) of the merged entity will solely depend on the DNA match between Berkshire's culture and the culture of the company being acquired.

With Great Myths Comes Great Power

On the evolution time line, the oldest ancestors of humans first appeared around 2.5 million years back. For next 2 million years, these human-like animals continued to co-exist with millions of other species of other organisms without having any significant impact on the environment. But today homo sapiens rules the planet.

For a long time, historians attributed human dominance to homo sapiens' intelligence and superior abilities, at the individual level. However, the history of human dominance began with cognitive revolution (70,000 years ago) when this obscure species of an ape in the corner of Africa developed cognitive abilities like thinking, remembering, learning, and communicating. With these new abilities, humans started creating and believing in imagined stories, like God and life after death. These myths facilitated large-scale collaboration between strangers and paved the way for human dominance.

Now, humans aren't alone who collaborate in large scale. Social insects like bees also collaborate but they do so in a very rigid manner. They are driven by instincts and DNA hardwiring. There are other animals like Chimpanzees who can collaborate with much more flexibility but only in small numbers. A chimpanzee will only deal with another of its kind if they know each other intimately.

But humans are different. Today we don't have to know a stranger before striking a deal with him or her. Both of us individually believe in some common stories about business ethics, money, economy, etc. And these shared beliefs make our collaboration frictionless. A chimpanzee can't ask for 10 bananas from another chimpanzee in exchange for securing a place in animal heaven.

So, humans live in dual reality. One is the objective reality, like nature i.e., trees, mountains, river, air etc. This objective reality is shrouded by another layer of imagined reality i.e., our myths like nation-state and culture. If you think about it, entities like Google (or any corporation for that matter), or even a country (the idea of a nation state) don't exist in reality. They are stories, created using legal and political rules, which themselves are again shared beliefs.

Money is probably the most powerful myth that exists in the modern world. The basic raw material for making money is human trust. It's especially more true today where most money doesn't get printed much. It's largely electronic data. Two countries may remain in conflict with each other for decades but when it comes to believing in the story of economic growth, another powerful myth, they are in complete agreement. It seems the answer to every problem is economic growth and when this fictional story about economic growth gets translated to an individual level, it becomes consumerism. Similarly, the belief in humanism and basic human rights is a story that almost every country in the world has come to believe, wholeheartedly, in last few centuries.

On one hand, this belief in fictional narrative and myths has rapidly advanced humanity, but on another hand, when these myths differed between large groups of people, it resulted in wars, genocides and concentration camps. So, there are both sides to the coin.

Agriculture – The Greatest Fraud

The agricultural revolution began about 12,000 years ago. It allowed humans society to evolve into more complex structures and lead to cities, kingdoms, temples etc. Agriculture is usually seen as a great leap forward for humankind. And it's true from the vantage point of those sitting on the higher pedestal (the elite and the upper class) because their quality of life, comforts and wealth increased many folds because of organised farming. But if you look at the agricultural revolution from the point of view of an average peasant woman, her life is much worse than an average hunter-gatherer woman.

Harari argues that farming brought long working hours for the hunter-gatherer, led to population explosion, a pampered elite, and a worse diet, along with pestilence, famine, and war. Thousands of years of evolution had brought humans to live as hunter-gatherers. As hunter-gatherers, we were designed to chase rabbits, run away from lions, gather wild berries and dig roots. Agriculture changed our physical activities to digging canals, carrying water and harvesting which our bodies were not meant for. For that matter, the kind of work that we do today i.e., driving, sitting on a chair for long hours, etc. are all against our biological software.

The biggest eye-popping insight that jumped at me was the comparison between agriculture and the modern industrial world. Agriculture was a luxury trap in the same way that people take up demanding jobs in high-powered companies, working hard to make money so that they can retire early. Harari speculates –

"In 8500 BC one could cry bitter tears over the Agricultural Revolution, but it was too late to give up agriculture. Similarly, we may not like capitalism, but we cannot live without it. Much like the Agricultural Revolution, so too the growth of the modern economy might turn out to be a colossal fraud. The human species and the global economy may well keep growing, but many more individuals may live in hunger and want."

The Discovery of Ignorance

The third big revolution of the history is the scientific revolution which began about 500 years ago. This is when homo sapiens began understanding the rules that govern the natural world around it and inside it. This has given so much power to humans, thanks to technology like genetic engineering and computers, that soon they will begin to change the way life evolves.

Contrary to popular beliefs, the scientific revolution isn't a revolution of knowledge. It's a result of homo sapiens discovering and acknowledging its own ignorance. The willingness to admit ignorance has made modern science more dynamic, supple and inquisitive than any previous tradition of knowledge, argues Harari.

Despite all the breakthroughs and advancements, science is unable to set its own priorities. In other words, science has given us immense power but it has failed to provide a convincing answer about what homo sapiens should do with all the newly acquired powers.

"For example, from a purely scientific viewpoint it is unclear what we should do with our increasing understanding of genetics. Should we use this knowledge to cure cancer, to create a race of genetically engineered supermen, or to engineer dairy cows with super-sized udders? It is obvious that a liberal government, a Communist government, a Nazi government and a capitalist business corporation would use the very same scientific discovery for completely different purposes, and there is no scientific reason to prefer one usage over others."

It's speculated that self-driving cars will soon replace almost all the automobiles on the planet. However, when it comes to making an ethical judgment, driverless car technology doesn't have all the answers. If an autonomous car is about to run over 5 people, should it take the decision of taking a sharp swerve and plunge down the cliff, killing its owner? That's an ethical question that no AI can ever answer. Which means science can never exist alone. It needs the assistance of ideology or a religion.

Conclusion

Sapiens is basically an investigation of what impact the three most important events of history, i.e., cognitive, agricultural and scientific revolution, have had on human life, animals, and the environment. However, what makes this book so insightful is the deep philosophical commentary which accompanies the narrative. And Harari's style is so engaging and entertaining that you would never feel for a second that you are reading a book on history. Sample this –

"Medieval nobleman wore colourful robes of gold and silk, and devoted much of their time to attending banquets, carnivals and glamorous tournaments. In comparison, modern CEOs don dreary uniforms called suits that afford them all the panache of a flock of crows, and they have little time for festivities."

Panache of flock of crows! That's so vivid and funny. I wish my history textbooks, back in school, had these nuggets of humour. Reading this book rekindled my interest in history so much that, if I had a time machine, I would go back to history than traveling to the future.

I have covered less than one percent of Sapiens' usefulness above, but I hope I have helped seduce you to read this book for yourself.

InvestorInsights: Kuntal Shah

Kuntal Shah is one of the founding partners of SageOne Investment Advisors and has an opportunistic inclination towards value-oriented and risk-controlled approach to investments. He has been an extremely successful investor over the past two decades and his success has come from exploiting the inefficiencies inherent in the markets.

Kuntal has in-depth understanding of value investing with focus on risk identification and mitigation, emerging trends and opportunities in key growth sectors in India, taxation and accounting. He also loves to teach on these subjects and in the past has lectured at UTI Institute of Capital Markets, IIM (Ahmedabad), IIT (Mumbai), Symbiosis, FLAME and Chartered Accountants Institute. Kuntal is an Electronics Engineer from Pune University.

Safal Niveshak (SN): Could you tell us a little about your background, and how you got interested in value investing?

Kuntal Shah (KS): I was brought up in a middle-class family in Mumbai. I am an engineer by qualification. Early life was a constant struggle to make ends meet for our family of five siblings given our father's limited earnings. I was lucky to be brought up in an environment where there was no compromise on education and was fortunate to be inculcated with middle class working ethos, frugality and conservatism of living within one's means without recourse to borrowing to prepone consumption.

I was always fascinated with the capital markets. Hence, a career in the same seemed like an excellent opportunity to develop a perspective on different businesses and figure out how their fortunes played out in long run and how stock prices got set in the short and long run. The initial phase of your career is spent learning the intricacies but the benefits flow all your life as learning and compounding of capital are both cumulative and a good means to attain financial independence.

On graduation, I joined a reputed electronics company and resigned by evening aware that I was not cut out for an engineering job. I also believed then that the prospects of such a career in India were not too rosy (this was in the era when IT revolution was not underway). Anyways, the very next week, I joined a brokerage firm owned by a friend's father who was kind enough to accommodate a novice. As soon as I started my career there, I was lucky to see my investments multiply in a short span of time along with the broader markets. But as I realized later, that boom was an outcome of diversion of banking funds illegally into the stock market by vested interests, and run up in my stocks was an outcome of a large securities fraud.

Anyways, I erred in not booking profits at the right time when valuation went ballistic. This was because I waited to increase my holding period to longer term to be eligible for long-term tax exemption. In the process, I gave up a significant portion of my gains. I learned the hard way that risking more and more to earn less and less and trying to minimize taxes too much was one of the greatest causes of dumb mistakes in investing. Nowhere does it say that investors should strive to make every percentage of potential profit. Hence considerations of risk must never take a backseat to return.

SN: You mention about the role of luck several times in your above reply, as the same seems to have helped you in your journey over the years. How do you view "luck vs. skill" on a scale? In investing, is it largely luck like Michael Mauboussin writes in his book The Success Equation? What has been your experience?

KS: Rumour has it that a subordinate once asked Napoleon, "What kind of generals do you want?" "I want lucky ones," he replied. I think a healthy mix of luck and skill is required to succeed in investing. You can't get there by relying on either skill or luck alone. You need both. Having stated that investing is a field where the range of skill is wide, the more skilful will succeed at the expense of the less skilful.

When I entered the markets, it was much inefficient and I was less skilled. In fact, I was making more returns with much less skills than I am doing now. With the entry of a lot of talent driven by passion and incentives which the markets offer, these have gotten progressively more and more efficient and participants more skilled. This is one of the lessons of the paradox of skill that with so many skilled participants, the role of luck somehow seems to be increasing as time goes by and competition sets in. Getting better in an absolute sense doesn't matter if it's offset by the competition. Hence one should focus on the process and if the outcome is suboptimal, have the humility to take it in one's stride and get ready to try again with quick acceptance of whatever results appear.

SN: Well, the humility and acceptance you talked about are so important and widely missing. Anyways, tell us about your evolution as an investor and what has been your broad investment philosophy? Has your investment philosophy changed much through the years?

KS: During the first decade of my investing career, I worked with a family office where I honed my understanding of how businesses create value and growth, and how equity markets function over the long term. I was

fortunate in getting early lessons in value investing and yet not pay too heavy a price of this learning.

We ran a two-tiered proprietary book. Let me explain this. A part of our capital was deployed based on an external recommendation by principals of family office, while our small internal group ran a portfolio with four to five securities accounting for the bulk of allocation. Since the capital was unlevered and permanent, there was no chance of us turning to be forced sellers in adverse market condition. We also had the flexibility to withstand temporary market downturns and in fact average on the downside.

I think running concentrated portfolios requires a combination of skill and stability of capital base, attributes that only a select few investors truly possess. For managing external money, combining our best ideas at the top of the portfolio with higher position sizing with number of non-correlated ideas at the bottom of the portfolio with lower allocation has improved both our returns and the reliability of those returns and has helped to soften the lumpiness in performance.

SN: And that has helped you compound capital at a good rate over the long run, right?

KS: Yes Vishal. You see, compound interest was described by Einstein as the eighth wonder of the world. The essence of compounding is captured in the following equation which states that –

Future value = Current value x (1 + rate of interest) ^ Time period of compounding

As applied to value investing, it becomes –

Longevity of growth + High rate of returns + Reasonable price = Wealth creation

Thus, to compound wealth, you need to invest in businesses that are deploying capital at a high rate of returns for a long period and purchase them at reasonable prices. Since the time horizon of compounding at the above average rate of return has an exponential impact on wealth creation, it's better to invest in a business with little lower compounding rate but far higher longevity of growth than in a business with higher compounding rate but lower longevity.

Also, it follows that a long-term investment horizon is an edge in obtaining superior returns as it allows the magic of compounding to work. Time, as Warren Buffett says, is the friend of a wonderful company and the enemy of a mediocre one. As we stand today around 96% of Buffett's fortune was created after his 50th birthday and nearly 90% came after his 60th birthday. (For additional reading refer to Buffett's note on The Joys of Compounding that he covered in his 1963 to 1965 annual letters to clients).

SN: Those letters Buffett wrote in the early part of his career are truly amazing and are a must read for anyone wanting to learn the concept and relevance of long-term compounding. So, thanks for bringing that up.

Anyways, you've mentioned about running concentrated portfolios. What are your views on the argument between concentration and diversification?

KS: While there is no clear answer for this, I believe the nature of capital one manages (long term or short term, permanent or transient, levered or unlevered and more importantly patient or hyperactive capital) must be borne in mind while deciding whether to concentrate or to diversify.

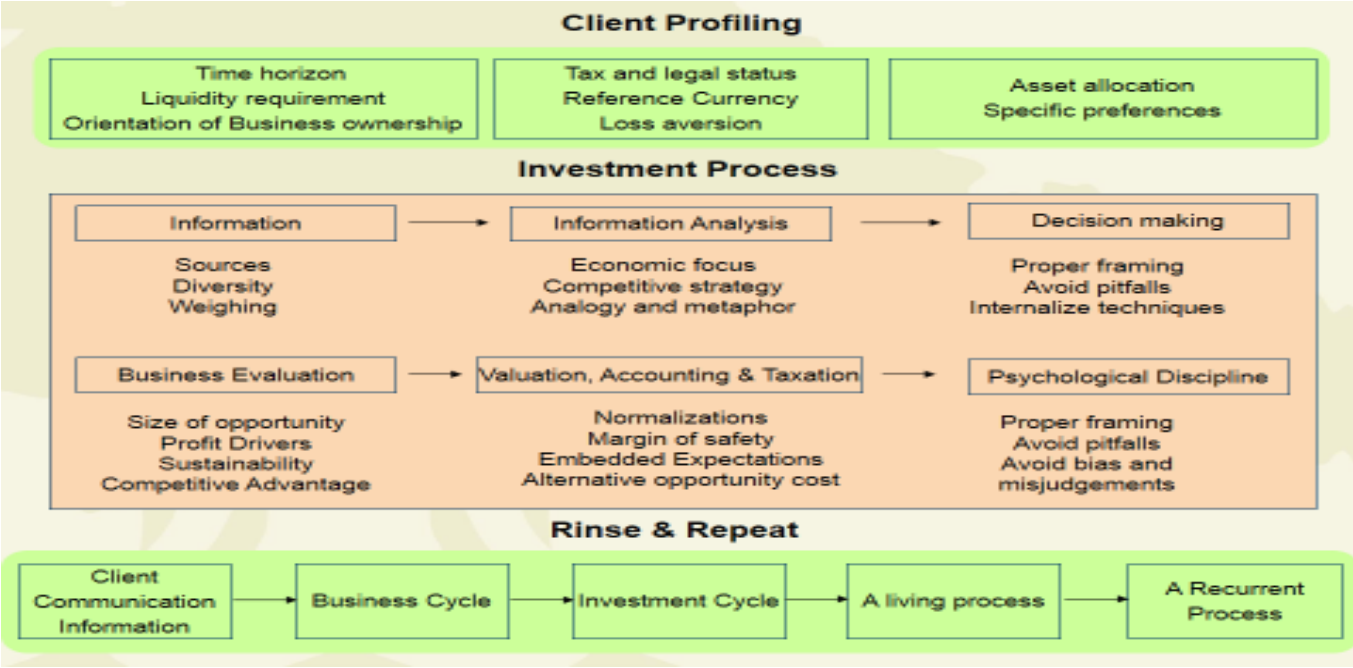
Concentration can be considered if one manages patient and permanent capital with an ability to hold cash and look foolish for an extended period and wait for the fat pitches. Also, concentration can be accompanied with healthy dosage of cash which serves as protection value of keeping portfolio safe during periods of dislocations, and provides optionality of liquidity to invest in bargains after such dislocations. This ability, quite often, is not available to fund managers who get told by investors that they are taking the equity/cash call at their end.

Currently, there is a trend towards over-diversification and passive investing. While it's good for an average investor with little time to devote to managing capital to buy a broad index or seek extreme diversification to get passive market returns, same is not good for an active investor. While there is limited amount of capital which is overtly indexed, there is a great deal of closet indexing or index hugging by fund managers who are so diversified that in effect they own a significant chunk of markets. If you pushed indexing and excessive diversification, you would get preposterous results.

SN: Tell us about your current investment process.

KS: Our investment philosophy is a multi-step process *(see charts on the next page)* with special emphasis on right companies within right sectors, run by right managements with capital allocation and corporate governance in place and available at right prices.

If we must pick outperformers, we must first eliminate underperformers and work with residual ideas. The initial screening process we deploy is pure science whereby based on liquidity, sales and profit growth rates, capital efficiency, we eliminate more than 97% of listed stocks and make our opportunity set more manageable. Otherwise, the sheer size and permutation of options would make the process a daunting task. Needless to say, some good ideas will slip us by in this process but that's the trade-off we are happy to make as we need only a few good businesses to construct our portfolio.


Client Profiling
Time horizon
Liquidity requirement
Orientation of Business ownership
Tax and legal status
Reference Currency
Loss aversion
Asset allocation
Specific preferences
Investment Process
Information
Sources
Diversity
Weighing
Information Analysis
Economic focus
Competitive strategy
Analogy and metaphor
Decision making
Proper framing
Avoid pitfalls
Internalize techniques
Business Evaluation
Size of opportunity
Profit Drivers
Sustainability
Competitive Advantage
Valuation, Accounting & Taxation
Normalizations
Margin of safety
Embedded Expectations
Alternative opportunity cost
Psychological Discipline
Proper framing
Avoid pitfalls
Avoid bias and misjudgements
Rinse & Repeat
Client Communication Information
Business Cycle
Investment Cycle
A living process
A Recurrent Process


Investment Philosophy
Fundamental driven
Superior Businesses
Margin of safety
Asset Allocation
Cash call @ overvaluation
Diversification
Non correlation
Business & Investment Cycle
Risk Budgeting
Screening
Investible Universe
4000 Companies
Liquidity and market cap filters
300 Watch list
Attractive Financials
Sector tailwind
New markets/products
Competent management
150 Focus List
Competitive Analysis
Entry Barriers
Cyclicality
Accounting and Corporate Governance
30 Core List
Active Monitoring
Optimization
Deep fundamental overlay
Downside analysis
Investment decision
Valuation
Capital Allocation: Size
Risk to hypothesis
Diversification
Correlation
Range of outcomes
Portfolio construction & Monitoring
14 to 20 holdings
Weighted by conviction
Less than 15% of portfolio in one stock at entry value
Sell discipline
Disconfirming evidence
Measurement and performance evaluation
Reporting
Process improvement


Universe 4000 Stock
Filter by Market Capitalization & Liquidity
Watch list 300
Sector attractiveness
Growth
Proprietary quantitative screening
Focus list 150
Qualitative overlay
In depth fundamental analysis
Core list 30
Identify drivers & catalysts
Portfolio 14 – 20
Stocks
Valuation
Optimization

SN: Thanks for your laying out your investment philosophy so clearly. Let's now talk about position sizing, which is a critical element of portfolio construction but not much talked about. Would you like to elaborate on how you look at this subject?

KS: Apart from finding a good idea with a high degree of conviction, one needs to maximize the payoff from the same to move the needle in a portfolio. And that can be done only by appropriate position sizing.

Position sizing is directly related to expected returns. As per the Kelly criterion, what drives position sizing are conviction level and degree of certainty derived from an ability to completely understand all aspects of the business especially risk factors, competitive position, valuation, and liquidity. So, if the investor has two ideas with the same expected return, but one is in a highly-leveraged financial company and one is a very stable consumer products company, the investor should allocate substantially more money to the latter because there must be a premium for certainty. What is overlooked by many is that higher the range of possible outcomes at the business level and higher the uncertainty with timelines, lower should be the position size. Then, at a certain wide range it should simply be excluded from the portfolio till the range narrows to reasonable levels. This is needed to guard against the risk-seeking attitude of most investors who are more focused on upside and return potential with lower regards to risk and how much they can lose.

SN: That's true. But how do you take this into account when you are managing such risk-seeking investors' money? I mean, how do you keep yourself sane, especially when dealing with clients with undue expectations?

KS: One of the greatest risks we face when managing other people's money is the risk of having the wrong investors. Hence having a base of intelligent and patient investor clients is very crucial. This is because your best skills could be undone if your clients panic and withdraw capital at the wrong time.

We encourage our investor clients to view stock ownership as fractional ownership of the underlying business and that changes in prices of securities are far unstable than the changes in underlying business fundamentals. We explain that partial ownership of a wonderful business is great means for satisfactory returns over long term, both for the salaried for their retirement planning and for business people for diversification from their core business which accounts for a bulk of their wealth.

Constant pressure to be fully invested, or the possibility of being hit by redemptions in a downturn are permanently damaging to the process of compounding as well our behavior. This risk hinders the ability to invest when markets become irrational. No matter how good our investment process is, even the best investors go through periods of underperformance.

If our partners leave us when our stocks are the cheapest, not only will they be doing themselves a disservice but they will make us a forced seller when in fact we want to be a greedy buyer.

SN: From what you've shared, it seems a real challenge to be a money manager. But how is it during market extremes? Like in situations of euphoria and market crashes?

KS: I think such periods are challenging for all investors. The reason is anything to do with wealth boils down to confidence, greed, and fear. And the pendulum of valuations swinging away from the center all the time isn't going away. It swings from too rich to too cheap, but it never swings halfway and stops. And it never swings halfway and goes back to where it came from. The momentum always is carried to excess on both sides. Reading about history whereby the harder lessons you can learn vicariously rather than through your own hard experience, the better it is for investors and has served us well. George Hegel was right when he said, "We learn from history that we do not learn from history."

Now, there is a misconception that fiat currency without an anchor and prone to central bank printing is responsible for this boom-bust cycle. But one must remember that bubbles, manias, and panics have been frequent across the world amidst diverse economic policies and varied timelines. They have occurred even in centuries when the gold standard prevailed. However, the frequency and magnitude of intervention by central and monetary authorities coupled with innovations in finance have made them more frequent in nature.

SN: What have been the best and worst times in your experience as a money manager? How did you handle, say, a situation line 2008?

KS: The best time was 2001 meltdown, after the dotcom bubble had burst). I had sold most of my stocks during the tech boom, and had sufficient cash to take advantage of the opportunity when several companies were cheaply available. The perfect storm of accelerating GDP, rising productivity and capital efficiency combined with low entry prices resulted in a good set of opportunities across a wide range of sectors.

My worst time in terms of performance was indeed the 2008-09 period. Ironically, we had seen it coming. While it was playing out in the US, Indian markets kept going up. We increased our cash position simply due to inability to find worthy ideas to stay invested at overvaluations witness in 2007. But we didn't realize the magnitude of downside possible and hence, in hindsight, didn't sell adequately.

Liquidity just dried up and small selling by indiscriminate and forced sellers led to a disproportionate decline in

quotations of our portfolio securities. I guess the inability to book profits at time of overvaluation and deploy the same in ensuing downturn was an act of forgone opportunity or a sort of omission on my part as many quality stocks got beaten down to ridiculous lows in the panic that arose. This was the time I became acutely aware that the opportunity set for an investor is not the current one but also range of opportunities that can arise later, given the current state of business cycles and valuations.

SN: What are some of the characteristics you look for in high-quality businesses? What are your key checklist points you consider while searching for such businesses?

KS: Value comes in many forms and there are many ways to skin the cat. All forms of discovery of mispricing, probability, and source of bridging the gap is intelligent investing. If everyone chooses to only invest in a high-quality business, what would happen to businesses not fulfilling the quality parameters? In such a situation, the pari-mutuel nature of markets would at many instances set the prices accordingly.

In his 2007 letter, Buffett described three types of companies – great, good and gruesome. This was based on their ability to generate rate of returns. Now, a company can deliver value in the following manners –

1. Companies that have superior free cash flows which can be used to increase unit volumes, which drives commensurate earnings or expand in related areas or acquire business at reasonable valuations. These companies should have decent return on capital, strong financial and competitive position and able to have decent return on incremental capital much more than nominal GDP growth rates. The valuation of such companies is very sensitive to changes in growth.

2. Companies that have significant free cash flows from operations and can return the surplus unencumbered cash to shareholders in a cash efficient form namely dividends when shares are not undervalued and via buyback when they are undervalued as compared to their future prospects.

However, in addition to these two sources of value creation from free cash flows and high ROE earnings, there are two other sources of value creation via monetization of asset and having access to capital markets on favourable terms.

3. Companies that choose to enhance the value of assets acquired at historical prices by corporate actions, which involve repositioning assets to higher uses, better financing of asset acquisitions, the refinancing of liabilities or both; and the creation of tax advantages. These companies can do so via M&As, leveraged buyouts or gearing to a healthy level by cheaper debt, spin-offs, and asset sales. Equity ownership is residual claim not only on earnings but also on assets of a company and repositioning of assets for better usage can create value.

4. Another source of ignored value is access to capital markets (debt and equity) at super-attractive terms and prices. There seems little question that far more corporate wealth has been created by taking advantage of attractive access to outside capital. If one can acquire capital market currency which can be issued at favorable terms at periodic intervals of high market valuations, the same can be a superlative source of competitive advantage *if* the company is run by an able capital allocator. Issuance of one's common stock for another business before or during or immediately after M&A requires evaluation and valuation of both acquirer and acquired. Hence, the need of good capital allocator to do so. Thus, an overpriced stock in hand of capable competent management can be its most important asset and the same can be said of an under-priced stock if the management resorts to buybacks. This is extremely neglected in most financial literature but is a great source of value creation if done right.

With regards to your question on a checklist, each of the above points would have slightly different considerations. This is given that the first two are based on earnings and use of retained earnings, the third one is based on corporate action as it pertains to asset usage, and the fourth one is kind of opportunistic financial arbitrage. Hence you need a different checklist and different mental models for different companies.

As stated earlier, one needs to develop one's own framework to understand value proposition of business (streams of revenue and mix, growth drivers, cost structures and advantages, ability to price, distribution channels, switching cost and loyalty, cost of search for alternatives, market share, asset turns, working capital needs etc.) and be alert to constant value migration within the ecosystem.

SN: Those were quite interesting and valuable insights. What about valuations? How do you differentiate between 'paying up' for quality and 'overpaying'?

KS: To a value investor, potential investments come in three varieties, based on price, after having established longevity of growth and superiority of rate of returns generated by business –

1. Undervalued at one price;
2. Fairly valued at another price; and
3. Overvalued at still higher price.

My goal is to buy the first, avoid the second but keep tracking the same, and sell the third, all things being equal.

One rough yardstick to use to ensure one doesn't overpay is to do back of the envelope calculation that the market

cap paid today should be equal to cumulative sum of profits likely to be earned by a company in the next 7-10 years without any equity dilution. And if by chance the profit of the company a decade from now shall be equal to its current market cap, then you have a sure multi-bagger in your hand.

Also, current stock prices reflect a set of expectations for future financial performance. Companies can increase earnings by retention of profits earned along with inflation. Simultaneously, they destroy value if the returns are below the threshold of comparable options available elsewhere. Instead of arriving at fair value today, one can examine the level of free cash flows implied in current valuation and then figure out the probability of that happening using *reverse DCF* (refer to Alfred Rappaport & Michael J. Mauboussin in their book Expectations Investing). Thus, if price implied expectations are very different from what your view is, there is an actionable idea of buy or sell and a potential profit opportunity.

Mathematically, it can be proven that over long periods of time, it is hard for equity investors to earn returns that are much higher or lower that the underlying business return on capital employed. This can be explained with the mathematics of a long-term bond where the rate at which coupons are reinvested determine investors' IRR rather than the yield at the time of purchase. After all, equities are similar claims as perpetual bonds with residual unpredictable and lumpy coupons.

Investors who are long-term oriented must not confuse *cheap* with *value* as the bitterness of poor quality remains long after the sweetness of low entry price is forgotten. The issue of paying up for quality versus overpaying is very much an individual choice which essentially boils down to the assessment of size of the opportunity, quality, and longevity of growth of the underlying business.

SN: Great insights, Kuntal! What about selling stocks, which seems a more difficult task than buying? How do you determine when to exit from a position? Are there some specific rules for selling you have?

KS: The discipline to 'sell' is as important as the discipline in making the 'buy' decisions. A rational criterion for when to sell a stock is vital to the management of a sound portfolio. As a rule, I exit investments based on a few factors including –

- Adverse changes in long-term sales growth and earnings power, migration of value across the value chain, wrong assessment of longer term competitive intensity and pricing power because of which original investment thesis that I used to buy the stock is no longer accurate.
- Loss of confidence in the management due to adverse capital allocation or corporate governance issue for which I have a low tolerance.
- Opportunities to allocate capital to more compelling investments.
- Reducing exposure in times of extreme market wide bubble.
- Excessive overvaluation of a company due to re-rating, without commensurate cash flow/earnings growth that can contract as easily.

SN: When you look back at your investment mistakes, were there any common elements of themes?

KS: Whatever failures I have known, whatever errors I have committed, whatever follies I have witnessed in the private and the public life have been the consequences of action without thought, planning, and strategy.

Good judgment comes from experience, and often experience comes from bad judgment. And while experience is a good teacher, she sends in terrific bills.

Like most investors, I too have also suffered from the seven deadly investment sins at different points of time –

1. Overconfidence/Pride: Needs a checklist and acceptance of disconfirming evidence
2. Sloth: Inability to deep dive into opportunities and be alert to risk and herding
3. Gluttony of information: Leading to high noise to signal ratio
4. Myopia: Overweighing short term vs. long term when investment horizon was long-term
5. Greed: Of losing opportunity and missing out
6. Fear: Of losing capital and missing out
7. Cowardice: Inability to invest big when odds are favourable and opportunity meets prepared mind.

However, my acts of omissions far dominate the outcome via lost opportunities. One common error I have made in the past is overestimating rationality by governments, central bankers, and regulators. It is very hard to interfere with the functioning of the markets without having lots of unintended consequences. Also, my inability to book gains by selling stocks completely when valuations had gone berserk falls squarely under the acts of omissions.

SN: How can an investor improve the quality of his/her decision making?

KS: Here are a few of my suggestions –

- Develop a checklist, analytical framework and start keeping detailed investment journal to monitor the progress of ideas.
- Try to develop informational, analytical, behavioural, and structural advantages in the process. Being process-oriented means examining all possible outcomes and all new information and assessing them relative to original thesis.
- Do pre-mortem as against post-mortem. Think about what can go wrong prior to making the investment and keep evaluating as you go along.
- Never invest in something you don't understand well, and have low conviction on, and is outside your circle

of competence. If one changes his or her investment approach in response to recent underperformance, one might be doomed to mediocrity. If adverse situations arise, avoid making decisions under extreme stress or seek opinion of a couple of unbiased and independent persons of skill and repute.

- Avoid anchoring bias and don't get fixated on a number or price. Put a foot in the door by buying small initial quantity if the business looks appealing. This allows psychological flexibility to average up. Practice the same while selling by averaging down. In absence of the above, one can be anchored to prices which may not be attained for a long period to come. Prices can go from being source of information to a source of influence due to reflexivity present in the equity market and one needs to keep them distinct.
- Along with the probability of being wrong, weigh the consequences and impact of adverse outcomes. As George Soros has said, it's not whether you are right or wrong that's important, but how much money you make when you are right and how much you lose when you are wrong that's important.
- Pay attention to the incentives and rewards system of the ecosystem and judge management from all possible angles of vision, strategy, ambition, execution and attitude towards wealth creation and minority shareholders.
- Be wary of leverage and empire building. Markets are there to serve you and not to instruct you. The way to get into trouble is doing the thing you don't understand and then doing them with lots of borrowed money.

SN: That was some valuable advice, Kuntal. Thanks! Let's now talk a bit about 'risk'? How do you look at it while making your investment decisions?

KS: Let's get the basics right here. Price movement of securities is not a risk. There are other forms of risk such as regulatory risk, inflation risk, asset-liability mismatch risk etc. Also, there is the conception that to obtain high returns, an investor must take correspondingly high risk. In my humble opinion, risk and return are negatively correlated. In fact, to attain higher return, one must reduce the risk of permanent loss of capital. Remember that the first rule of investing is to not lose money, and the second rule is to never forget the first rule.

An investor faces several kinds of risk, some of which can be eliminated (concentration, complexity, liquidity, adverse taxation etc.) while some can be mitigated and managed through framework (capital risk, currency risk, correlation risk etc.) and some which shall have to be embraced keeping odds, impact and margin of safety in mind (information asymmetry and deficiency, event risk, key personnel risk, business risk, corporate governance and capital misallocation risk etc.)

SN: What's you two-minute advice to someone wanting to get into value investing? What are the pitfalls he/she must be aware of?

KS: My single most important piece of advice would be to read voraciously. This also involves conscious efforts to eliminate noise and seek the best use of productive time one has, which is a finite commodity.

I like business biographies because these tend to show how passionate people who live and breathe their businesses have created something out of nothing. Also learn from business failures as they contain lessons on what not to do. Learn from the works of eminent dead and living people and companies in different geographies who have experienced success in related areas who've been winners and failures, and then try to identify why and what it is they're doing that causes/caused them to be successful or failure.

SN: Which unconventional books/resources do you recommend to a budding investor for learning investing and multidisciplinary thinking?

KS: I suggest reading offbeat stuff like biographies of successful/failed entrepreneurs and businesses. In terms of newsletters, I suggest Outstanding Investors Digest and Grant's Interest Rate Observer. Here are some of my other recommendations on what to read –

Financial History

- Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay.
- The Great Crash, 1929 along with A Short History of Financial Euphoria by John Kenneth Galbraith
- Manias Panics & Crashes by Charles Kindleberger
- This Time is Different by Carmen Reinhart and Kenneth Rogoff

Accounting

- Financial Shenanigans by Howard Schilit
- Accounting for Value along with Financial statement Analysis and Security valuation by Stephen Penman
- The Financial Numbers Game Along With Creative Cash Flow Reporting by Charles Mulford
- Quality of Earnings by O'glove
- Financial Statement Analysis by Martin Fridson
- Financial Fine Print by Michelle Leder
- Its Earnings That Count by Hewitt Heiserman

Process Improvement & Multidisciplinary Thinking

- Poor Charlie's Almanack by Peter Kaufman
- Best Practices for Equity Research Analysts: Essentials for Buy-Side and Sell-Side Analysts by James Valentine
- The Investment Checklist: The Art of In-Depth Research by Michael Shearn
- The Power of Habit: Why We Do What We Do in Life and Business by Charles Duhigg
- 100 to 1 by Thomas Phelps
- 100 Baggers by Christopher Mayer
- Thinking, Fast and Slow by Daniel Kahneman
- Influence by Robert Cialdini

- All three books by Peter Bevelin: Seeking Wisdom, A Few Lessons from Sherlock Holmes & All I Want to Know is Where I Am Going to Die So I'll Never Go There.

Understanding Business

- Understanding Michael Porter by Joan Margretta
- Value Migration by Adrian Slywotzky
- Competition Demystified by Bruce Greenwald
- The Five Rules for Successful Stock Investing by Pat Dorsey and Joe Mansueto
- Business Adventures by John Brooks
- Berkshire Hathaway Letters to Shareholders, 2015 by Max Olson
- The Outsider by William Thorndike
- Business Model Generation by Alexander Osterwalder

Valuing Business

- Valuation and Managing the Value of Companies by McKinsey & Company Inc.
- All three books by Aswath Damodaran on valuation – Damodaran on Valuation, Investment Valuation and The Dark Side of Valuation

SN: Great list indeed! Which investor/investment thinker(s) do you hold in high esteem?

KS: I like Charlie Munger and Warren Buffett, Howard Marks and Seth Klarman, Jeffrey Gundlach, Prem Watsa, and Benjamin Graham. Also, there are a host of great investors whose letters, writings and achievements attained in one lifetime have had an influence on me. I would also suggest reading about works of Michael Mauboussin, James Montier and Daniel Kahneman.

SN: Hypothetical question – Let's say that you knew you were going to lose all your memory the next morning. Briefly, what would you write in a letter to yourself, so that you could begin relearning everything starting the next day?

KS: This one has got me thinking. In such a hypothetical scenario, I would focus on writing about my friends and family and pen down the social framework of my existence and well-being. I would tell my near and dear ones to be patient and loving with me and help me regain the semblance of my original self by sharing memories and experiences. With regards to professional material, there is lots of it stored in my library, emails and Evernote account and that is well documented and archived.

I believe getting one's principles, leanings and learnings, emotional and personal life would be more important to note down as they have not been as well chronicled as business aspects have been.

SN: One final question – What other things do you do apart from investing?

KS: I have few ongoing efforts directed at giving back to the society and focusing on the well-being of less fortunate ones. I am a big fan of music and good movies and love to catch up on the same when time permits. I also love to teach. Teaching and writing require the discipline of understanding, deliberate practices of communication, constant learning, and updating material as your idea evolves. Hence I am associated with FLAME University, which is a pioneer of liberal education in India and is doing some interesting work in the field of developing good programs for Indian capital markets. They also have one of its kind of business library in this part of the world with books on diverse topics. This library is an affiliate of the Library of Mistakes which is very interesting. Please do check it out.

SN: On that wonderful note, Kuntal, let me thank you for sharing your amazing and deep insights for Safal Niveshak readers. I'm sure readers are going to attain great benefits out of your thoughts and experience.

KS: Thanks for the interview, Vishal! I really enjoyed it.

Also Watch: Wizards of Dalal Street: A Fresh Breeze – Kuntal Shah

StockTalk: Havells India Ltd.

We explore the business of India's leading electrical equipment brand and discuss the opportunities and challenges it faces.

Statutory Warning: *This is NOT an investment advice to buy or sell shares. Please make your own decision, as blindly acting on anyone else's research and opinions can be injurious to your wealth. I do not own the stock, but my analysis may be biased, and wrong. I have been wrong many times in the past. I, Vishal Khandelwal, am a registered Research Analyst as per SEBI (Research Analyst) Regulations, 2014 (Registration No. INH000000578).*

About Havells India Ltd. (HIL)

HIL is one of India's largest electrical equipment companies. It was started by Qimat Rai Gupta (QRG as he's more popularly known) who quit his job teaching in a school in Punjab in 1958, and came to Delhi with Rs 10,000 in hand. QRG started an electrical goods trading company in Old Delhi and few years later spotted an opportunity in the distressed 'Havells' brand, named after its founder, Haveli Ram Gupta.

He bought it for around Rs 7 lakh in 1971, and followed up with a series of acquisitions, joint ventures and entry into new product categories *(Read [Havells: The Untold Story of Qimat Rai Gupta]() to get an insider's view on how the company came into being and grew over the years, and more importantly about the life and initial struggles of QRG).* In the latest completed financial year, i.e., FY16, HIL had sales and net profit of around Rs 7,700 crore and Rs 1,200 crore respectively and its latest market cap stands at around Rs 20,000 crore.

HIL has products ranging from industrial and domestic switchgears, cables and wires, lighting, and electrical consumer durables like fans, water heaters, and small appliances, and is among the market leaders across all these spaces.

MARKET SHARE

	Product	Indicative Market Size (Rs. in crores)	Indicative Market Share	Indicative Rank
Switchgears	MCB	2,000	27-28%	# 1
	Switches*	2,200	14-15%	# 3
Cable	Domestic	8,000	16%	# 3
	Industrial	12,000	10%	# 3
Lighting	Lighting & Fixtures	6,500	10-14%	# 2-4
ECD	Fans	6,200	15%	# 3
	Water Heaters	1,400	9%	# 4-5
	Other Appliances	5,200	2-3%	-

5 * Premium modular plate switches

The Sylvania Adventure

The company maintains a strong balance sheet, with negligible debt and very comfortable cash position. But this was not the case a few years back, when HIL had acquired a business 1.5x larger than itself and 5x the size of business it was looking to acquire, Sylvania (typical case of managements biting off more than they can chew). The balance sheet got stretched and the entire business was on a shaky ground till the management turned it all around.

It all started in 2005 when HIL bid for the UK-based Electrium, which it eventually lost out to Siemens in a bidding war.

But a year later, led by the management's ambitions to grow big, have a presence in the world market, and break into the US$ 1 billion sales league, the company went in pursuit of Germany-based SLI Sylvania, which it acquired in 2007. This was the biggest overseas takeover by an Indian electrical equipment manufacturer at that time,

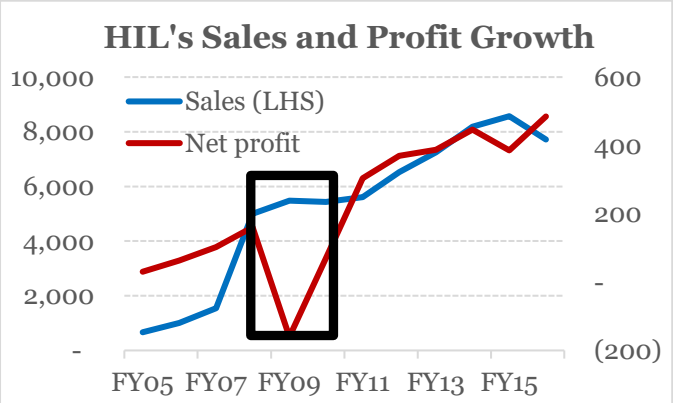
but incidentally happened just before the world financial markets and economy was about to go into a tizzy.

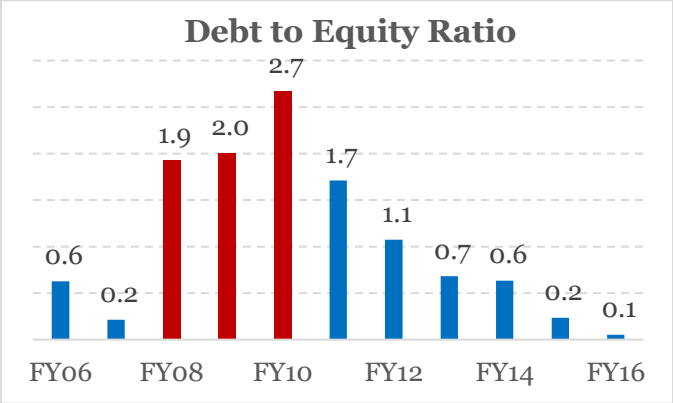
At the time of acquisition in FY08, Sylvania had a turnover of €500 million and an operational profit of €30 million (HIL bought it for around €230 million). As mentioned in his biography, QRG was betting on Sylvania's strong 100-year-old brand in about 50 countries, and its worldwide network of 10,000 distributors and dealers which was difficult for HIL to replicate on its own. Prior to this, HIL had a track record of five successful acquisitions, but this time it was different. Sylvania was huge and then it was bought just before the business was to suffer badly owing to a global crisis.

As the meltdown rocked Sylvania's largest markets in Europe, its sales fell, leading to net losses of €16 million in FY09 and €26 million in FY10. Sales declined from €500 million in FY08 to €440 million in two years.

And given that Sylvania was huge in the whole scheme of things, its performance started affecting HIL's consolidated numbers. In fact, from a net profit of Rs 160 crore in FY08, HIL reported a consolidated net loss of Rs 160 crore in FY09. Given that the acquisition was made using a debt of around €200 million – €120 million on Sylvania's balance sheet and €80 million on HIL's – added to the latter's woes (though immediately after the acquisition, the company placed 11% equity with Warburg Pincus – equivalent to €80 million – and repaid the entire debt on its own balance sheet).

HIL's problems were compounded by the fact that the management had little experience in the lighting business and the global markets, and as the current CMD Anil Rai Gupta writes in QRG's biography, "...the intricacies of Sylvania's production, marketing, and technology were a bit hazy for us." Note that this feeling sunk in *after* HIL had acquired Sylvania and *after* the business had fallen into troubled times.





Anyways, during an 18-month restructuring plan, Sylvania's CEO was sacked, manpower costs were slashed, and a few factories closed. Some part of the manufacturing was also shifted to India and China. The results showed up, and Sylvania's sales and net profits began to rise, which also helped HIL at the consolidated level.

In FY16, apart from a few of its other international operations, HIL sold 80% of its stake in Sylvania (excluding subsidiaries in the US, Chile, Brazil and Thailand – Chile operations have been shut down and US is being downsized; Brazil and Thailand have achieved breakeven at the EBITDA level) to one of the top-10 lighting companies in China, thus renewing its focus on the Indian markets.

The Sylvania sale was made for Rs 1,100 crore. As mentioned earlier, Sylvania's operations, which were around 40% of consolidated revenue and 10% of operating profit reported net loss of about Rs 800 million in FY15, thus dragging HIL's consolidated performance.

The reason I've discussed HIL's adventure with Sylvania here is because it showcases both the willingness of some managements to take decisions that can be highly detrimental to shareholders' returns, and on the other side, their ability to turn around a messy situation.

Anyways, let us now understand HIL using a set of questions to test the underlying business and management quality.

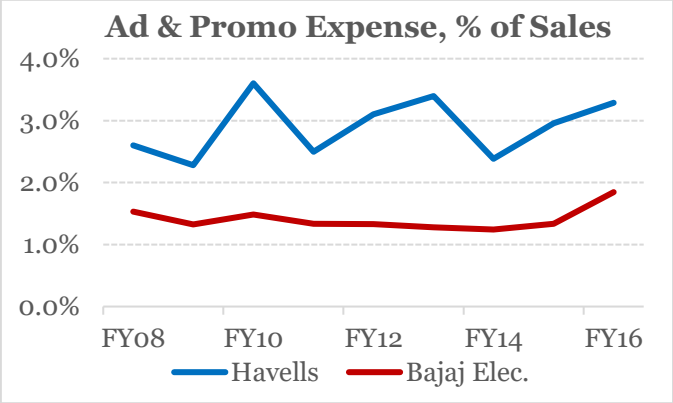
1. Has the company done well in terms of sales and profit growth over the past few years?

Over the last five years (FY11 to FY16), HIL's consolidated sales and net profits have grown at average annual rates of 7% and 10% (excluding one-time gain from sale of Sylvania stake) respectively. Over the past three years, sales and profit growth have been weaker at CAGR of 2% and 8% respectively. Apart from the overall demand weakness in the international markets, these consolidated growth numbers were impacted by FY16 numbers being on the lower side owing to divestment of stake in Sylvania. This is validated by the fact that sales of the standalone business (excluding Sylvania) have grown at a much better CAGR of 9% over the past three years.

So the domestic business has done well for HIL over the years, and after its Sylvania stake sale and ample cash in hand, this is where the management's focus will be lying.

Apart from the fact that HIL is among the market leaders in all its product offerings (see 'Market Share' table on page 16), which is well diversified into industrial and retail consumers, the company is likely to be a key beneficiary of the government's Make in India campaign.

The management has also made sustained investment in brand building – advertising and promotion spends has been around 3-4% of sales over the past five years (3.3% in FY16) as compared to 1-2% for peers like Bajaj Electricals – which while impacting profits now, is likely to pay off in the future.



2. How profitably have retained earnings reinvested?

HIL has averaged gross and operating margins of 8.1% and 5.3% on a consolidated basis (including Sylvania) over the past five years. The numbers of India operations (HIL standalone) are better at 11.9% and 8.3% respectively.

Note that while these margins may look less on an absolute basis, these are the best in the listed Indian electrical equipment and appliances space (the business is volume intensive). And this is largely due to the company's brand strength and management's focus on margins.

It comes out clear from what the company's CMD wrote in QRG's biography about dealing with Sylvania –

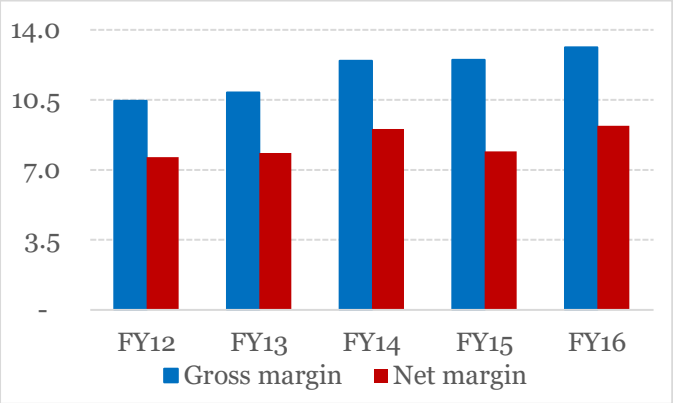
"...we figured that there was a mismatch between the positioning and pricing of Sylvania's products. While the brand had credibility in terms of quality and performance, prices were too low and the company operated at wafer-thin margins, even incurring losses in certain product categories.

We decided to change this mindset. We asked the managers to look at the prices of all the products. We sought to make Sylvania's managers understand that we were not in the commodity business and, hence, we were not necessarily in the volumes game.

We had to behave like a branded company from now on, and charge a premium on each product. Tactically, it meant that everyone had to focus on margins; every product category had to be a profit centre.

To achieve this, if prices had to be raised, so be it. The managers were asked to revisit, tinker and change prices of products in all the countries where Sylvania's products were sold." (from "Havells: The Untold Story of Qimat Rai Gupta" by Anil Rai Gupta)

Note that they were talking about raising prices in a business i.e., Sylvania, that was not just facing demand headwinds but also struggling against competition.



The company continues to work on a good mix of products through innovations and premiumization, and higher volumes (across categories), which have aided overall margins.

As far as its returns ratios are concerned, HIL has earned average ROE and ROCE of 22% and 28% respectively over the past five years (on a standalone basis) which is again better than industry standards. Improvement in profitability across business operations is expected to lead to a revival in cash flow generation and improvement in return ratios going forward.

3. Does the business have a durable competitive advantage?

The kind of products HIL makes are not impulse purchases. One buys fans, LEDs, switches, geysers, wires and appliances occasionally. Given this, it's important for the company to have top-of-the-mind recall, so that when the buyer goes to the market, he should ask for the brand. HIL has been successful on this account.

Its key strength lies in it being one of the best-known brands in the Indian electrical equipment market. It's the commonest mistake many make about HIL's brand – and I tested it myself asking a few shopkeepers selling HIL's products and a few users within my family – that 'Havells' is a foreign brand. And they can be forgiven for thinking so, given the company's name that doesn't sound Indian, and its products that truly look international (talking from my personal experience recently while renovating my home).

Plus, the company has advertised well in past (remember its Shock laga kya and Rimpoche campaigns?). As mentioned earlier, HIL has spent around 3-4% of sales as advertising and promotion expenses over the past few years, which is more than double what its competitors spend and comparable with industry leaders in paints (Asian Paints), and adhesives (Pidilite). And this *investment* seems to have paid off in strengthening the 'Havells' brand. How else could it have transited commodities like MCBs and wires into such well-known brands?

Another strength the business possesses is its strong distribution network. HIL currently has around 6,500 dealers and sells its products through 100,000 retailers. More importantly, the company has around 150,000 electricians on its network that provides it direct access to the end consumer.

The company also operates Galaxy Stores, which is a platform to connect with existing and potential customers, including professionals like architects and interior designers, and showcase its entire range of products at a single place. HIL currently has around 375 Galaxy stores.

4. How has the management fared?

HIL is a family-owned business. QRG is no more, but his family and holding companies own around 61% of the company. Despite the bad name that a lot of small and mid-size family owned businesses in India have got, HIL has been managed extremely well and cleanly, and the owners have brought in professionals in their top management.

As mentioned in QRG's biography, he was never in favour of putting family members in key positions. The current board of twelve only has three family members. The owners have done well over the years to steer HIL from a small, local brand to now a market leaders across all spaces it operates in. That the company has also maintained a strict focus on margins and return on capital even considering competition and its Sylvania misadventure talks highly about the management's capabilities to steer the business well.

5. What are the risks to the business?

Given the near exit from Sylvania, and thus a large part of international operations, risks for HIL from now on are largely local. And these include continued weakness in the economy that may keep demand for HIL's products depressed.

Another risk could be capital mis-allocation, given that the company is sitting on a huge cash reserve (Rs 1,100 crore at the end of September 2016) after it stake sale of Sylvania. But given the management's experience in digesting Sylvania earlier, I expect them to be over cautious on this front. Though the management is looking out for an acquisition in the Indian appliances space.

One more potential risk could be a family feud in the future, given the experience of many family-owned organizations as they reach their third-generations – when internal stakeholders increase rapidly as the family expands. HIL is currently being managed by second generation members after the demise of QRG in 2014, and there have been a few feuds and separations, though not meaningful to HIL, that the Gupta family has faced in the past.

Valuation

HIL's stock is currently trading at around Rs 320 (as on 18th Nov. 2016), which implies a P/E multiple of about 34.5x its trailing 12-months earnings of Rs 9.2 per share (this excludes the one-time gain on sale of its international businesses, especially 80% of Sylvania).

As one of the marquee names in the Indian electricals sector, HIL has built its business on a solid tripod of distribution, large-scale manufacturing, and brand power. Its cash flow generation and return ratios remain impressive, and are expected to improve after the Sylvania exit. Exclusive focus on the Indian market should help in revival of sales growth, which may help the company further consolidate its leadership in the sector.

You as an investor must consider both sides of the case – opportunities as well as risks – plus ensure sufficient margin of safety in the stock's price, before making any investment decision.

Statutory Warning: *This is NOT an investment advice to buy or sell shares. Please make your own decision, as blindly acting on anyone else's research and opinions can be injurious to your wealth. I do not own the stock, but my analysis may be biased, and wrong. I have been wrong many times in the past. I, Vishal Khandelwal, am a registered Research Analyst as per SEBI (Research Analyst) Regulations, 2014 (Registration No. INH000000578).*

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