

Value Investing

# The Sanjay Bakshi Way

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

**Save paper. Save trees. Think before printing this document.**

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# Foreword

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I recently had the privilege of meeting one of the highly regarded professors in the field of value investing and behavioral finance, Prof. Sanjay Bakshi in New Delhi.

Prof. Bakshi teaches MBA students (at MDI Gurgaon) two popular courses: “Behavioral Finance & Business Valuation” and “Financial Shenanigans & Governance”.

He is also the CEO of Tactica Capital Management, a boutique firm engaged in deep value investing.

It was like a dream come true for me, having met a guru who has been a great teacher in my investing pursuits over the past few years. So it was obvious for me to wait for Prof. Bakshi’s arrival with butterflies in my stomach.

Anyways, the moment he came in and spoke a few words, I knew that I had to get comfortable given that I was meeting a person not only with great intelligence, but also amazing humility.

Prof. Bakshi took it on himself to read all questions and answer them one by one, making it a very informal session of sharing his experience and learning in value investing.

Anyways, what follows next are fifty-eight pages of complete enlightenment in case you are a value investor or are working towards being one.

# Value Investing, the Sanjay Bakshi Way

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**Safal Niveshak:** *Value investing requires a great deal of research, discipline, and patience. What do you suggest an investor just starting out could do to practice these habits to ingrain them in his/her investing mindset? How easy or difficult were these and other relevant habits for you to form in your early years as a value investor?*

**Prof. Bakshi:** One of my role models is Charlie Munger who often talks about the idea of “inversion” like the man who wanted to know where he was going to die so he never went there. So, I’m going to use the same trick by inverting your question. Let me focus on not what an investor who’s just starting out should do, but on what he must avoid doing.

## **Don’t ask the barber, you need a haircut**

So, my first advice to investors who are just starting out is that they must avoid listening to intermediaries, whose interests are not aligned to their own interests.

You’re really on your own out there. Warren Buffett’s office table has a framed quotation: “*A fool and his money are soon invited everywhere.*”

People who invested in the Reliance Power IPO or the Facebook IPO would know what that means.

You see, there are these people out there who look like experts and talk like experts, and they will produce a very impressive document that will convince most untrained people that you should buy whatever is it that they are pitching to you.

You just have to understand the power of perverse incentives and what they are capable of producing. They want you to buy this stock, and they get paid when you buy

it, and they don't get paid if you don't. And you're not paying them. The issuers of the new securities are paying them.

Well, with incentives so misaligned like that, even garbage can be turned into "diamonds." When sense prevails, however, those "diamonds" turn into dust.

So you just have to avoid listening to people who get paid by selling you products, by the creators of these products.

### Don't ignore "Vicarious Learning"

The second thing you have to do is to learn from the mistakes of others.

There are two types of experiences – and I talk about this in my class a lot. You can get direct experiences – things you learn by doing it yourself which includes learning from your own mistakes. Or, you can get vicarious experiences – things you learn by observing others including the blunders of others. And most people tend to overweigh their own direct experiences, and underweigh vicariously acquired experiences.

Think about it for a moment. Of all the experiences you have in your life, your own experience is going to be very tiny fraction of the sum total of all human experience. By not learning from the mistakes of others, then, is a big mistake in itself.

So what you really want to do is to figure out a way to learn from other people's experiences and one way to do that is to read the best books on the subject you're trying to master. And there are a few very good books on this subject. The ones which I like a lot are the classics. Any professor of value investing would tell you to read them.

Top on the list is a book called "Extraordinary Popular Delusions and the Madness of Crowds" by Charles Mackay, written in 1841. Why is this book still around? Why did Andrew Tobias, a respected American author say that "if you read no more of this book

than the first hundred pages – on money mania – it will be worth many times its purchase?”

Why did the famous value investor, John Templeton, say that this book “opened my eyes”?

Well, the reason I think this book is still around is because it’s a very important book. Why is it such an important book? Because it tells you a lot about human nature. It describes how people can go mad during certain periods.

It talks about the Tulipomania (<http://bit.ly/bDcOi8>), which took place in 17th century Holland, when people sold off their homes to buy a single bulb of tulip because other people had become rich by speculating in tulips. They thought the tulip’s price will continue to soar and soon they will sell it to buy many homes. Needless to say, they were ruined.

Mackay also talks about the South Sea Bubble (<http://bit.ly/g3sRA>), which was an IPO bubble in 18th Century England. At its extreme, the bubble became so ludicrous that a newly-formed company whose purpose was to “carry on an undertaking of great advantage, but nobody to know what it is” had no trouble in getting an over-subscription. Even Isaac Newton lost a fortune in this bubble.

Galbraith wrote two classics: “The Great Crash 1929,” and “A Short History of Financial Euphoria.”

These are amazing books because once you start reading them books, you notice similarities between what happened in the 17th century Holland, in 18th Century England, also happened in 1929 in the US. Manias and crashes keep reoccurring. The last big one was the dotcom bubble of 1990s.

You notice similarities because human nature has not really changed all these centuries. The same emotions of greed and fear keep on returning, over and over again. It's as if the same drama is being replayed over and over again. The script is unchanged, but the players keep on changing.

Reading these books is extremely instructive because investing is as much about understanding human nature, as it is about understating business economics. History of financial folly is contained in these books and it makes a great teacher.

Reminds me of what Mark Twain once said, *"The man who does not read great books has no particular advantage over the man who cannot read them."*

The other thing that you can do vicariously is to observe the folly of other investors and businesses. So instead of only focusing on things that go right, you must also focus on things that go wrong – and learn to avoid doing things that produced that folly.

Again, this happens over and over again. It's the same pattern you will see over and over again. You will see the economic expansion resulting in overconfidence amongst investors and businesses which feeds upon further expansion often fed by borrowed money.

Overconfidence and leverage go together. People will become rich and richer for a while, and then the bubble will burst. The most leveraged players will be the ones that will get slaughtered in that collapse.

So whether it is individual investors who borrow on the margin to buy stocks, or it is banks who are blowing up because they are over-leveraged or are gambling in derivatives, or giving loans to people who could not afford to pay them back, or it was any operating business that was expanding recklessly with borrowed money – whatever the case may be, you will find overconfidence and leverage as a very lethal combination.

It's very fascinating and instructive to learn from all this and how you can avoid this. This is like the place where you are going to die so you can decide not to go there.

I think, it's terribly important to see how companies like Unitech, DLF, Suzlon (and many others) lost more than 90% of their value over the course of just a few years. These were darlings yesterday. Today, they lie in the stock market's gutter.

One of the things I tell my students is that all learning comes from the extremes. So if you think of the world as a bell curve, then at one extreme lie the great successes – and most people and teaching institutions will tell you to learn from the great successes. At the other extreme, are the great failures, which can also be your great teachers. What can you learn from them? Well, you can learn how not to end up like them!

Charlie Munger once said, "You don't have to pee on an electric fence to learn not to do it." I think that's pretty fundamental isn't it?

### **Don't Ignore "Base Rates"**

One of the great lessons from studying history is to do with "base rates".

"Base rate" is a technical term of describing odds in terms of prior probabilities. The base rate of having a drunken-driving accident is higher than those of having accidents in a sober state.

So, what's the base rate of investing in IPOs? When you buy a stock in an IPO, and if you flip it, you make money if it's a hot IPO. If it's not a hot IPO, you lose money. But what's the base rate – the averaged out experience – the prior probability of the activity of subscribing for IPOs – in the long run?

If you do that calculation, you'll find that the base rate of IPO investing (in fact, it's not even investing...it's speculating) sucks! It's that's the case, not just in India, but in every market, in different time periods.

In the same way, what is the base rate of investing in penny stocks?

When you buy those 1 or 2 rupees stocks, some of them will go up to 4, or 5, or 10 bucks...there's no question about it. But the averaged-out experience of putting money in penny stocks is bad, because most of those companies are junk companies.

When you evaluate whether smoking is good for you or not, if you look at the average experience of 1,000 smokers and compare them with a 1,000 non-smokers, you'll see what happens.

People don't do that. They get influenced by individual stories like a smoker who lived till he was 95. Such a smoker will force many people to ignore base rates, and to focus on his story, to fool themselves into believing that smoking can't be all that bad for them.

What is the base rate of investing in leveraged companies in bull markets?

It's not difficult to know that you're in a bull market. You pick up the P/E multiple of an economy and compare with the average past P/E multiple and generally look at the prosperity around. It's not difficult for an investor to figure out that she is in a prosperous environment. Well, the averaged out experience of people buying stocks of highly-leveraged companies in such an environment is bad!

This is what you learn by studying history. You know that the base rate of investing in an airline business sucks. There's this famous joke about how to become a millionaire. You start with a billion, and then you buy an airline. That applies very well in this business. It applies in so many other businesses.

Take the paper industry as an example. Averaged out returns on capital for paper industry are bad for pretty good reasons. You are selling a commodity. It's an extremely capital intensive business. There's a lot of over-capacity. And if you understand micro-economics, you really are a price taker. There's no pricing power for you. Extreme competition in such an environment is going to cause your returns on capital to be below what you would want to have.

It's not hard to figure this out (although I took a while to figure it out myself). Look at the track record of paper companies around the world, and the airline companies around the world, or the IPOs around the world, or the textile companies around the world.

Sure, there'll be exceptions. But we need to focus on the average experience and not the exceptional ones. The metaphor I like to use here is that of a pond. You are the fisherman. If you want to catch a lot of fish, then you must go to a pond where there's a lot of fish. You don't want to go to fish in a pond where there's very little fish. You may be a great fisherman, but unless you go to a pond where there's a lot of fish, you are not going to find a lot of fish.

The same idea applies to investing. You may be think you are super-skilled in penny stocks, or leveraged stocks in bull markets, or IPOs, or airline stocks, or paper stocks. But that doesn't matter as much as the idea that fishing in such ponds won't get you a lot of fish.

On the other hand, the base rate of investing in dominant FMCG companies bought at attractive prices over the long-term is good. It's very good in the US, in Europe, Australia, Japan, India – it's good wherever you look. That's a pond with a lot of fish, which fishermen mustn't ignore.

So one of the great lessons from studying history is to see what has really worked well and what has turned out to be a disaster – and to learn from both.

## Find role models

The other thing that I want to tell you is to find a few great role models.

I have a many role models, and every year I pick up a few more. The obvious ones are Warren Buffett, Philip Fisher, Charlie Munger, Ben Graham, partners of Tweedy Brown, Marty Whitman, Nassim Taleb, and some academic ones.

So to go back to your question on how do you inculcate all this – you have to read through the lives of these people and what have they done over the years and how did they learn, and then learn from their experiences vicariously.

Some time back I gave a talk on Confessions of a Value Investor (<http://scr.bi/b5NS1u>), where I listed out 10-12 mistakes people made, including me. So you really have to do your own homework.

## Value of patience

You asked about the value of patience. Reminds me of what Buffett once wrote: “You can’t produce a baby in one month by getting nine women pregnant.” In the same way, you cannot get good results by focusing on the short term.

Value investing is really not meant for people who don’t have patience. There are other kinds of investing – momentum investing is one, and high frequency trading is a variant of that. There are a lot of ways in which people make money in the stock market. Value investing is just one of them but to become a successful value investor, you have to have patience. You may not need patience if you are a momentum investor, but you do need extreme amount of patience if you want to be a successful value investor.

You just have to see how people have got rich in stocks. If you look at genuinely successful people in the stock market, you will find that an over-whelming majority of them bought stocks of good companies at attractive prices and just sat on them for a long-long time.

I give this example in the classroom. I put up two situations and you are a super-smart stock picker in each of them. Imagine that you can double your money every year. So, in the first situation – let’s call it “market timing strategy” – you buy a stock at the beginning of a year, and pay a transaction cost of say 0.5% (which includes securities transaction tax or STT, and brokerage etc.), you hold it for a year, when it doubles, and at the end of year 1, you sell it. You pay a tax of 10%, and then reinvest the remaining cash in another stock, paying the transaction costs for the third time (earlier you paid it when you bought at the start of the first year and then when you sold it at the end of that year).

By the end of year 2, the stock doubles again. You sell it, and invest the post-tax, post transaction costs proceeds in another stock, which again doubles by the end of year 3. This process continues for 30 long years. The excel model shows that you would have turned that one rupee into Rs 17 cr. Not bad at all.

Now compare that, with another strategy – let’s call it “buy and hold strategy” – in which you invest one rupee in a stock, which doubles every year for 30 years, and then you sell it, pay the transaction costs and taxes at the same rate. In this situation, you end up with Rs 95 cr.

The staggering difference between the results of the buy-and-hold investor and those of the market timer cannot be attributed to superior stock picking skills, because they were the same in both situations. So, what explains the difference? Well, the answer is transaction costs and deferred taxes- both derived from a single virtue: patience.

In fact, you can use the same example, and work backwards to figure out how much well the stock picked by the buy-and-hold investor needs to do to equate its return with that of the stocks bought and sold by the market timer, and students find out substantially poorer stock-picking skills in a buy-and-hold strategy equates superior stock-picking skills in a market timing strategy.

But many investors don't get it. They don't look at the numbers the way they should. And one big reason is because they think, "Oh, it's just 0.5% transaction charge. It doesn't mean much, it's so very small." But the truth is that tiny changes, over long periods, add up to a lot.

**Safal Niveshak:** *You have talked and taught a lot about the importance of psychology in investing. What are the key mental models that investors must learn about and use while investing? Apart from Munger, are there any other great resources from where people can learn about these mental models?*

**Prof. Bakshi:** Munger's idea of mental models is very powerful. He doesn't limit himself to thinking in terms of models from only psychology. His models come from various disciplines. He talks about multi-disciplinary thinking (<http://bit.ly/PUEOCP>).

Sure, he has given a lot of focus on the models he picked up from the field of psychology – even though he picked them up quite late in his career. I joke with my students that they are getting them well before Munger did, so they are luckier!

To become a good investor, understanding the role of psychology in financial markets is terribly important and, in my view, the single most important source to learn it from is by reading and re-reading the transcripts of various versions of Munger's talk "The Psychology of Human Misjudgment" (<http://bit.ly/9AioVI>). Every student of value investing must read these transcripts.

He talks about 20 models, six of which came from Cialdini's "Influence: Science & Practice" and the rest from Munger's direct and vicarious experiences.

In my class, I focus on just 10 of these models. These are:

- Availability bias (<http://bit.ly/O6Lb5E>)

- Contrast effects
- Deprivation super-reaction syndrome (scarcity model)
- Bias from commitment and consistency
- Bias from over-influence of authority
- Bias from social proof
- Dopamine (Chemical dependency, as per Munger)
- Incentive and incentive-caused bias
- Bias from over-optimism and overconfidence
- Bias from Pavlovian mis-association

These are 10 different biases. If you really work hard towards removing or reducing these biases from your own personalities, I tell my students, you will become a better decision maker and a better investor.

While we don't have time to talk about all ten, I will talk about one: bias arising out of availability heuristic.

### **Availability bias**

As I mentioned earlier, people overweigh facts and data that are easily available to them. For example, they overweigh their own personal experiences, as those are the experiences they remember the most.

It's harder for us to relate to a situation from somebody else's experiences. It's much easier to relate to our own experiences. And that results in mis-cognition in many ways.

### **“Prediction Newsletter Scam” story**

Let me tell you this by way of a story. Let's say one day you receive a newsletter sent to you by a person who claims to have some predictive skills about the stock market.

The newsletter states that Reliance Industries will go up by more than 10% over the course of next one month. You look at it and you toss it aside, but you don't forget to notice that after one month, it has actually gone up by 10%.

You say, "Well, that can happen any time. It's a random thing."

The next newsletter comes in the beginning of next month, and this time it predicts that Reliance will fall by 10%. Again a month passes and you notice that the second prediction has also come true.

A third prediction comes at the beginning of the next month, and this time he makes another prediction about Reliance which also comes true. And the fourth, fifth, and the sixth prediction also turn out to be true.

You start thinking, "This can't be a coincidence! This man has real predictive powers."

But, what's really going on? Well, it's a scam. The newsletter publisher has no predictive powers. But he does know that if he makes three different predictions about Reliance – that it will go up, or down, or nowhere – then one of the predictions will come true, although he has no clue which one will come true.

So he sent his first newsletter to 364,500 people. 121,500 people get the first prediction, and an equal number get the second and the third prediction. Obviously, one third of the recipients – 121,500 of them – will get the correct prediction.

The publisher drops the others and focuses on these 121,500 for the next edition. This time he divides them again in three groups each having a size of 1/3rd or 40,500 recipients. Again, each group gets a different prediction, and one group, will obviously get the correct prediction.

He continues this process for four more rounds by which time, he would have 500 very-impressed recipients each of whom would have received six correct predictions in a row and you were one of them.

And you don't know what's really going on. All you get to see is six correct predictions in a row.

So, when the next six predictions are offered to you, for a price of Rs 50,000, you immediately start thinking how easy would it be for you to recover this cost from the trading profits made on the basis of the next prediction alone. Moreover, you would get over-confident and perhaps borrow money to finance the next operation.

You will also, eventually, go broke.

It's a funny story, and the way it is told, it's obvious to anybody that this is a scam. But to the gullible people, under the influence of "availability bias" – where they don't see what they don't see – and therefore assume that that's all that there is to see – well, they go broke.

In the investment business this happens often – that people go broke over-reacting to what they know, and under-reacting to what they don't.

I mean just think about it – Isn't mutual fund advertising a variant of the "stock market newsletter scam"?

When you look at mutual fund advertisement, what do you see?

You see claims like: "During such and such period, our Technology/Infra/Real Estate fund was the best performing fund in the country."

What you don't see is that the fund house has a number of funds, which may not have done as well as the one being touted in the advert. So you are unlikely to be made available all of the facts about all of the ones. Rather, what that will impress the most will be the one that's made available to you.

If you are in charge of designing adverts for mutual funds, you know that you must only talk about winners to take advantage of the gullible public which will chase recent excellent performance.

You'd know that your job is essentially to exploit the reader's availability bias. And if the IT fund is not doing so well anymore because that bubble has burst, then perhaps it's time to not talk about it anymore, and perhaps it's time to replace it with data pertaining to the hot Real Estate fund.

### **Beware of the “story” factor**

What you don't see can really kill you! And people don't see the base rates. Base rates are not as influential as stories are. Recall the story I told you about the man who smoked three packs of cigarettes a day and he lived to be 95 years old. His story is vivid.

The base rate of smokers living to as old as 95 may suck, but that doesn't matter. What matters is this captivating story of the 95-year-old smoker.

People love stories. They captivate you. Base rates, on the other hand are boring.

Investment bankers are pretty good at telling stories. Facebook is the latest fairy tale story out, which is turning out to be more of a horror story for people who bought into its IPO. The stock is down almost 45% from its IPO price. And this isn't a small company. This is a large company which was valued at US\$ 70 billion less than 3 months ago and is now valued at US\$ 40 billion.

But the story, when it was pitched, was captivating. Facebook was going to be the “next Google” or the “next Apple”.

What really happened? Why did the stock crash?

Simple: the earnings produced by the company turned out to be insufficient to support the IPO valuation.

So beware of “story stocks” with a lot of promotion behind them – promotion done by people incentivized to manipulate you.

Isn't the Facebook lesson – a fool and his money are soon invited everywhere – so hard to get?

Well, if you learn psychology, it won't be so hard to get such lessons. Better yet, you can get them vicariously.

### **Junk the news...avoid “recency bias”**

Another variant of availability heuristic is the idea of recency. You remember what you had for breakfast yesterday, but you probably won't remember what you had for breakfast six weeks ago, do you?

Recent events tend to be much more remembered than not-so-recent ones. They are more “available” in your memory, so you will tend to over-weigh them.

So if something happened recently, which was terrible, but has little influence on overall value, might mis-influence you. There might be a poor election result, a bomb blast, a plague scare, an earthquake, or even a terrorist attack.

All these are instances of bad news, and typically markets crash when they occur. Fear spreads like contagion, thanks to the extensive media coverage and that fear translates into lower stock prices.

But in moments like these, isn't it a good idea to have, what I call as the "DCF Frame of Mind?"

When in such a frame, you think along the following lines: "Ok, so there is a crash. But the value of any financial asset is the present value of its future cash flows. So there should be only two reasons why stock prices should come down because of this terrible event. Either, my estimates of future cash flows must come down, but that's not true.

"Even though the cash flows may come down for a quarter or two, as far as long-term cash flows are concerned, this is really a non-event. Or, the interest rate used for bringing back the future cash flows to present value must come down. But that's also not true. Interest rates aren't going to change because of this terrible event. So, the decline in price must be irrational, unless of course the earlier price was higher than underlying value."

So, if neither your estimates of cash flows, nor interest rates are going to change because of this terrible event, then the event is really a non-event, isn't it?

But people find it hard to have a "DCF Frame of Mind" at such times. That's because there is fear all around, which causes most people to become either paralyzed, or to just to what everyone else is doing, which is to rush for the exits.

Very few people actually think of buying. But if you look at the base of long-term returns for investing on such "terrible" days, you'll find that those returns are exceptional. This reminds me of the wonderful Buffett quote: "Fear is foe of the faddist, but a friend of the fundamentalist."

People focus too much on short-term quarterly results and too little on how the financial statements will look like 5 or 10 years from now, under reasonable assumptions. Well that's recency bias.

### Avoid “first conclusions bias”

Another variant of availability bias is the idea of “first conclusions bias”. Our minds jump to conclusions. Humans tend to solve problems by using the first solution that comes to mind. Charlie Munger often says that “to a man with a hammer, everything looks like a nail.”

Let me give you an example of this from my own experience, as to why first conclusions are often wrong.

Let's go back to the year 2003. This was the time when the steel industry was down in the dumps, and it was about to take off for a very big bull run. At that time, some of my value investor friends and I came to the conclusion that steel prices are going to go up. This was a time when most steel companies in the world were losing money. In fact, there were just a handful of companies that were making any money.

The steel cycle had been down for a very long time. We felt that here was a tipping point coming and things would get better, and steel prices will go up because steel capacity is getting tight and world economy, and in particular, Chinese economy, is growing.

Therefore, we thought there was going to be a shortage of steel, and it would take a long time for the shortage to go away because steel is a long gestation period industry.

We concluded that steel companies would benefit because of the huge rise in steel prices, which was a great insight. So far so good! But apart from concluding that rising steel prices must be good news for steel stocks, we also concluded that the same would be horrible news for auto stocks.

This kept us away from auto stocks based on pure automatic first conclusion that high steel prices were bad news for auto stocks. That first conclusion turned out to be wrong.

Think about why it went wrong. The value of an auto stock (or any stock) is based on present value of its future cash flows. And rising steel prices may or may not be bad news so far as those cash flows are concerned. A rising input price may be passed on to customer without suffering any volume decline. Or the rise in volumes caused the industry growth, may more than offset the shrinkage in margins because of a rise in input prices which the company is unable or unwilling to pass on to customers.

So the key factor to think about is not impact on margins but impact on cash flows. But the mind doesn't always do this automatically. It jumps! It jumps to first conclusions, which are often wrong.

So you really have to train yourself out of first conclusion bias. You have to avoid seeking easily available answers to questions that begin with "why".

Let me explain this with the help of an example. Let's look at this hypothetical stock. It has substantial cash on its balance sheet. It has no debt or other liabilities which have a prior claim on that cash. It also has an operating business. But the market value of the company is less than cash assets alone. This is a "cash bargain".

Many of my students when they look at this thing, they say, "My God, this is not possible! How is it possible that in a market that is supposed to be efficient, you are seeing a stock selling below cash?" They want to buy it based on their first conclusions.

But under what circumstances would that first conclusion be wrong? You see, the mind does not automatically think in those terms. The mind, instead, latches on to the first conclusion, which, in this case, is that the stock is ridiculously cheap, so it must be bought.

Now, I tell my students, “Let’s force ourselves to think of three reasons why buying such a stock would be a mistake.”

They have to come up with three reasons. Why three? Why not one? Why not four? Well, three is good enough! The idea is to force yourself to come up with multiple reasons that go contrary to your first conclusion and only when you force your mind to come up with three, will it generate three very good reasons.

So what are the three reasons for “not” buying that cash bargain based on your first conclusion that it’s cheap?

**Reason 1 – Cash burn:** Maybe the operating business is losing money and cash will be dissipated away in just a few quarters.

This is what happened to dotcoms after that bubble burst. Many companies had raised cash in the IPO bubble and now that the bubble had burst they were selling below cash. There wasn’t any debt because no sane banker would lend such start-ups any money.

But the operating businesses were burning cash at a rapid pace and it was only a matter of time when the cash would disappear.

Buying such “cash bargains” when they became available in the stock market, would have been a mistake.

**Reason 2 – Corporate mis-governance:** What if the promoters of the company are well-entrenched because they have a 70% stake, and they have no intention of sharing the wealth of the company with the minority investors?

They pay no dividends, and will never liquidate the company. What's such a company worth? This company is what Graham once called the "frozen corporation" which will never be liquidated and will never pay a dividend.

Then what the company owns is irrelevant for minority investors, isn't it? So just because the stock is selling below cash assets alone doesn't necessarily make it an attractive investment.

**Reason 3 – Bubble market:** When the markets are frothy, people desperately looking for value gravitate towards "cash bargains" because they are evidently cheap.

Well they are almost certainly making a mistake because history shows that when the markets decline, these stocks will also decline, often by much more than the market.

So, now we have three very good reasons for not buying the stock and we can now have a much more balanced debate about whether or not we should buy it.

We have trained ourselves out of first conclusion bias. And you have to do this automatically, like breathing.

To question your first conclusions by thinking forcefully about why they could be wrong – by doing this over and over again – you will become a better thinker, decision maker, and investor.

**Safal Niveshak:** *The same amount of cash in the hand of an ethical person would make sense, right?*

**Prof. Bakshi:** Absolutely, but only when there were no other reasons strong enough to offset the reason to own the stock.

The metaphor I like here is that of a "tijori" (Hindi term for a safety locker for storing valuables).

Some of your money is in a tijori, and it is open, and you don't have access to it but the fellow who has access to it is a crook.

What's your money really worth? How much would you expect to fetch for your interest in that tijori when you sell it to another person in an arms-length transaction?

Well, the owner of a "cash bargain" in a company run by crooks is the functional equivalent of the part-owner of such a tijori.

Investors have to know that everything that's cheap is not necessarily a sound investment. There are value traps to watch out for.

### Watch out for "value traps"

It is useful to think about this in the following manner. There is a universe of stocks out there. A sample of such stocks is value stocks. A very large proportion of these value stocks are value traps. They are cheap for a very good reason. And they're going to remain cheap.

People make this misconception of first conclusion bias that "because it's cheap, I must own it. And if I own it, only good things will happen to me." Well, maybe not!

That was my "little brief" on cognitive errors arising out of "availability bias." But I just talked about a few variants of this bias – stock market prediction newsletter, vivid stories, recency, and first conclusions.

I could talk about 3-4 more variants of availability bias, but your readers will go to sleep, so I will refrain.

Psychology is so fascinating and if you get down to the details, you discover so many aspects of human nature which have a bearing on your investment thinking.

The reason why I don't watch CNBC anymore is because I think I'm going to get over-influenced by what is happening "right now". It's not that important.

What's important is what these numbers will look like 5 or 10 years from now, not what they are looking like right now. So the TV interview with the management on why this quarter's result is off the street's estimate is almost certainly noise. It doesn't make any difference to the overall valuation of the company.

**Safal Niveshak:** *Do you believe in meeting managements before buying stocks?*

**Prof. Bakshi:** Not always. Sometime it's very clear as the management is very communicative in the annual report about the underlying business and what is happening in that business.

You get to know a lot from the annual reports and the interviews that they might have given to other people – interviews which cover not quarterly results, but long-term economics of the business and the strategy being followed by the company.

But one thing that I must tell you is that in value investing, or for that matter any activity which is to do with social sciences, there is no way anybody can say that this is the right way to do it and that is the wrong way to do it. It depends on what will work.

So if you think that you prefer to meet the managements before investing, so be it. If you think that you will get mis-influenced by meeting managements, so be that.

There are people who will not invest without meeting managements, and they'll do very well. And there are people who will meet the management and still not do very well. Walter Schloss did not believe in meeting managements.

So there is no law out there which says that meeting managements is a must. This is not physics. There is no way you can say that you must meet the management to get this result.

You have to try it out and see whether it works for you or not. Sometimes you will figure out, “Well, I don’t want to meet the management because they tell me all the good stuff and I may get influenced by them.”

Or you may come to the conclusion, “Well, I want to look at their body language and be able to tell whether they are telling the truth or not, and if there something wrong going on.”

So try it out. I don’t have a view on whether you must meet managers or not.

**Safal Niveshak:** *One more question on psychology. You mentioned that we need to go into the depth on these aspects, both from our personal lives and also learn from the mistakes of others. So once you do all this kind study and form a habit of practicing good behaviour, can you completely eliminate all the behavioural errors from your investing?*

**Prof. Bakshi:** You can’t eliminate errors. Life is about making errors and learning from those errors. So when you’ll fix one error, you’ll have another one creeping in. But you’ll make fewer errors and certainly fewer of the devastating errors that can destroy your returns or your life. What you trying to accomplish here is not to make big mistakes. You’re really trying to improve a process.

### **Focus on process, not outcome**

The thing I like to say here is the idea of process versus outcome. The world looks at outcomes but really should look at the underlying processes that produce those outcomes.

**Safal Niveshak:** *That's exactly like the athletes do. They focus on the process more than the outcome.*

**Prof. Bakshi:** Yes, in any field of excellence, you have to work on a process.

A gambler may walk into a casino, which is a wrong process, but he may get lucky and win some money or even a lot of money. And that will make him attribute his success not to luck but to his special skill in drawing cards or throwing dice.

It will also make him over-confident and he will inevitably go back and gamble more. Eventually, he will lose it all.

So, when you see a good outcome, you need to understand that it could be the consequence of dumb luck. Whereas, if you have a good process, and if you stick to that good process, and if you improve it over a period of time, you must inevitably end up with a good outcome.

That's what you are trying to do here is that over time, you're trying to make fewer mistakes and one of the best ways to do that is to learn from social psychology.

**Safal Niveshak:** *How can a small investor build up a "positive loop" that you talk about to increase his circle of competence, given the time, education or background constraints? How did you do this when you started out as a small investor yourself?*

**Prof. Bakshi:** Buffett talks a lot about the idea of "circle of competence". But what do we mean by the term?

I like to define it in a creative manner. Most of my students are engineers and have little or no accounting background. One way to think about circle of competence for them is to only specialise in engineering stocks. And students who are specialising in marketing may develop their circle of competence in FMCG stocks.

### **Creativity in defining your “circle of competence”**

That’s the conventional way of thinking about circle of competence. There are other ways. For example, you may specialise in micro-caps. Some of my students are doing exactly that. They have no interest whatsoever in large cap stocks.

They are thinking – “I am managing a small amount of money, and I want an edge. I want to track companies which have never been tracked by any large, institutional broking house – where there’s no analyst coverage whatsoever.”

Well, I think that’s a very smart thing to do. You want to build a speciality or your own circle of competence in a manner that will give you an edge. That’s what you are trying to do.

The business of investing is a highly competitive business, so you must find an edge. You may decide to specialise only in “special situations”. You may say – “I only want to work in event-driven strategies. I don’t want to take bets on India’s long-term growth story because almost everyone else is doing that. I know there are often mis-priced bets in the field of tender offers, share buybacks, large dividend payouts, spinoffs, going-private transactions, mergers and acquisitions, capital structure changes, asset sales etc.”

You may even decide to only work in bankruptcy workouts. Some of the highest risk adjusted returns have come in this field – for example, see what happened to Jindal Vijaynagar Steel and Wockhardt – and if some student of mine wanted to specialise in only this field and nothing else, I wouldn’t think of that as a bad idea at all.

You may develop your circle of competence in statistical bargains by using creative screens like debt-capacity bargains, cash bargains that are not likely to be value traps, dividend yield bargains, earnings yield bargains, net-nets, growth for free, debt-reduction, asset conversion etc.

You can have 15 different kinds of screens out there and you may never actually meet managements because that would bias you. You may rely on the edge you get from the numbers alone.

In effect, you'd operate like the owner of a successful casino having three key policies:

1. Every bet made by every gambler has odds tilted in the casino's favour;
2. You have lots of customers i.e., you practice wide diversification; and
3. You put a cap on the maximum bet that can be made by any customer on a single gamble.

These are three principles that work in running a successful casino and the same three principles that work in running a successful statistical bargains operation.

Or, you may think – “Well, I'm going to build my circle of competence by ignoring any company which has no moat – a term Buffett uses to describe a sustainable competitive advantage.” You may decide to only focus on moats.

Pat Dorsey in his wonderful book, “The Little Book that Builds Wealth” (<http://bit.ly/O4v08Z>) writes:

*“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.”*

Dorsey is obviously right. Any starting value investor should read this book in my view. He is giving you an elegant solution to the complex problem of developing an edge.

Investing is a very competitive business. You really need an edge. So you can pick any one of the above ways of creating one, or you may develop some other edge.

What I tell my students is that they should get exposure to a variety of value investing styles. You can create your own circle of competence by deciding to focus only on moats, or statistical bargains, or bankruptcy workouts, or special situations, or micro-caps etc.

I tell them, “Don’t limit yourself early on in your career. Try to get exposure to the Warren Buffett style of investing, the Ben Graham style of investing, the Marty Whitman style of investing. You should try them all and see what works best for you, because if you stick with something that suits your temperament, that’s likely to work for you.”

**Safal Niveshak:** *How do you differentiate between risk and uncertainty and how do you deal with each of them. Also, how does one factor in the “uncertainty” part in margin of safety? Please help with 1-2 case studies from your personal experience in the past.*

**Prof. Bakshi:** In March 2012, I gave a talk to the Indian Association of Investment Professionals, titled “Understanding the Universe of the Unknown and the Unknowable” (<http://bit.ly/w0dfAg>).

### Four Role Models

To answer your question as to how do I differentiate between risk and uncertainty, I’m going to pick up four role models: Warren Buffett, Richard Zeckhauser (Professor at Harvard University), Nassim Taleb, and Ben Graham.

## Buffett on Risk

Let's first talk about Buffett. What does he say about "risk"?

If you go through his letters, he talks about risk in a very different way as compared to the way finance academics talks about risk.



In academic finance, risk is the same as volatility. An asset that moves around a lot is riskier than an asset that doesn't move around a lot and one of the measures of this movement is "beta".

A stock with the beta of 3 is much more volatile – and therefore risky according to academic finance – than the stock with a beta of 0.5. There are elaborate asset pricing models based on this statistic in academic finance.

Moreover, cost of capital – the hurdle rate which determines whether to invest in a project or not – also has beta as a key component.

Buffett doesn't agree with any of this. In his view, risk is something much simpler, although it cannot be reduced to a mathematical formula.

For him, **risk is simply the probability of "permanent loss of capital" and that has nothing to do with the volatility of the asset's earnings or price.**

Assets could be very volatile but not necessarily risky. Conversely, assets could be very risky but not necessarily volatile.

One key component of risk for Buffett is inflation. He once wrote...

*"If you forego ten hamburgers to purchase an investment and then, over its holding period, receive dividends which buy you two hamburgers and receive, upon sale,*

*proceeds that will buy you eight hamburgers, then you have had no real income from your investment, no matter how much it appreciated in dollars. You may feel richer, but you won't eat richer."*

Isn't that fundamentally true? Isn't this an accurate description of "permanent loss of capital"?

Yet people around the world think of treasury bonds are "risk free" even though the returns on such bonds are typically below the rate of inflation. You are virtually certain to suffer permanent loss of capital through them.

Equities, on the other hand, are thought to be risky simply because they are volatile even though they offer the best returns over time.

### **Taleb on Uncertainty**

Let's keep Buffett's concept of risk in mind, and move on to Nassim Taleb's idea of "black swans" – rare, high impact, and unpredictable events.



Black swans could be negative or positive.

Taleb advises you to avoid exposure to negative black swans and seek exposure to positive ones.

### **Zeckhauser's Approach**

Let's keep this idea – of seeking exposure to positive black swans in mind, and move on to Richard Zeckhauser whose famous essay "Investing in the Unknown and Unknowable" (<http://hvr.d.me/b87ESq>) is a must-read for all investors.



In this essay, Zeckhauser discusses a few critical things. Let me

just list them out.

First, most investors can't tell the difference between risk and uncertainty.

Risk, as you know from Buffett, is the probability of permanent loss of capital, while uncertainty is the sheer unpredictability of situations when the ranges of outcome are very wide.

Take the example of oil prices. Oil has seen US\$ 140 a barrel and US\$ 40 a barrel in less than a decade. The value of an oil exploration company when oil is at US\$ 140 is vastly higher than when it is at US\$ 40. This is what we call as wide ranges of outcome.

In such situations, it's foolish to use "scenario analysis" and come up with estimates like base case US\$ 90, probability 60%, optimistic case US\$ 140, probability 10%, and pessimistic case US\$ 40, probability 30% and come up with weighted average price of US\$ 80 and then estimate the value of the stock.

That's the functional equivalent of a man who drowns in a river that is, on an average, only 4 feet deep even though he's 5 feet tall. He forgot that the range of depth is between 2 and 10 feet.

Let's come back to what Zeckhauser says on this subject.

Most investors, according to Zeckhauser, whose training fits a world where states and probabilities are assumed to be known, have little idea how to deal with unknowable and treat as if risk is the same as uncertainty.

When they encounter uncertainty, they equate it with risk, and tend to steer clear. This often produces buying opportunities for thoughtful investors who shun risk but seek uncertainty on favourable terms.

Second, Zeckhauser states that historically, some types of unknowable situations – those that Taleb calls positive black swans – have been associated with very powerful investment returns and that there are systematic ways to think about such situations. And if these ways are followed, they can lead you to a path of extraordinary profitability.

One way to think of unknowable situations is to recognise the asymmetric payoffs they offer. The opportunity to multiply your money 10 or 100 times as often as you virtually lose all of it is a very attractive opportunity.

So if you have a chance to multiply your money 10 or a 100 times, and that chance is offset by the chance that you can lose all of it in that particular commitment, is a good bet, provided you practice diversification, isn't it?

That's the power of asymmetric payoffs.

So, Zeckhauser's idea of profiting from unknowable situations is akin to Taleb's idea of getting exposure to positive black swans.

Third, there are individuals who have complementary skills – they bring something to the table you can't bring. They get deals you can't get.

An example that comes to mind is the deal Warren Buffett got from Goldman Sachs when he bought the investment bank's preferred stock on very favourable terms during the financial crisis of September 2008 – a US\$ 5 billion investment in Goldman's preferred stock and common stock warrants, with a 10% dividend yield on the preferred and an attractive conversion privilege on the warrants.

Essentially what Zeckhauser says is that there are people who can get amazing deals – that they have this ability to source these transactions.

They have certain skills that allow them to attract such transactions to them – maybe they've got capital, contacts, or something in them which a typical investor does not have.

Zeckhauser advises that when the opportunity arises to make a “sidecar investment” alongside such people, you shouldn't miss it.

For many Indians, sidecar investing can best be understood by remembering that famous scene in the movie “Sholay” in which one sees Veeru driving the mobike and Jai enjoying the free ride in a sidecar attached to the bike.



That's essentially the idea here. The investor is riding along in a sidecar pulled by a powerful motorcycle driven by a man who has complimentary skills. The more the investor is distinctively positioned to have confidence in the driver's integrity and his motorcycle's capabilities, says Zeckhauser, the more attractive is the investment.

So how do you bring all this together? Let me summarise.

We talked about Buffett's idea on risk. We talked about Taleb's ideas on uncertainty and the need to avoid negative black swans and the need to get exposure to positive black swans. We talked about Zeckhauser's advice on uncertain and unknowable situations and how to profit from them.

Sure, as value investors, we want exposure to positive black swans. But we are not like private equity investors or venture capitalists.

We are far more stingy and risk averse than those people. We want exposure to positive black swans on extremely favourable terms.

But what do we mean by "extremely favourable terms?" Well, that's where Graham – our fourth role model comes in.

### Graham's "Margin of Safety"

Graham is all about "margin of safety".

In his books, including "The Intelligent Investor," he talked about margin of safety. In every operation he did, he was seeking out value much more than the price he paid. He was seeking out favourable odds of making money.



He didn't know which of his bets will pay off. That is why he practiced wide diversification.

He was, in a sense, buying "free lottery tickets". As a value investor, you won't ever buy a lottery ticket but you don't mind getting one for free.

The idea of collecting free lottery tickets is a very powerful idea in value investing.

Graham had situations where he could buy stocks of companies which were selling at multiples reflecting zero growth or no growth. Effectively the growth component of value was coming to him for free. That's a "free lottery ticket"!

He thought of growth as an uncertain factor, and he was unwilling to pay for it. He was buying into uncertainty on extremely favourable terms.

So, we're going to use Graham's idea of creating free lottery tickets and combine it with Buffett's thoughts on risk, Taleb's idea of exposure to positive black swans, and Zeckhauser's advice on sidecar investing with people who have complementary skills.

### Case 1: Piramal Healthcare

This is an example that I gave in early 2011 in my blog (<http://bit.ly/esCMHf>).

Essentially, I wrote about Mr. Ajay Piramal – a man who built a business from Rs 6 crore to Rs 17,000+ crore in 22 years.



He did that by injecting very little amount of new capital. He did that by buying out distressed sellers who were very eager to exit the country in the pharmaceutical space. He also grew these businesses organically. And he had an excellent track record in increasing his topline (sales) by around more than 30% per annum, and also the bottomline (net profit) at that rate.

He also acquired about a dozen businesses, which did exceptionally well. Now, this is a very interesting point because if you look at the averaged-out experience in M&A, it sucks. Most acquisitions fail to create value and here is a man who has done a dozen of them, and they created value.

Then add to that a rare scenario, the fact that he is not just a shrewd buyer of cheap assets, he is also a great, high-quality-growth-oriented operating manager, as the numbers attest.

These two skills – great in operating skills and great in capital allocation skills (acquisitions) – they are rare as it is but rarer still in combination.

Now add the fact that Ajay Piramal was able to sell Piramal Healthcare's formulations business to Abbott at a very rich price – in fact the most expensive large-size cross-border M&A deal in the pharma space ever. How did he do that?

Because he has complimentary skills. He built trust with MNC pharma, which was instrumental in his getting such a rich valuation.

Ajay Piramal did not sell all the businesses of the company. He only sold one – the largest one, and he retained four businesses about which he is very optimistic.

He kept CRAMS (Contract Research and Manufacturing Services), he kept OTC that has brands like Lacto Calamine, Saridon, iPill, and many others. He kept Critical Care, which is a business he created in anaesthetic gases. He also kept Piramal Life which is a very interesting business with positive black swan attributes and which was later merged into Piramal Health.

So, when I wrote that blog, the situation was that the stock market was valuing a drug pipeline consisting of 14 molecules and having a cost of between US\$ 150 to 200 million (which if you were to think in terms of valuations in the US markets, could be worth several times that cost), three operating business with great long-term prospects, cash on the balance sheet, and Ajay Piramal – a great capital allocator with complementary skills, for less than cash alone.

Now, what's the risk of suffering a permanent capital loss in a situation like that? Practically none, in my view.

So, in a sense, one could get exposure to positive black swans embedded in the drug pipeline business of Piramal Healthcare (Taleb) by making a sidecar investment alongside a man with great capital allocation and complementary skills (Zeckhauser) on extremely favourable terms (Graham) and have practically no risk of permanent loss of capital (Buffett).

Subsequently, Mr. Piramal used his complimentary skills to park some of the cash he raised from the sale to Abbott in a deal with Vodafone, locking in a guaranteed return of somewhere between 17% and 21% per annum while retaining the possibility of earning much more if Vodafone's shares enjoyed premium valuation in its planned IPO.

Can you get a deal like that? Probably not. But people like Ajay Piramal can, and the stock market, sometimes offers you the chance to ride along a sidecar with such people on extremely favourable terms.

**Safal Niveshak:** *Are there other good allocators of capital that you've identified in India?*

**Prof. Bakshi:** There are so many of them. All the big companies that have done exceptionally well for shareholders, effectively they are excellent allocators of capital. Take a look at Nestle, for example.

But the question is not whether you can spot good allocators of capital. The question is whether you can become partners with them on favourable terms. That's the key!

If you had bought Infosys in the year 2000 at a P/E multiple of more than 200 times, you would have 10 years of no returns.

Keep in mind this would have happened during a period when India experienced the biggest bull market in its history. So the best company with the best managers, best business model, most ethical and growth oriented management delivered zero return over a decade. And it isn't that the earnings did not grow.

Every year's earnings were higher than the previous year's. And yet an investor for a decade didn't make anything in that!

So much for long-term investing in high-quality businesses, without any regard to price being paid!

So it's not about spotting a great business. It's also about getting in on favourable terms.

### **Case 2: IL&FS Investment Managers**

This is a current example. Please note that I am not making a recommendation here. I am merely citing how, at a price – which is not the current price, by the way, the stock of this company would be akin to acquiring a free lottery ticket.

This is a company which has got a very unique business model as an asset management company (AMC) managing about seven private equity funds in infrastructure and real estate. And, as you know, both of these spaces are completely bombed out and are riddled with huge uncertainties.

This company has no net debt, and it derives its earnings from these funds by way of two earning streams. One is the asset management fee, and the other is the “carry”, which is a profit share above a threshold, and is contingent on the performance of the funds under management. They have to deliver IRRs over and above a threshold to be able to earn that carry.

So, you have a highly predictable earnings stream and you have a highly unpredictable one as well – that’s what the uncertainty is about.

The business of AMC does not require much capital. And they have grown from nothing to US\$ 3.2 billion of assets under management (AUM) in just about 8-9 years.

In most businesses you have to put up more, to earn more. This is one of those rare situations where earnings can grow disproportionately as compared to capital employed in the business.

Now, let’s add the idea of a “vicious circle” in which the company finds itself. Its ability to raise capital in more funds – that is its ability to grow its assets under management (AUM) – is dependent on the IRRs it delivers on existing funds.

If it delivers high IRRs, then two things happen:

1. The AMC gets a big carry and by the way the management team gets to keep 70% of that carry, so the incentives are extremely high to deliver those high IRRs.
2. The AMC can launch more funds to replace ones that are being liquidated.

But the ability to get those high IRRs is dependent on how well the infrastructure and real estate sectors do, and right now, as you know, they are doing terribly.

So the vicious circle arises out of the bad environment in infra and real estate making it difficult to get high IRRs on exits, making it difficult to both earn a significant carry and to launch new funds to replace old ones.

Will this vicious circle become a virtuous one where a recovery in infra and real estate sectors enables the AMC to get good IRRs on the investments made by the funds under

its management, which in turn, deliver exceptional carry to the AMC and also make it much easier for it to grow its assets under management? I don't know.

I do know, however, that one can think of it in terms of scenarios.

One scenario is that the infra and real estate space will recover, and that the AMC will be able to grow its AUM and will also earn a large carry. That's the optimistic scenario.

Another scenario could be that AUM won't grow from here and the AMC will earn a small carry.

Finally, we can visualize a pessimistic scenario that the company should be viewed as a liquidation play because they won't get good IRRs and so will not earn any carry and that would destroy their ability to raise more funds and they would have to liquidate.

In this last, most pessimistic scenario, they would earn just the asset management fee till the funds are redeemed.

Now, what if, the market priced the stock at below the liquidation value envisaged under the most pessimistic scenario?

Would that not be akin to getting a free lottery ticket on the recovery of infra and real estate (Graham)?

Would that not be akin to getting exposure to positive black swans of growing AUM with hardly any incremental investment (Taleb)?

Would that not be akin to getting a chance to make a sidecar investment with private equity players having complimentary skills on favourable terms (Zeckhauser)?

And would that not be akin to an investment where the probability of permanent capital loss is negligible (Buffett)?

So, there is a price at which the stock of this company becomes terribly attractive. And you can work it out.

When it comes to understanding uncertainty in the above example, the mental model of “feedback loops” comes to mind. Vicious circles can turn into virtuous ones and if you can get in before they do, on very favourable terms, then good things should happen, if you keep on doing it repeatedly.

**Safal Niveshak:** *Can you draw down a series of steps and checklists – the process – you use to identify stocks to buy using the value investing route?*

**Prof. Bakshi:** You need different checklists for different styles of investing.

If you are analysing a bankruptcy situation, the checklist you will use will obviously be different from the one when you are buying into a business on the basis of the skills of one person, like Ajay Piramal.

Buying into Piramal Healthcare was essentially a bet on the man’s ability to allocate capital. So to evaluate how likely he will do that in the future, your checklist must first examine how well he allocated capital in the past and also how did he treat his minority investors in the past.

Once you’ve done the past evaluation and formed a positive view, the next question that you have to answer on your checklist is: How likely is it that Ajay Piramal will get opportunities to allocate capital well in the future within his circle of competence?

You also have to think about how the existing businesses the company owns may do in the future and as you know one of the businesses – drug discovery – is one that possesses the possibility of delivering one or more positive black swans.

So your checklist has to incorporate how to deal with the uncertainty.

Obviously, the due diligence required in such an investment operation is very different than one required in evaluating the economics of a tender offer.

When there's an open offer at Rs 100 and the stock is selling at Rs 95, you can make Rs 5 in a two month period, then the process revolves around whether they (the company) are going to honour it or not, whether the offer will get delayed or not, and what are the risks involved in the transaction.

In such situations, you really don't have to worry about the quality of the management, the earnings, P/E multiples etc. Those things become completely irrelevant.

So you have to think about the process very carefully, and every style, every single opportunity will have its own checklist.

**Safal Niveshak:** *But what could be a checklist for a small investor who is focusing on a simple Buffett kind of a strategy – buying good companies with durable moats?*

**Prof. Bakshi:** The single most important thing here is that if you buy great companies, then you can go wrong only when you overpay for them.

If it's going to remain a great company, you are unlikely to have a permanent loss of capital. Even in Infosys, people who got in it in 2000 have not lost money. They have made a little money, but much less than what they would have made if they had been smarter.

It's hard to lose money in a great company, run by ethical managers, except when you have grossly overpaid for it. Even if you have moderately overpaid for it, it is not going to kill you in the long run.

People get killed by buying mediocre or shady companies at high prices. They don't get killed by buying good companies at good prices.

The checklist for a small investor who focuses on buying good companies with durable moats would revolve around three factors – business, people, price.

For evaluating business, I highly recommend reading Pat Dorsey's book – *"The Little Book that Builds Wealth"*.

It's such a simple, common-sensical book that investors can learn from. It will help them in spotting moats. It will also help them in keeping away from thousands of companies that have no moats. So, for "business" factor checklist, read that book.

For "people factor", you need a checklist for evaluating managements. Perhaps, we can work on this together for the benefit of your readers.

It would be a simple checklist covering skills (operating as well as capital allocation) and ethical conduct.

There are lot of red flags one should look for:

- You don't want to see management paying itself exorbitant salaries and perks.
- You don't want to see promoters merging their private companies into the company whose stock you are evaluating.
- You don't want them to appoint their relatives who don't have adequate qualifications.

- You don't want them to have a lot of related-party transactions with their own privately held companies.
- You don't want to be involved with companies where the promoters trade in and out of the stock.
- You don't want to be get involved with promotional managements.

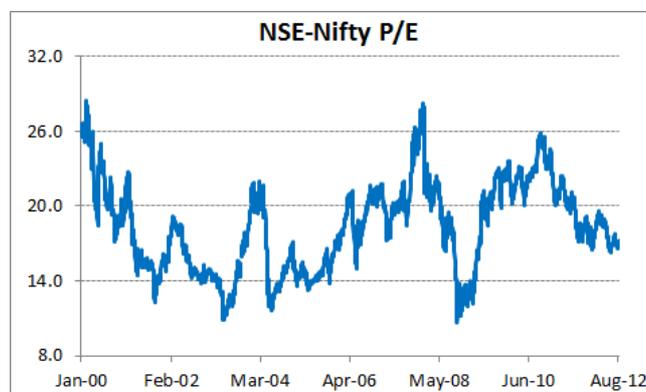
Essentially, you want to keep away from shady promoters.

For “price factor,” a simple rule can be used. You don't have to make it complicated. A rule like never paying a more than a P/E multiple of 13 (where “E” is expected minimum future earnings) can be used. Since the stock has already passed the tests on “business factors” and “people factors,” having a simple rule on the “price factor” makes a lot of sense.

**Safal Niveshak:** *At low valuations, the mediocre companies are anyways value traps, right?*

**Prof. Bakshi:** Absolutely! So the checklist that I would have for a small investor would also have a question – Is this the right time to buy stocks?

The simple rule that I can give is that the Indian stocks have hovered from 11x P/E multiple on the lower end for the NSE-Nifty to a 27x on the higher side.



Data Source: Ace Equity

So obviously if you are buying stocks when the P/E multiples are 23, 24 or beyond, you should be a bit careful. You shouldn't put a lot of money in stocks.

But if the stock that you like a lot is available to you in an environment where the aggregate multiples are 12-14, or even right now, which is about 15, then it's a good environment to buy into long term stocks.

So think a little bit about timing. You don't want to buy great companies at fabulous prices during bull runs. You want to buy them in bear markets, and then you have to exercise patience.

**Safal Niveshak:** *Yes, I have a kind of a checklist that I use with my stock analysis. It's like a logic chart that helps you go through a checklist of what you want to see in a company and what you want to avoid, including a behaviour checklist. I'll share it with you.*

**Prof. Bakshi:** Yes, I've seen it. It's very good. It would also be great if you had a checklist on corporate governance, including things like what auditors are saying about the company, how frequently auditors are being changed, what is happening in the insider activity, are they trading in and out of the shares very frequently, or are they not doing that and they are building a stake in the company and are there for the long term.

**Safal Niveshak:** *Thanks for the idea! My next question – If you were to go back to the start of your career as an investor, would you like to change something – add or delete?*

**Prof. Bakshi:** I'll add patience.

One of the things about investing is that when you are young, you are much more impatient than when you get older. Maybe it's to do with age, maybe it's to do with experience, or maybe it's to do with learning the hard way.

So I would add patience. I used to be much more active earlier. I used to be hyper-active – jumping in and out!

I realized that it was a mistake. So that is one thing I would definitely add – the value of patience.

Recall the point I made earlier about the role of long term compounding at a given rate which will give you much better results than the same rate of compounding achieved by jumping in and out of the market.

The second thing I would add is this – I would think very carefully about the idea of value traps.

Again, this is something I've learned the hard way and I am still learning it, by the way – that you end up buying into things that you think are cheap, but they will remain cheap for very good reasons.

Graham used to say that in the short-run the market is a voting machine but in the long run it's a weighing machine.

Well, some people take that metaphor too far (I certainly did) and forget that it's not a law of physics for every cheap stock to eventually rise to its intrinsic value.

Value investors should recognise that out of a universe of 6,000 stocks, a significant number would be “value stocks” but a very significant proportion of “value stocks” are “value traps” and it's important to avoid those and focus on the rest.

The third thing I wish I had added earlier is this – Paying up for quality.

These three things even Buffett learned over time. He was much less patient than he is now – he bought Berkshire Hathaway which he later confessed to be a value trap and he extricated himself from a bad situation by taking out the cash flow from the shitty textile business and putting it into cash generating businesses.

He also learned, over time, to pay up for quality.

I think when people think in terms of cost, they don't think a lot about "opportunity cost." For most people out-of-pocket costs loom much larger than opportunity costs, and since foregone opportunities are not out-of-pocket costs, people under-weigh them.

Not paying up for quality carries huge opportunity costs. These costs won't show up in your P&L because a P&L does not reflect what you could have done but did not do.

The errors of omission are sometimes far more than the errors of commission. In the long run, opportunity costs really matter in the long run.

You must not say – "Well, my P&L will never show the opportunity losses, therefore they don't matter."

**Safal Niveshak:** *You talked about holding on to a stock if you had bought it on favourable terms. The question is – How long should one wait for the value to be realised?*

**Prof. Bakshi:** Graham had a very simple rule of dealing with value traps.

He basically said, "I'm doing statistical bargains. I don't know which of these companies are going to perform, but I will limit the underperformers."

So he kept a very simple rule. He would sell a stock if it went up by 50%, or 3 years, whichever happened first. That was a very simple rule which largely kept him out of value traps. But, this kind of a rule applies only to Graham & Dodd statistical bargains.

On the other extreme is the Philip Fisher Rule. In his book, he writes, “If the job has been correctly done, then the time to sell a stock is almost never.” Warren Buffett grabbed this rule and he dropped the Graham rule. Of course he did that after he changed his investing style as well.

Think of the following combination:

- A high return on capital with the ability to reinvest that capital at a high rate of return
- Those returns are sustainable because there is a moat – either in the form of a low cost advantage or in the form of a pricing power
- You can continue to grow without requiring new outside capital (so there is no dilution of equity)
- Balance sheet is extremely conservative (no debt and plenty of surplus cash )
- Management that is both skilful – both in operations and in capital allocation – and honest
- The entry price at which you had bought this share is not at the frothy end of the bubble market, and the multiple you had paid for this company is not excessive in relation to its own history.

If you get this combination, you’ll do very well over the long term, which is more than a decade. I have yet to encounter an exception to this rule.

Maybe there could be 4-5 years when the stock doesn’t do anything. But I don’t know an exception to this rule when you have all these attributes and you didn’t do well in the truly long run, which in my view is about a decade.

So that's the point here. Think in terms of decades. Don't think in terms of 3-4 years.

Indian stocks, from September 2007 till July 2012 have done nothing. So does that mean that Indian stocks are dead? Does that mean this is death of equities? I don't think so!

I think we are poised for a very long bull run which will start, I don't know when, but I think it's going to start. And I think money will be made by the patient investor. But there will be periods of underperformance.

You are really looking for businesses that are going to keep on doing well even during adverse economic conditions, and stick with them.

So when it comes to the idea of selling, I wouldn't want to sell them just because they didn't do anything for the next 2, 3, or 4 years. I won't apply the Graham rule to such stocks.

It's very rare to find such situations. Think about Nestle. The guy, who found it 20 years ago or 10 years ago, doesn't need to do anything else in his life. For him, to switch out of that stock simply because it's moved up a lot, or not gone anywhere for 3 years – either of those two decisions – would have been foolish.

Thus doing anything in that stock would have been a mistake, other than just buying and sitting on it. Some stocks are of that nature and true wealth is created by being in those stocks and remaining there – not by jumping in and out.

**Safal Niveshak:** *When you came back to India in 1994 after finishing your course at LSE, you believed in India growth story and that you can apply Buffett principles here. What are your views on India growth story now?*

**Prof. Bakshi:** I still believe in the India growth story. I believe that India will create more wealth in the next 20 years than it has in the last 30 years and the pace of change is

only going to accelerate. Even though things don't look good right now, things didn't look good in 1991 also.

**Safal Niveshak:** *Maybe that's also because of the "recency effect". We are seeing and hearing bad news all around us!*

**Prof. Bakshi:** Absolutely! I have no hesitation in saying that the entrepreneurial spirit of India is alive and kicking.

A new wave of entrepreneurs will come, and replace the older ones. And the next wave of optimism is going to be bigger than the previous one.

And this is going to keep on happening. This is cyclical, but living standards will continue to grow and people are going to get richer and they are going to continue to spend and consume. Companies are going to benefit from this process for a long-long time. There is no stopping India as far as I can think.

As far as applying Buffett principles over here is concerned, I think those principles – whether they came from Buffett or Philip Fisher or Ben Graham or Munger – they make a lot of sense.

These are universal principles. But you have to adapt them to local conditions. You cannot blindly copy-paste!

I'll give you an example. Graham used to invest in "net-nets". This was at a time when the working capital of a company was a very important component of value. Today you live in a world where the best companies have negative working capital.

So the importance of working capital in the valuation of a company has actually gone down. This is point number one.

Two, in early situations, when companies sold below working capital, they could be liquidated for working capital at least, plus some money for fixed assets, and you could actually get liquidation value which was more than the market cap. Therefore there were good reasons to buy into those situations.

The probability of liquidation was higher then, than it is right now. American companies had diffused ownership. Indian's companies are mostly controlled by a family of promoters who own stakes large enough to prevent any liquidation.

So a prosperous company selling below liquidation value is not going to be liquidated. And a troubled company doesn't have much of a liquidation value for stockholders.

Think Kingfisher here. And most troubled companies have no working capital left anyway.

So, relying on working capital as a source of margin of safety is a very dangerous idea in the current environment where companies will not get liquidated.

The idea of buying into net-nets worked in the US for a while, but if you blindly copy-paste it here – a completely different market because ownership is concentrated – then it's not going to work.

**Safal Niveshak:** *Can you describe some of your most notable investment mistakes and what did you learn from them?*

**Prof. Bakshi:** I will talk about three classes of mistakes.

First one is over-confidence, which results in over-sizing.

Buffett influenced me a lot in the early years of my career, a lot more than other people. I had only one role model then, while now I have many more.

He basically talked about focused investing. He talked about “betting the bank” or “backing up the truck” so to speak – putting a lot of money behind the ideas in which you have the maximum conviction.

In early years, I made this mistake. Even up to recently I made this mistake of buying into situations where I had a lot of confidence (which in hindsight turned out to be overconfidence), which resulted in over-sizing of the bet, and which was a bad idea that had bad consequences.

You have to think very carefully about position-sizing. No matter how good you feel about an idea, there has to be a cap. And that cap should not be 40-50%.

No matter how confident you are, you shouldn't have more than maybe 10% in a stock. You should have at least 10 names in a portfolio – maybe more, but 10 is the minimum that you need to have.

I know there are people who will disagree with me completely, but I am giving you my thought process. I am giving you an insurance policy against over-confidence.

The second mistake that I made is again to do with something I mentioned earlier – “opportunity loss” which occurred not only by mistakes of omission but also by selling too early.

The sell decision is a very difficult decision, much more difficult than the buy decision. A stock you own goes up 100% and you start thinking, “Oh my God, it's already gone up so much! How much more can it go?” You get fearful of losing gains already made and you sell it and then it goes up by another 300%!

**Safal Niveshak:** *Indeed! Anyways, can you talk about 5 reasons why you would sell a stock?*

**Prof. Bakshi:** Single most important reason to sell a stock is that you made a mistake. It doesn't matter what it cost you.

In fact, you should be blind to cost when determining whether you made a mistake or not. If the reason why you bought a stock no longer exists, sell it.

Most people find this very hard to do. They get emotionally attached to their earlier stock picks – even when they are obviously wrong. Or they start thinking, “It's below my cost, and I can't sell it because if I do, I'll have a loss.”

That kind of thinking is foolish. The loss happened the day the wrong stock was bought, not on the day it was sold. On the sale date, economic loss became accounting loss, that's all.

So, not selling something simply because it is below cost is a foolish way of thinking. You see, going wrong in a buy decision is ok. No matter how careful you are, you're going to make mistakes. But holding on to something rotten – simply because it is below cost or in the hope that someday it will go up – that kind of a mistake is inexcusable.

Making mistakes is ok, perpetuating them is not.

The second reason to sell is when it's gone to fair value. So there is no margin of safety left.

The value was 100, you bought it at 30, it's gone to 90-95, nobody is sure what the value is but the price is absolutely sure, and there is very little margin of safety. So you sell it.

Notice, I said “it's gone to fair value” and not that “its price has increased to fair value”.

For a stock to no longer be a bargain, it's not necessary for price to rise to value. It can happen the other way as well – Value can fall to a point where there is no margin of safety left.

And value falls for all sorts of reasons – there could be an unexpected impairment arising out of a bad capital allocation decision, a natural calamity which destroys earning power, an adverse and unexpected change in regulatory environment, etc.

So, you have to keep in mind that it's not necessary for price to rise to meet value. Value can come down to say hello to price as well.

Reason number three to sell – selling an 80-cent dollar to buy a 30-cent dollar. Of course you will do this only when you don't have any investible cash left.

Reason number four to sell – A stock has risen so much that it has become just too big a part of the portfolio that it is giving you sleepless nights.

Sell it down to the sleeping point. It's not just about making money, you see. It's also about living a stress-free life.

What's the point of becoming so rich that you're not unable to even sleep?

Reason number five to sell – Pare exposure to equities in a bubble market.

This is a top-down decision. Everyone loves their stocks in a bubble market because they are getting rich and they don't want to leave the party. But the party will end eventually as all bubbles burst.

Doesn't it make sense to pare exposure to equities despite the temptation to stay invested? I think there is. And if you have to sell, then you will have to deal with reducing exposure to your much-loved ideas. Hard to do, but necessary!

One way to deal with it is to think along the following lines – “I’ve to let you go right now, or at least a part of what I own of you, but I know you will come back to me, and then maybe we will live happily ever after. But for now, it’s bye-bye!”

In other words, follow Gordon Gekko’s modified advice – “Don’t get [too] emotional.”

**Safal Niveshak:** *Are there any risks inherent to value investing except falling into value traps?*

**Prof. Bakshi:** First, if you use the wrong kind of money for value investing, then you will fail. And the wrong kind of money is what I call as “impatient capital.”

Borrowed money is impatient capital. Interest keeps on compounding and markets don’t always co-operate, so you mustn’t borrow money to practice value investing, most of the time. There are exceptions but they are very few.

Another form of impatient capital is money taken from clients for value investing but money which can be withdrawn by the clients at a very short notice. That kind of money is not suited to value investing. Value investing needs patient capital.

Second, if you don’t have the right temperament, you will fail.

It doesn’t matter that you understand the idea of value, and you know there is the margin of safety. If you don’t have the right temperament – for example, if you get influenced by people in a party who are investing in the latest hot real estate fund and you feel that you have missed out on the action – all your friends are making money and you look like a fool and your temperament doesn’t want you to look like a fool – then value investing is not for you.

If you're a party person, or you love being popular, or you love a lot of action, then don't try value investing. It's not for you. Do something else.

Typical value investors are loners. They hate crowds. They are independent thinkers who don't get influenced by what the crowd is doing. They love doing unconventional and unpopular things. They are also extremely patient.

**Safal Niveshak:** *How do you deal with a situation when you fall into a value trap?*

**Prof. Bakshi:** The first thing to do is to recognize it. Many people find this hard to do. They go into denial.

If something you bought has gone down 50%, something is wrong either with the market, or maybe something is wrong with you. And it's not a good idea to assume that the market is wrong. It's often wrong, no doubt, but not always.

Look at the fate of folks who bought into DLF, Unitech, Lanco, Rcom, and Suzlon in Jan 2008 and who are still holding those stocks. Here are the stock price returns from 1 Jan 2008 till date:

- Lanco: -85%
- DLF: -80%
- Unitech: -95%
- Suzlon: -95%
- RCom: -93%

People, who held on to these names since 1 Jan 2008 – at some point, they went into denial. They kept on inventing new reasons to own these stocks even though the original ones were no longer valid.

People need a way to de-bias themselves and one good way to do that is to mentally liquidate the portfolio and turn it into cash and then, for each security, ask yourself, “Knowing what I know now, would I buy this stock?”

Often the honest answer would be a most certain “no”. Then the next question you have to face is – “Then why do I own it now?”

You have to deliberately expose yourself to cognitive dissonance and then you have to learn to promptly resolve it.

I used the above names as examples even though none of them were value stocks. But the same rules apply to value stocks, which turn out to be value traps. You have to recognise it which will expose you to cognitive dissonance, and then you have to rationally resolve the dissonance. And there is only now way to resolve it rationally – swallow your pride and sell it.

I’m reminded of something that someone sent to me recently titled – “Ten Rules for Being Human”.

Of these, as investors, there are four that really stand out.

**Rule Two – You will be presented with lessons.**

You are enrolled in a full-time informal school called “life”. Each day in this school you will have the opportunity to learn lessons. You may like the lessons or hate them, but you have designed them as part of your curriculum.

**Rule Three – There are no mistakes, only lessons.**

Growth is a process of experimentation, a series of trials, errors and occasional victories. The failed experiments are as much as a part of the process as the experiments that work.

**Rule Four – A lesson is repeated until learned.**

Lessons will be repeated to you in various forms until you have learned them. When you have learned them, you can go on to the next lesson.

**Rule Five – Learning does not end.**

There is no part of life that does not contain lessons. If you are alive, there are lessons to be learned.

- Read “Ten Rules for Being Human” by Dr. Chérie Carter (<http://bit.ly/btsbES>)

**Safal Niveshak:** *Certainly! As they say that the romance of life is not in “knowledge”, but in “knowing”. So you have to keep learning.*

**Prof. Bakshi:** That’s true Vishal.

**Safal Niveshak:** *Finally, what’s your recommendation for books that an investor must read?*

**Prof. Bakshi:** Everybody will talk about the classics. But the single most important source that I talk about is the letters of Warren Buffett. (<http://bit.ly/83Xk3>)

One of the things about valuation is that people don’t put a lot of value on things that come to you for free. And because these letters are free on a website, people say, “Oh, they’re there for anybody and they are free, so they aren’t worth much.” That’s completely the wrong way of thinking about it!

Those letters are the most valuable source for learning about finance and investing in the whole world. And unfortunately people don’t treat them as such simply because they are free.

The other thing is that you have to read these letters by downloading them, taking a printout, and spending 2-3 days on one letter. You cannot skim through them. You have to read each one of them in a slow manner to actually absorb and make notes of what is important and connect various these across letters. You have to really do that! Then, of course, there are all these classic books like:

- The Intelligent Investor by Ben Graham
- Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay
- The Short History of Financial Euphoria by John Kenneth Galbraith
- Security Analysis by Graham & Dodd
- Margin of Safety by Seth Klarman
- The Black Swan by Nassim Taleb
- Influence by Robert Cialdini

So those are the classics. But I want to talk about four recent books that I liked a lot. One of them is “Thinking Fast and Slow” by Daniel Kahneman, the Nobel laureate who’s created the field of behavioural economics.

Another really good book that I read last year was “One Small Step Can Change Your Life: The Kaizen Way”. It’s about making small incremental changes in your life, like what Charlie Munger talks about the “slow contrast effect” or the “boiling frog syndrome”. Slow changes will get unnoticed, but if you have to change a habit, do it gradually, very slowly. And it works. It worked for me.

There are two other recent books I liked. One of them I mentioned earlier: “The Little Book that Builds Wealth” by Pat Dorsey. Then there’s a book that came last year, and it’s exceptionally good for those who have accounting knowledge. It’s called “Accounting for Value” by Stephen Penman.

He’s a professor at University of Columbia, and one who has related modern DCF with value investing styles of Graham & Dodd and Warren Buffett. He teaches you how to

think about valuation, without thinking about beta, or capital asset pricing model. It's a very good book.

**Safal Niveshak:** *Do you plan to write a book?*

**Prof. Bakshi:** Eventually I will. But for now, I prefer to blog and talk. (<http://bit.ly/rwm8iR>)

**Safal Niveshak:** *Thank you so much Prof. Bakshi for taking out time from your busy schedule to answer so many questions on value investing that readers of Safal Niveshak have put forward to you. It has been a great session of knowledge sharing from you. I thank you on behalf of the entire Safal Niveshak tribe. Hope to meet you soon. Thank you!*

**Prof. Bakshi:** The pleasure was all mine, Vishal. All the best!

## Share the Learning!

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I hope you enjoyed reading this interview I had with Prof. Bakshi.

Now I'd like to ask you a small favour.

Provided you've liked what you've read in this interview, kindly share it with your friends and colleagues who might be interested.

You can also invite them to sign up for my free e-letter on investing and personal finance – The Safal Niveshak Post (<http://bit.ly/N0oIqS>)

Thank you again for being there!

## About Safal Niveshak

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Safal Niveshak is a movement to help you, the small investor, become intelligent, independent, and successful in managing your investments and personal finance.



My name is Vishal Khandelwal, and I am the founder of Safal Niveshak. Before starting work on the idea of Safal Niveshak, I was working as a stock market analyst for eight years. During this period, I felt the pain of seeing small investors lose large amount of their hard earned money, for reasons ranging from:

- Scams...where companies simply vanished, to
- Speculation...to earn fast money, to
- Bad decisions...mostly backed by insensible and short-term advice from self-centered brokers and self-proclaimed stock market experts.

While the probability of a stock market analyst to work on a social cause is miniscule, here I am driving this movement called Safal Niveshak. Through my experience in the stock markets, I have come to believe that “you” alone are the most capable person alive to manage your money. You just need to form the right habits, and behave yourself.

You can write to me at [vishal@safalniveshak.com](mailto:vishal@safalniveshak.com) to know more about this initiative and how you can benefit from it and/or support it.

With respect,

Vishal Khandelwal

Founder & Tribesman, Safal Niveshak

[www.safalniveshak.com](http://www.safalniveshak.com)