

Lessons in Elementary, Worldly Wisdom As It Applies to Business and Investing



Vishal Khandelwal | August 2015

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I'm here to brainwash you!

Let's Start With What's On Top of Your Mind...



I would like to talk for just a few minutes to you about your future when you leave here. Because you will learn a tremendous amount about investments, you all have the ability to do well; you all have the IQ to do well. You all have the energy and initiative to do well or you wouldn't be here.

Most of you will succeed in meeting your aspirations. But in determining whether you succeed there is **more to it than intellect and energy.**

I would like to talk just a second about that. In fact, there is a guy we know as Warren Buffett, who says, he looks for three things in hiring people: integrity, intelligence and energy.

He says if the person did not have the first, the latter two would kill him, because if they don't have integrity, you want them dumb and lazy.

We want to talk about the first because we know you have the last two, i.e., intelligence and energy. You are all MBA students, so you have gotten to know your classmates.

Source: Warren Buffett's lecture at University of Florida School of Business, 1998 – <http://www.tilsonfunds.com/BuffettUofFloridaspeech.pdf>

Think for a moment that I grant you the right to buy 10% of one of your classmate's earnings for the rest of their lifetime.*

Who will you choose?



*** Conditions –**

1. You can't pick someone with a rich father
2. You have to pick someone who is going to do it on his or her own merit.

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Who Will You Choose?



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Will you give them an IQ test and pick the one with the...

- Highest IQ
- Best grades
- Most energetic
- Best looking
- Best networked

I doubt it! You will start looking for qualitative factors, in addition to (the quantitative) because everyone has enough brains and energy.

You would probably pick the one...

- You responded the best to
- Leadership qualities
- Able to get other people to carry out their interests

That would be the person who is **generous, honest and who gave credit to other people for their own ideas.**

Here's another question – I grant you the right to “short” one of your classmate.

**Who will
you choose?**



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Anyways, let me throw in another question. In addition to this person, you had to go short one of your classmates.

That is more fun. Who do I want to go short? You wouldn't pick the person with the lowest IQ.

You would think about the person who turned you off, the person who is egotistical, who is greedy, who cuts corners, who is slightly dishonest.

Who Will **You** Choose to **Be**?

- Integrity
- Leadership
- Generosity
- Honesty

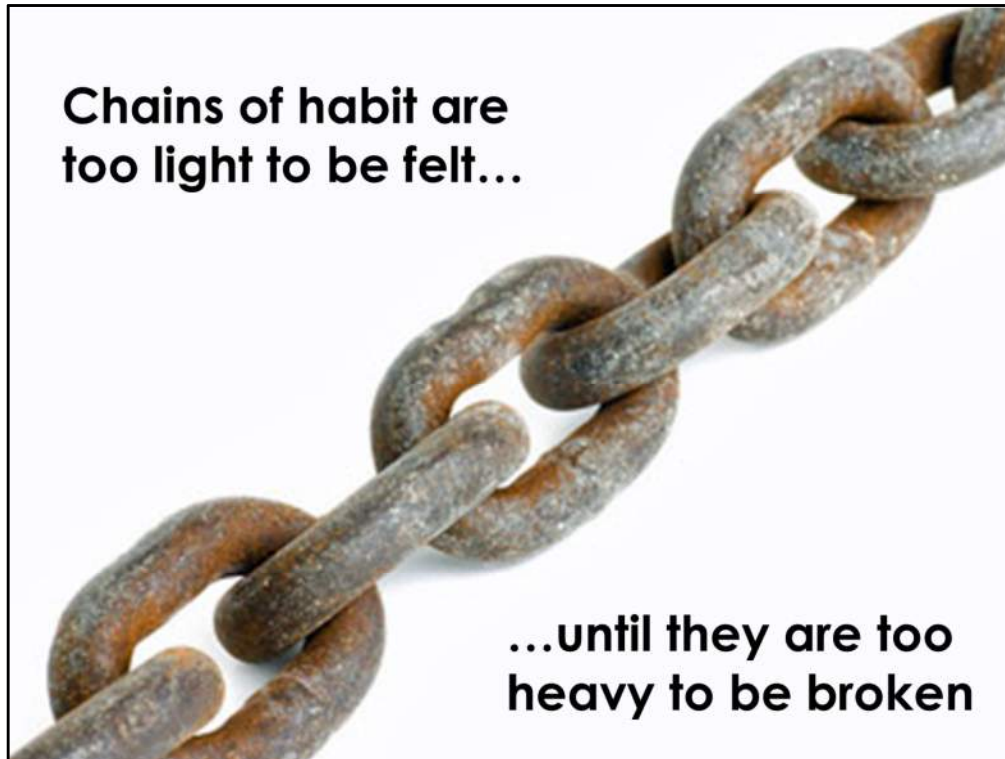
- Who turns you off
- Egotist
- Greedy
- Cuts corners
- Dishonest

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Now, as you look at those qualities, there is one interesting thing about them. It is not the ability to score a perfect 100 score in exams, it is not the ability to run the 100 yard dash in 9.3 seconds, it is not being the best looking person in the class, they are all qualities that if you really want to have the ones on the left hand side, you can have them.

They are qualities of behavior, temperament, character that are achievable, they are not forbidden to anybody in this group. And if you look at the qualities on the right hand side the ones that turn you off in other people, there is not a quality there that you have to have.

You can get rid of it. You can get rid of it a lot easier at your age (early 20s) than at my age (late 30s), because most behaviours are habitual.



I see people with these self-destructive behavior patterns at my age or even 15-20 years younger and they really are entrapped by them.

They go around and do things that turn off other people right and left. They don't need to be that way but by a certain point they get so they can hardly change it.

But at your age you can have any habits, any patterns of behavior that you wish. It is simply a question of which you decide.

Ben Graham, the father of value investing, did this in his low teens and he looked around at the people he admired and he said, "I want to be admired, so why don't I behave like them?" And he found out that there was nothing impossible about behaving like them.

Similarly he did the same thing on the reverse side in terms of getting rid of those qualities. I would suggest is that if you write those qualities down and think about them a while and make them habitual, you will be the one you want to buy 10% of when you are all through.

The Backward Bicycle



See video - <https://goo.gl/u08iGg>

It's really difficult to re-train your mind to adopt new habits. So, the earlier you start forming the good ones, the better it will be. And remember, good habits, like bad ones, are also hard to give up.

Why am I talking about getting your behaviour and habits right in a lecture on stock market investing?



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“Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ.

Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.”



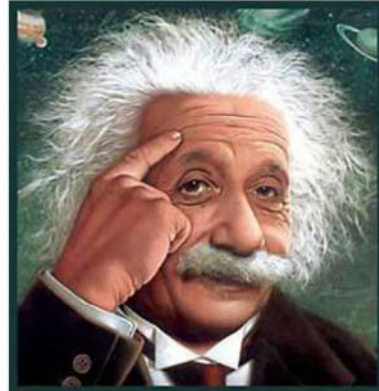
Intelligent Investing is...

**99% Good Behaviour
+
1% Intelligence**

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How you learn to behave now, when your brain allows you to form the right behaviour and habits easier than when you will be 10 years older, will determine how you will do in your life, and your investing life.

**You DON'T
need to be a
GENIUS to
become a
successful
investor.**



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In fact, being a genius can have dangerous results in life...

Genius!



Swiss mathematician Johann Underwald
"The Next Albert Einstein"

Genius = Overconfidence = Danger

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His peers described Johann Underwald, a Swiss mathematician, as the next Albert Einstein.

Ironically though, it was a mathematical error that led to his death in October 1999. Underwald made a 250-foot bungee jump with a 300-foot bungee cord and died instantly on impact.

Genius!



People with IQs in the top 2% of world population

Portfolio returns between 1986 and 2001...

S&P 500 = 15.3% CAGR

Mensa = 2.5%

That's genius for you.

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Mensa is the largest and oldest high IQ society in the world. It is a non-profit organization open to people who score at the 98th percentile or higher on a standardized, supervised IQ or other approved intelligence test.

Between 1986 and 2001, Mensa Investment Club's investments gained an average of 2.5 percent per year. Over the same time period, the S&P 500 earned 15.3 percent resulting in a stunning under performance of about 13 percent per year. In one of the biggest bull markets, the club managed to grow a \$10,000 investment into \$15,000. The same investment in a S&P 500 index fund would have turned into \$84,500.

How did the club manage to suck so badly? Turns out that instead of buying a basket of stocks and holding it for the long-term, as most investment clubs do (and still trail the benchmarks), the Mensa club churned its portfolio at an alarming rate by following a complicated system of trading that resulted in a 40 percent loss in 2001 alone.

Genius!

Genius!

Newton and South Sea Co.



Even Newton wasn't immune to this lesson in gravity!

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Newton bought low, sold higher and almost trebled his investment in quick time. But the stock kept rising higher. Newton bought again thinking, "If everyone else is making money, how can I miss out!" The stock crashed, and Newton's net worth was wiped off!

The guy whom gravity found, could not find the gravity in financial markets. Genius!

Genius!



Myron Scholes (left) and Robert C. Merton (LTCM)

**Speculative bets
= Lost US\$ 4.6 billion in 3 months
= Brought the US economy to a catastrophe**

Genius!

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Long Term Capital Management – Only the name was “long term”. The geniuses there used absolute-return trading strategies combined with high financial leverage.

Initially successful with annualized return of over 21% (after fees) in its first year, 43% in the second year and 41% in the third year, in 1998 it lost \$4.6 billion in less than four months following the 1997 Asian financial crisis and 1998 Russian financial crisis requiring financial intervention by the US Federal Reserve, with the fund liquidating and dissolving in early 2000.

Genius!

What Genius Can Do!

Exhibit 2
\$1 Invested in LTCM



Source: Lowenstein

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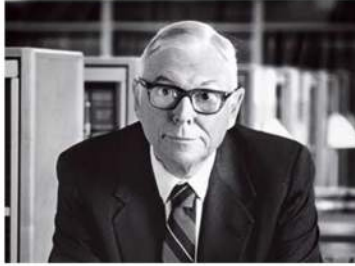
Genius + Overconfidence + Leverage = Disaster!

Instead of focusing on becoming too smart, I urge you to focus on avoiding foolish behavior.



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“A lot of success in life and business comes from knowing what you want to **avoid: early death, a bad marriage, etc.”**



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8 Things to Avoid in Investing

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Avoid #1 – Arrogance



On the morning of the Battle of Waterloo in 1815, Napoleon Bonaparte smugly assured his generals, *“I tell you Wellington is a bad general, the English are bad soldiers; we will settle this matter by lunchtime.”*

Then, around 100 years later, just before the Titanic was about to embark on its maiden journey, one passenger asked a ship’s agent for extra insurance on some valuables in her luggage. The agent replied, *“Ridiculous. This boat’s unsinkable.”*

Captain Smith himself was asked about the safety of the Titanic. He answered – *“I cannot imagine any condition which would cause a ship to founder. I cannot conceive of any vital disaster happening to this vessel. Modern shipbuilding has gone beyond that.”*

Cut to almost 100 years later. In 2008, fund managers and stock investors who were betting big on infrastructure and realty stocks, when asked about the valuations at which they were buying such stocks, said, *“Real estate and infra are the new gold and prices will continue to head north.”*

If we’re repeatedly successful – like fund managers and analysts prior to 2008 – we’re tempted to believe that we’ve found the formula for success and are no longer subject to human fallibility. This is devastating, especially in a world that is continually changing, and where every right idea is eventually the wrong one. Staying humble with your analysis and forecasting powers (which you don’t have anyways) will keep you from risking too much in a view of the future that may well turn out to be wrong. Don’t be blinded by arrogance. A little humility can help you steer clear of disaster, especially in the stock market.

Avoid #2 – Envy



“Envy is a really stupid sin because it's the only one you could never possibly have any fun at. There's a lot of pain and no fun.”

“Someone will always be getting richer faster than you. This is not a tragedy.”

~ Charlie Munger

Newton was burned by envy of seeing others getting richer, faster.

Avoid #3 – Predictions



“We've long felt that the only value of stock forecasters is to make fortune tellers look good.”

~ Warren Buffett

Avoid #4 – Timing



5.62	11,310.45	4.95
11.70	10,115.63	8.72
26.32	n.a.	22.29
22.50	115,979.23	17.99
32.55	110,170.25	24.38
5.78	3,329.38	3.99
30.72	60,991.84	23.71
4.82	8,699.39	4.11
6.11	3,688.26	5.11
19.50	11,026.73	17.41

It's time in the market, not timing the market, that matters.

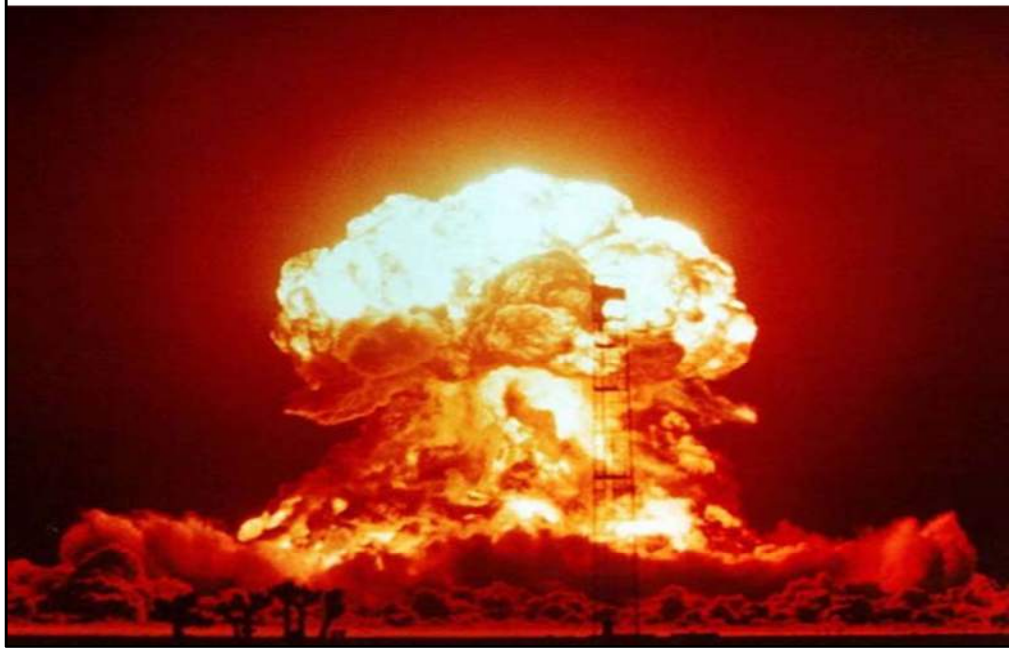
Avoid #5 – Trading



“Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years.”

~Warren Buffett

Avoid #6 – Derivatives



Buffett – Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.

You are studying derivatives in your MBA. Believe me, it's dangerous! Stay clear of it in real life.

Avoid #7 – Leverage



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“When you combine ignorance and leverage, you get some pretty interesting results.”

~ Warren Buffett

Avoid #8 – Tips

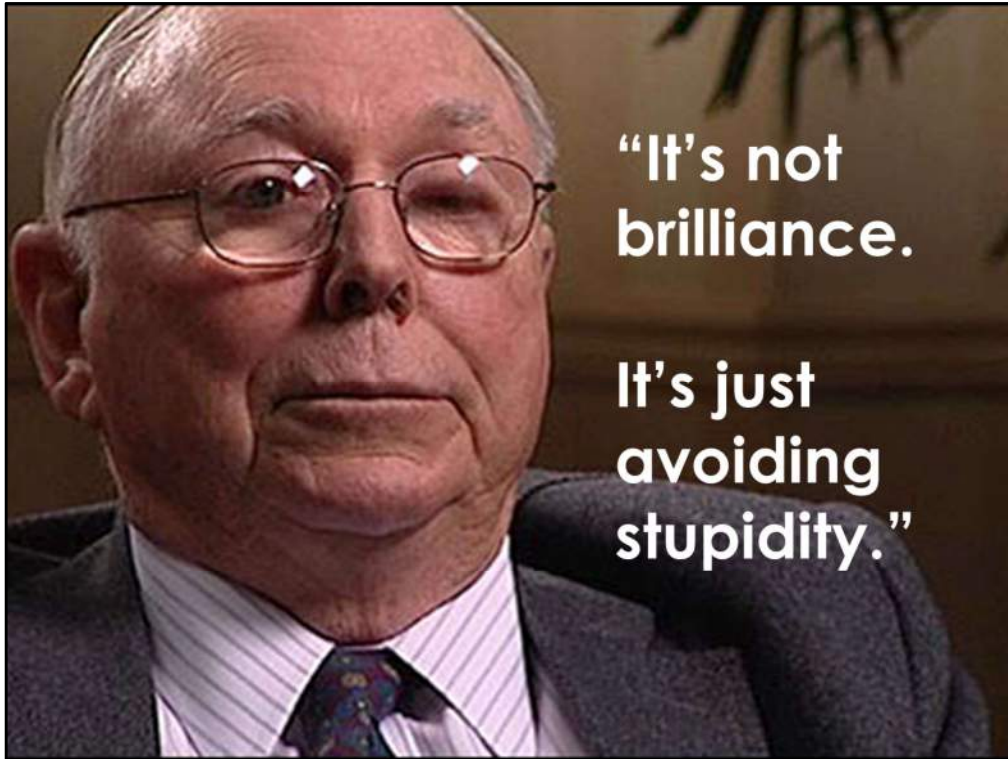


"Regular', 'Hot' or 'Extra-hot'?"

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"Tips are just that. Tips. Following blindly is setting you up for epic ruin."

~ Jesse Livermore



**"It's not
brilliance.**

**It's just
avoiding
stupidity."**

How to Avoid Stupidity?

**Be A
Learning
Machine.**



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"I constantly see people rise in life who are not the smartest, sometimes not even the most diligent, but they are learning machines.

"They go to bed every night a little wiser than they were when they got up and boy does that help, particularly when you have a long run ahead of you." ~ Charlie Munger

How to Become Wiser?

**Read.
A lot.**

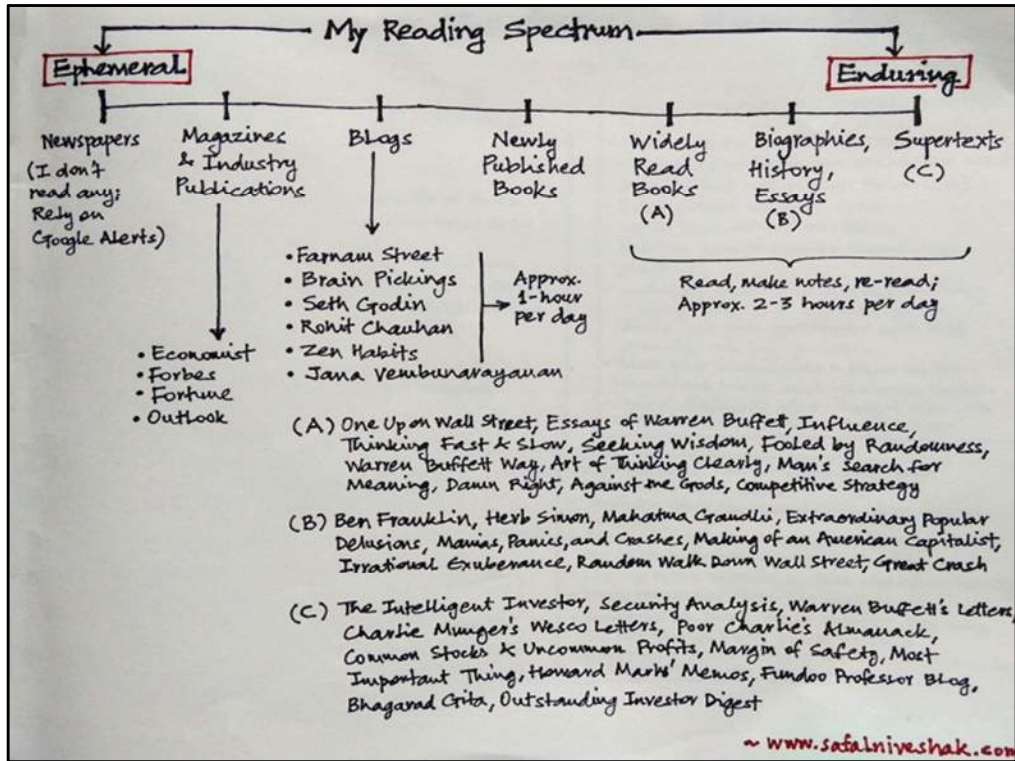


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Knowledge builds up, like compound interest.

Sadly, all of us can build our knowledge but most of us won't put in the effort.

Stop reading newspapers or watching business channels. Spend time, even if 15 minutes a day, reading stuff that matters...



Here's some stuff that matters...

What I Learned about **Learning** from Sherlock Holmes



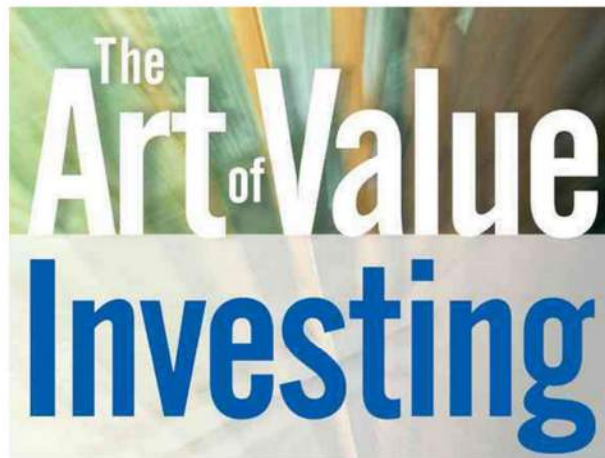
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“I consider that a man’s brain originally is like a little empty attic, and you have to stock it with such furniture as you choose. A fool takes in all the lumber of every sort that he comes across, so that the knowledge which might be useful to him gets crowded out, or at best is jumbled up with a lot of other things so that he has a difficulty in laying his hands upon it...”

“Now the skillful workman is very careful indeed as to what he takes into his brain-attic. he will have nothing but the tools which may help him in doing his work, but of these he has a large assortment, and all in the most perfect order. It is a mistake to think that that little room has elastic walls and can distend to any extent. Depend upon it there comes a time when for every addition of knowledge you forget something that you knew before. It is of the highest importance, therefore, not to have useless facts elbowing out the useful ones.”

~ Arthur Conan Doyle, *A Study in Scarlet*

Anyways, let's now talk about...



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Beat The Market**

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7 Wonders of the World



**Heard of the
8th Wonder?**

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First, Answer This Simple Question....

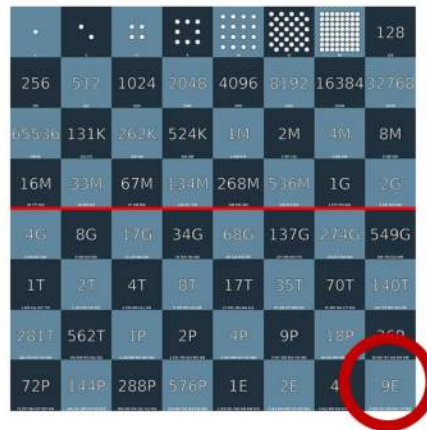
**If I put 1 grain of rice on the first
block of the chessboard, and
double it for every block, how
many grains of rice would I have
on the 64th block?**



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Any guesses?

How Close Was Your Answer?



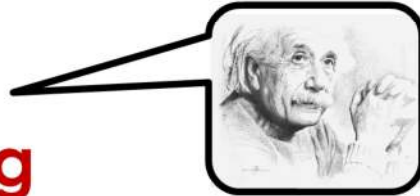
$$\begin{aligned} 9E &= 9,223,372,036,854,780,000 \\ &= 9,223 \text{ Quadrillion} \end{aligned}$$

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Rice on entire chessboard = Heap larger than Mount Everest, or 1,000 times the global production of rice in 2010.

**What Rice Grains and
Chessboard Have To Do With The
World's 8th Wonder...**

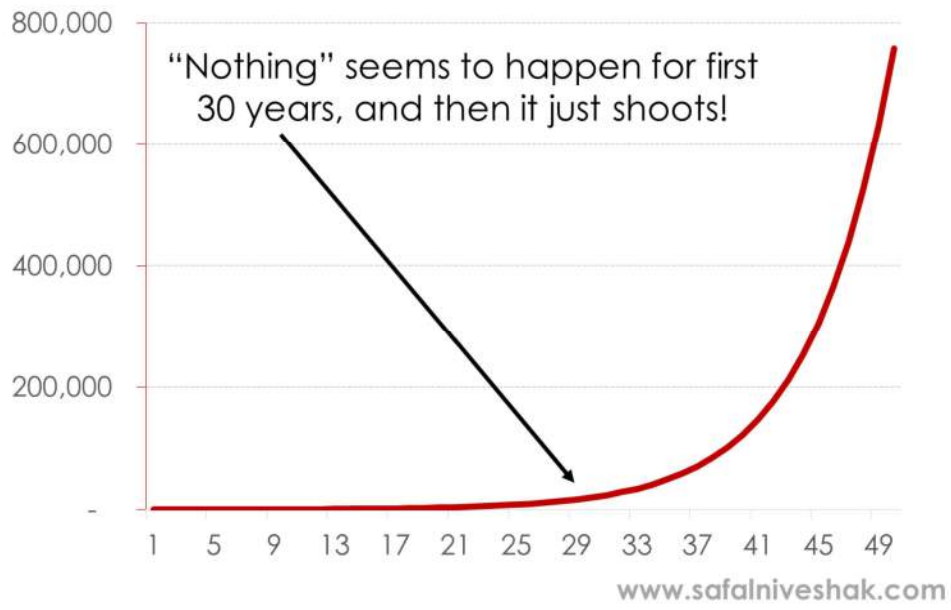
**Power of
Compounding**

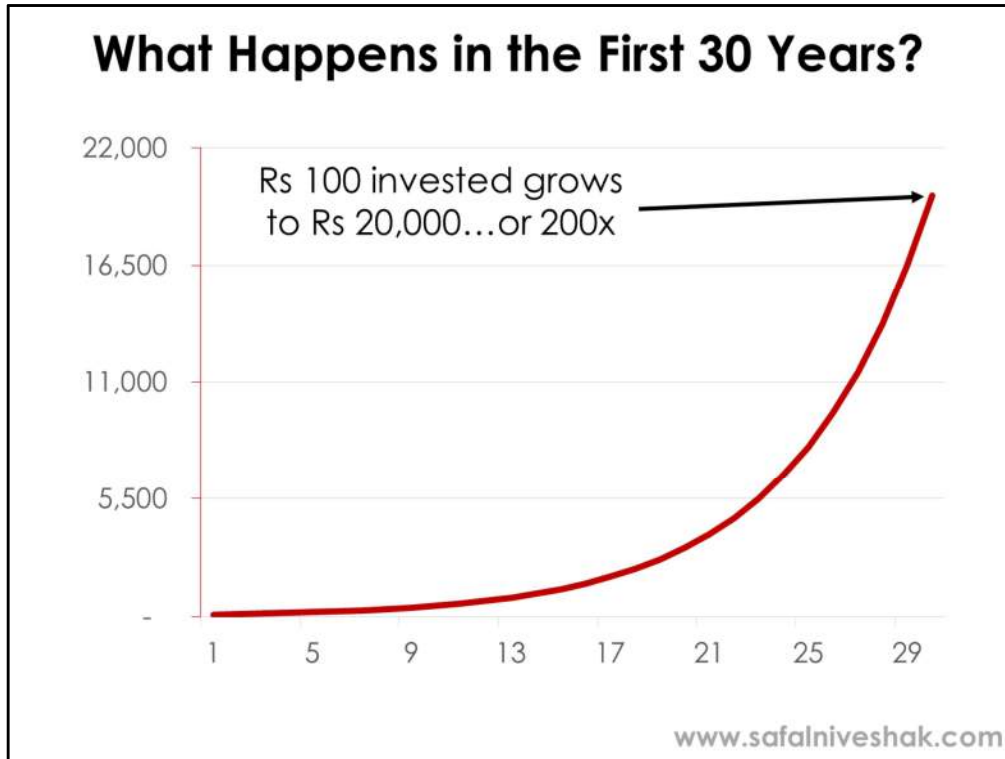


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Let me explain...

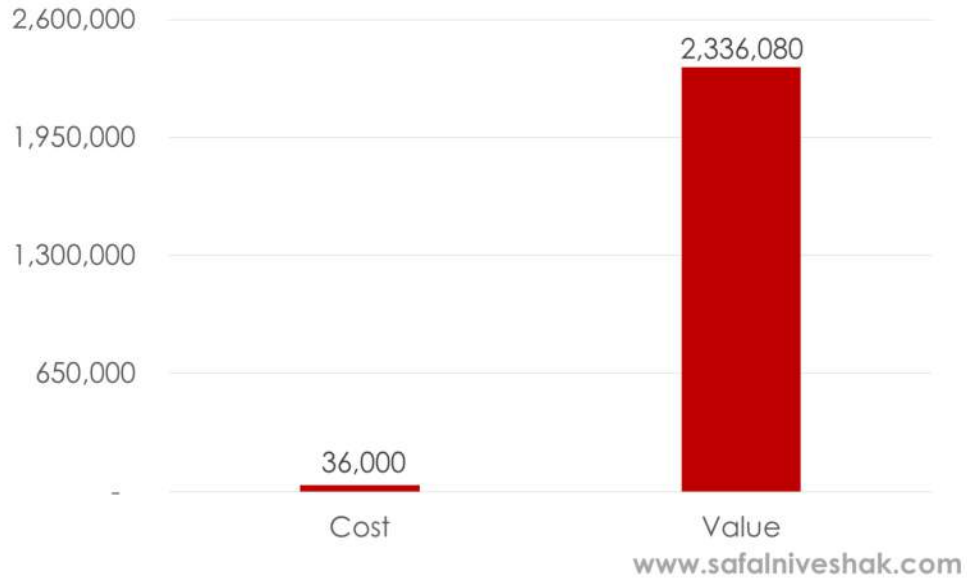
When Money Grows @ 20% p.a. Over 50 Years

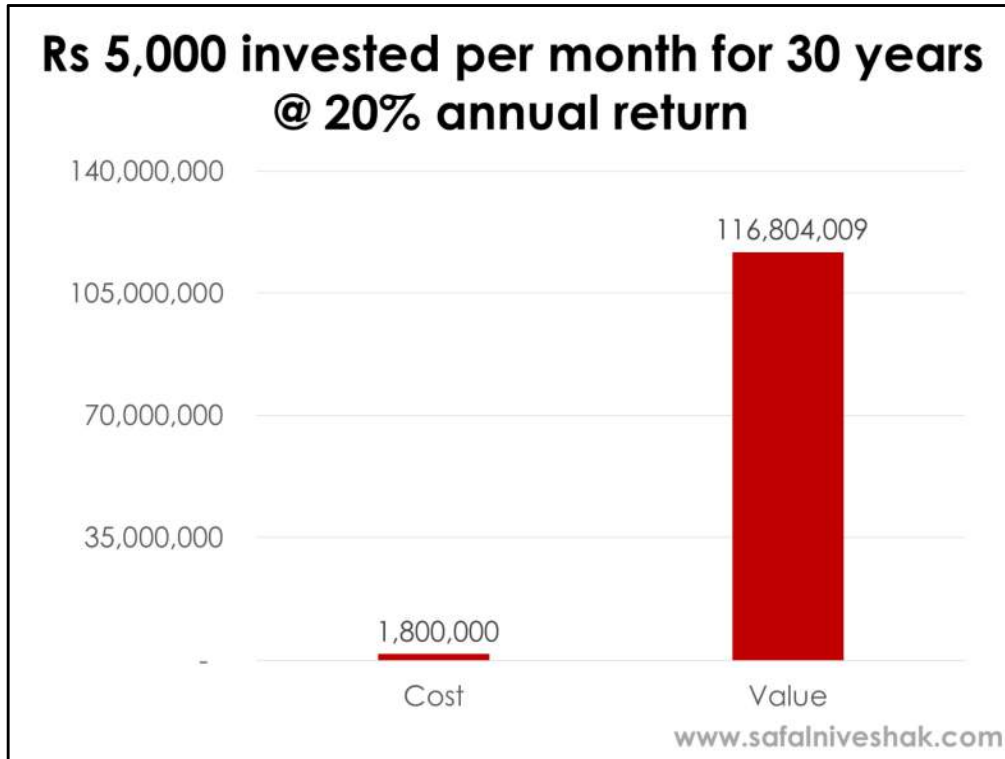




And this is just Rs 100 invested once. Imagine investing Rs 100 every month for 30 years. What happens then?

Rs 100 invested per month for 30 years @ 20% annual return





If you think that's simple...

**So Why
Doesn't
Everyone
Get Rich?**



It's **[BAD]** Behaviour, Stupid!



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Remember This List?



1. **Arrogance**
2. **Envy**
3. **Predictions**
4. **Timing**
5. **Trading**
6. **Derivatives**
7. **Leverage**
8. **Tips**

**This is what most people indulge in,
in the stock market...**

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They See Stock Market As A...



There indeed are some similarities as well as differences between casino and stock market. The closest similarity between the two lies in the mindset of the players/gamblers. Gamblers go to the casino hoping for the big win. We all hear about the person who went in poor and left the casino with millions. This seems an easy way to get rich. What we fail to understand is the enormous odds against such a huge win. But we remain hopeful and optimistic, and so casinos thrive. "I would be the next millionaire!" is what all gamblers think till the time they come out of the casino.

Unfortunately, the stock market has become like a casino for too many people. I see most people check the stock price ticker every 10 minutes for the next month, just like the gambler watching the wheels turn on a slot machine, waiting for that "Yes, I'm the millionaire!" moment. If it doesn't pay off, they speculate on another stock, just like a gambler goes to another slot machine to try his luck. However, the market does not operate exactly like a casino. It's the gamblers who think it does. **In a casino, the longer you play, the more you will lose (remember, the house always wins!). However, in the stock market, the longer you play, the more likely you are to win.**

Of course you will hear stories of people who made a quick killing in the stock market, just as there have been people who left the casino with millions, but always remember this for a fact – these are exceptions, not the rule. The rule is that you can create wealth from the stock market by buying quality businesses and holding them over the long run...till they remain good quality.

And This is Where They End Up...



How **YOU** Should Think About The Stock Market?



A Lesson on Elementary, Worldly Wisdom As It Relates To Investment Management & Business

Charles Munger, USC Business School, 1994

Everybody goes there and bets and the odds change based on what's bet. That's what happens in the stock market. Any damn fool can see that a horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on. But if you look at the odds, the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it's not clear which is statistically the best bet using the mathematics of Fermat and Pascal. The prices have changed in such a way that it's very hard to beat the system. And then the track is taking 17% off the top. So not only do you have to outwit all the other betters, but you've got to outwit them by such a big margin that on average, you can afford to take 17% of your gross bets off the top and give it to the house before the rest of your money can be put to work. Given those mathematics, is it possible to beat the horses only using one's intelligence? Intelligence should give some edge, because lots of people who don't know anything go out and bet lucky numbers and so forth. Therefore, somebody who really thinks about nothing but horse performance and is shrewd and mathematical could have a very considerable edge, in the absence of the frictional cost caused by the house take.

How Do You Win at Such a Game?

“The wise ones **bet heavily when the world offers them that opportunity.** They bet big when they have the odds. And the **rest of the time, they don't.** It's just that simple.”



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How Do You Win at Such a Game?

The way to win – in life and investing – is to work, work, work, work and hope to have a few insights.



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Now, how many insights do you need? Not many, Buffett says. He says –

I could improve your ultimate financial welfare by giving you a ticket with only 20 slots in it so that you had 20 punches—representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all.

Under those rules, you'd really think carefully about what you did and you'd be forced to load up on what you'd really thought about. So you'd do so much better.

What You Need to Win At The Investing Game?



...AND...

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A lot of
GOOD LUCK



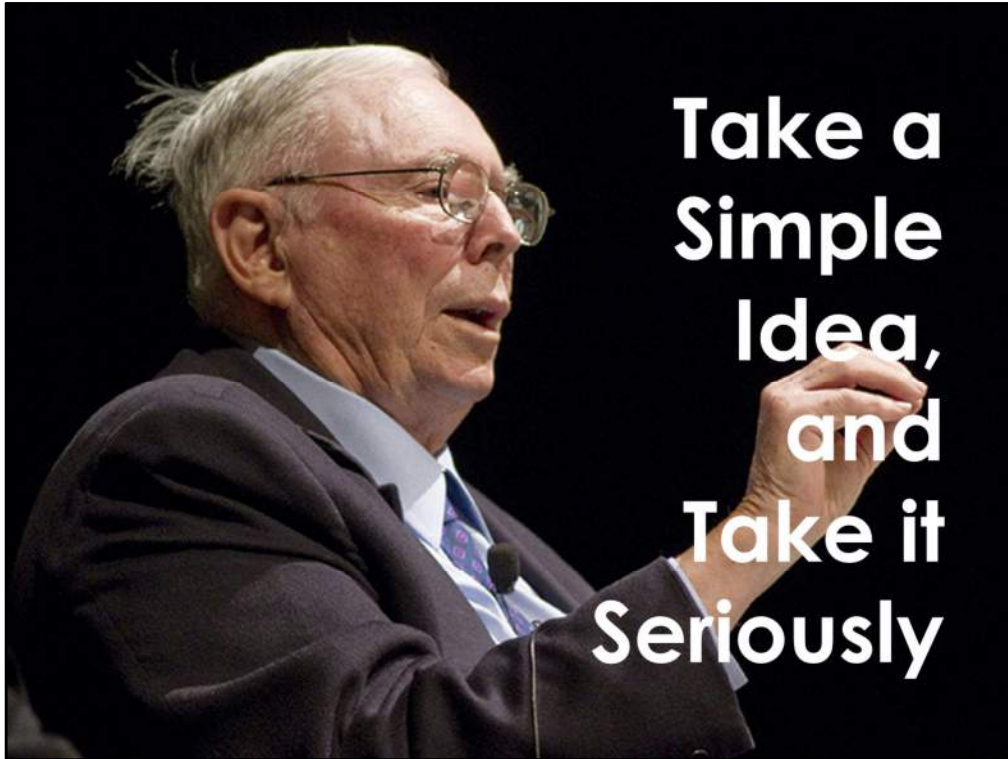
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LUCK, like LOVE, is a “VERB”



When you practice, and when you do the work...
you get lucky.

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Welcome to the Amazing World of...

Value Investing



"It hasn't helped me sell more hot dogs, but I've had several inquiries for investment advice."

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What is Value Investing?

“...one which, upon **thorough analysis**, promises **safety of principal** and an **adequate return**.”



Operations not meeting these requirements are speculative.”

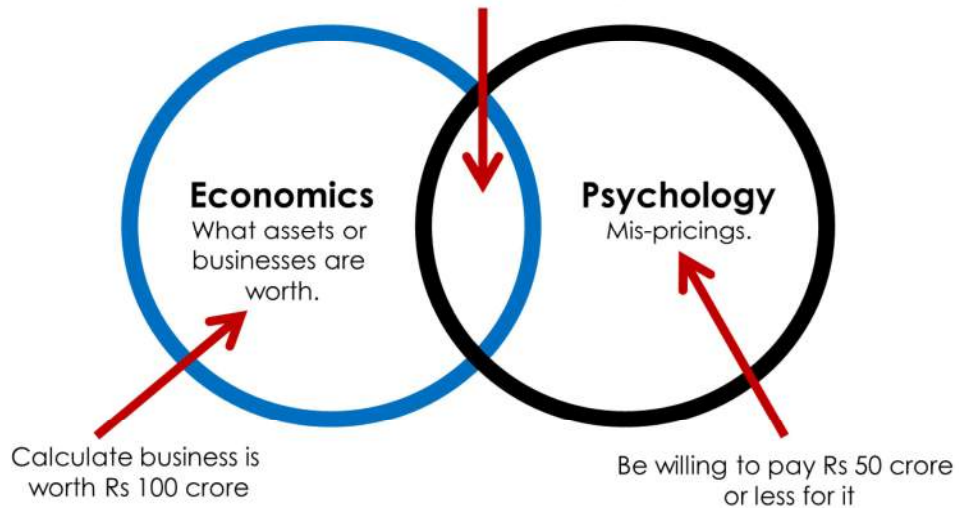
~ Benjamin Graham, Intelligent Investor



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Why Value Investing is Successful?

Value Investing



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How Value Investing Can Make You Money?

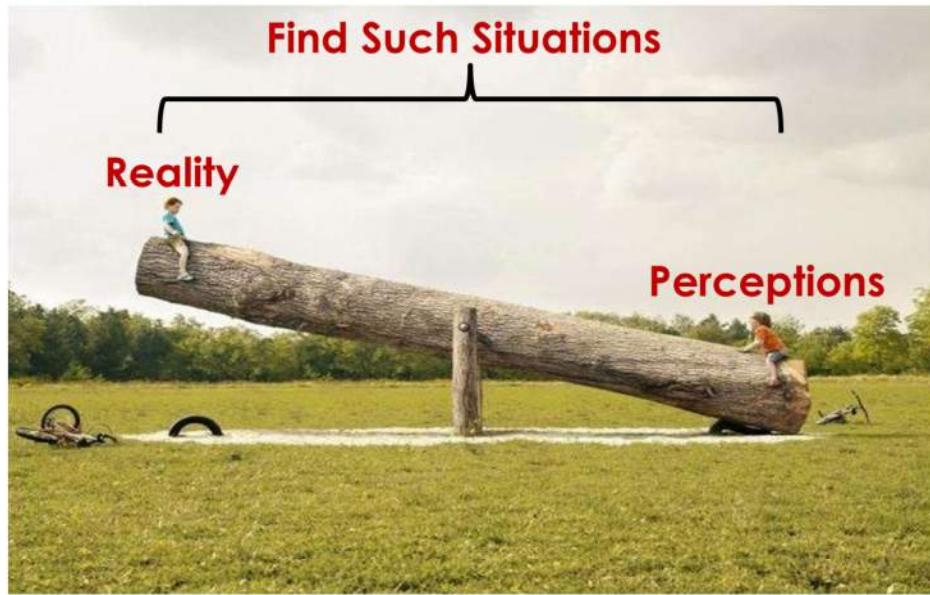
Prices fluctuate more than Value



...and therein lies the opportunity

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How to Make Money Using Value Investing?



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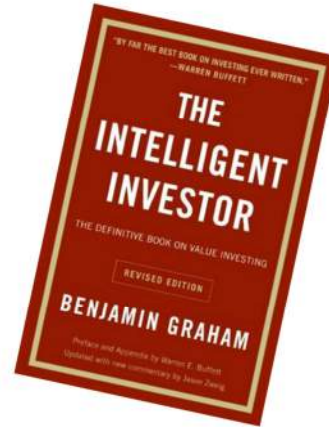
8 Rules of Value Investing

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1. Read “The Intelligent Investor”

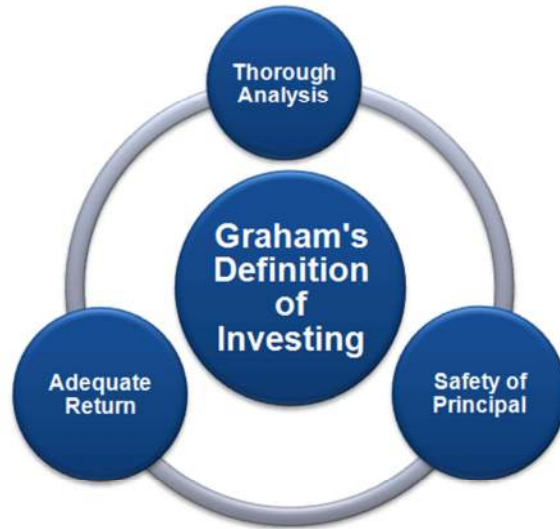
“At age 19, I read a book and what I’m doing today, at age 76, is running things through the same thought process I learned from the book I read at 19.”

~ Warren Buffett



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2. Understand the Difference between Investing and Speculation



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3. Think like a Businessman

**Underneath
every stock
is a business.**



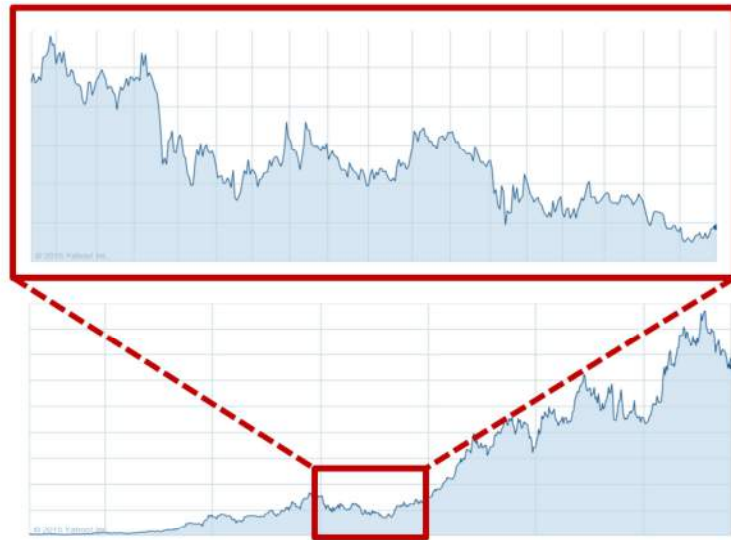
The goal is not excitement, but making a profit.

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A stock is not a piece of paper. It's a share in a business – its profits, cash flows, and growth.

4. Focus on Value, NOT Price

Which
is a
better
stock?



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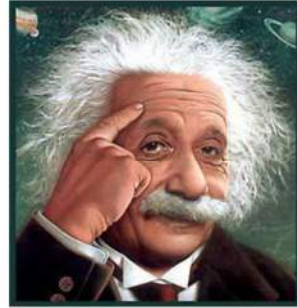
Volatility, or Beta, is NOT risk! You should not focus or worry about that. But then, Beta is what will get you marks in MBA!

The Simple Equation of Value Investing

Figure out what a business is worth

+

Pay a lot less for it



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5. Make Mr. Market Your Servant



The most important thing you will ever read about stock prices – from Warren Buffett’s 1987 letter...

“Graham said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

“Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market’s quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

“Mr. Market has another endearing characteristic: He doesn’t mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

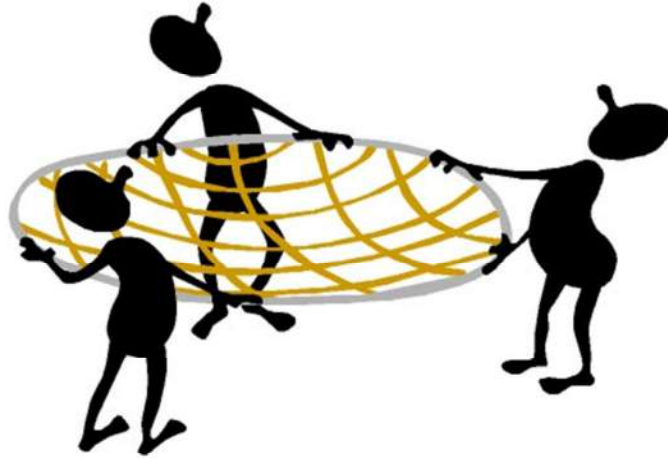
“But, like Cinderella at the ball, you must heed one warning or everything will turn into

pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game.

“Ben's Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising "Take two aspirins"?

“The value of market esoterica to the consumer of investment advice is a different story. In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.”

6. Never Forget The 3 Most Important Words in Investing – **Margin of Safety**



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7. Think Independently



“You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right – and that's the only thing that makes you right.” ~ Benjamin Graham

“People want to make money fast, but it doesn’t happen that way. Value Investing doesn’t promise enough for many people. You don’t know when it will happen, but you just wait for the fat pitches within your circle of competence.”



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8. Believe in Luck, and Give it Some Credit



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Businesses: Great, Good, Gruesome

"It's a funny thing about life; if you refuse to accept anything but the best, you very often get it."

~ W. Somerset Maugham

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7-Point Checklist To Identify Great Businesses



1. Consumer Monopoly Or Commodity?

1. **Seek out companies that have no or less competition**
(Due to Patent / Brand / Unique Product).
2. Such companies will typically have **high gross and operating profit margins because of their unique niche.**
3. Look for companies with **gross, operating and net profit margins above industry norms.**

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2. Is the Business Simple to Understand?

If it's a choice between owning stock in a...

- Fine company with excellent management in a highly competitive and complex industry, or
- Boring company with average management in a simple industry with no competition

...take the latter.

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“Go for a business that any idiot can run – because sooner or later, any idiot is probably going to run it.”

~ Peter Lynch



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3. Is the Company Conservatively Financed?

1. Seeks out **simple, safe balance sheets**.
2. Such companies tend to have **strong cash flows, with little need for long-term debt**.
3. Look for **low debt to equity** or low debt-burden ratios.
4. Also seek companies that have history of **consistently generating positive free cash flows**.

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4. Are Earnings Strong and Do They Show an Upward Trend?

1. Rising earnings serve as good catalyst for stock prices.
2. Seek companies with strong, consistent, and expanding earnings (profits).
3. Seek companies with 5/10 year EPS growth > 20% (along with safe balance sheets).
4. More important than the rate of growth is the consistency in such growth. So exclude companies with volatile earnings growth in the past, even if the "average" growth has been high.

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5. Does the Company Stick With What it Knows?

1. Like you should stick to your circle of competence, a company should invest its capital only in those businesses within its circle of competence.
2. Look at the company's past pattern of acquisitions and new directions. They should fit within the primary range of operations for the firm.
3. Be cautious of companies that have been very aggressive in acquisitions in the past.

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6. Is the Company's Return on Equity Above Average?

1. Seek companies with above-average (better than competitors) returns on equity without employing much debt.
2. Average return on equity for Indian companies over the last 10 years is approximately 16%. Seek companies that earn at least this much (16%) or more than this.
3. Consistency is the key here.

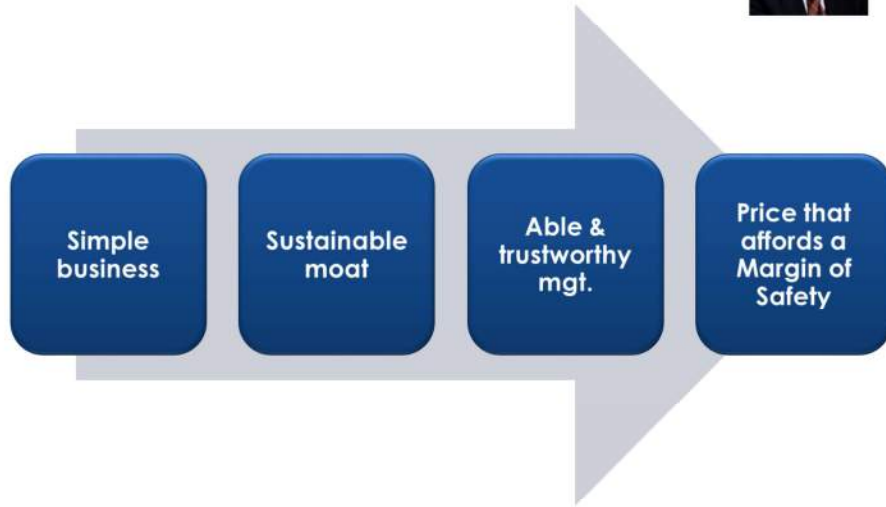
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7. Does the Company Need to Constantly Reinvest in Capital?

1. Companies that consistently need capital to grow their sales and profits are like bank savings account, and thus bad for an investor's long term portfolio.
2. Seek companies that don't need high capital investments consistently.
3. Seek companies that consistently generate positive and rising free cash flows.

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Munger's Four Filters



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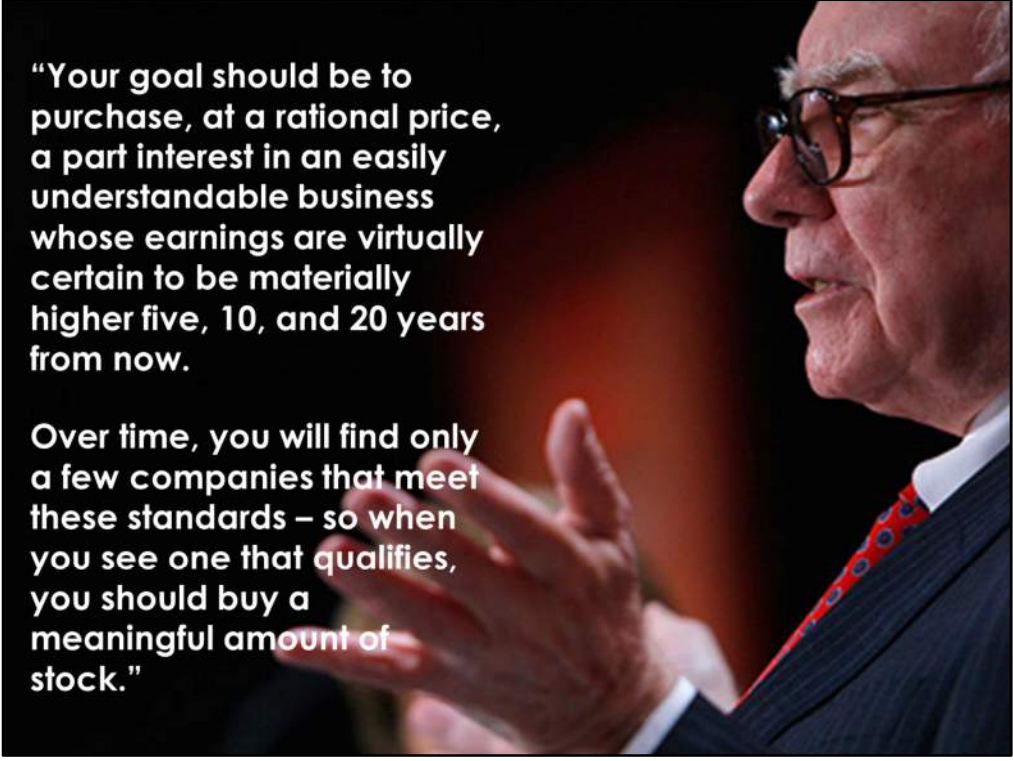
A Word on Moats



Buffett loves moats. He uses the metaphor to illustrate a business's superiority "that make life difficult for its competitors."

"What we're trying to find is a business that for one reason or another — because it's the lost-cost producer in some area, because it has a natural franchise due to its service capabilities, because of its position in the consumer's mind, because of a technological advantage or any kind of reason at all — has this moat around it. And you throw crocodiles and sharks and piranhas in the moat to make it harder and harder for people to swim across and attack the castle."

A truly great business, says Buffett, must have an enduring moat around its economic castle that protects its excellent returns on invested capital."



“Your goal should be to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher five, 10, and 20 years from now.

Over time, you will find only a few companies that meet these standards – so when you see one that qualifies, you should buy a meaningful amount of stock.”



Hold a water bottle, and ask for its weight.

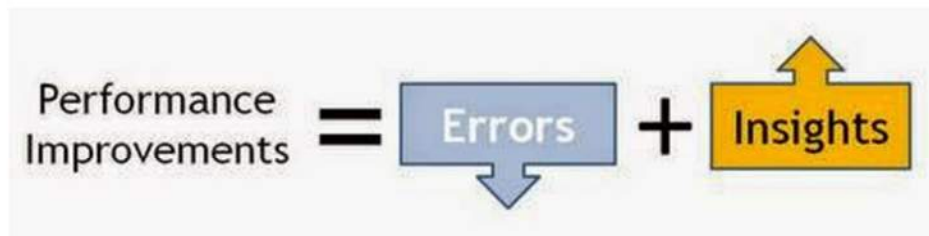
Investing and Human Behaviour



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How To Get Better At Anything?

Gary Klein's excellent book, "Seeing What Others Don't: The Remarkable Ways We Gain Insights" starts with a neat looking equation:

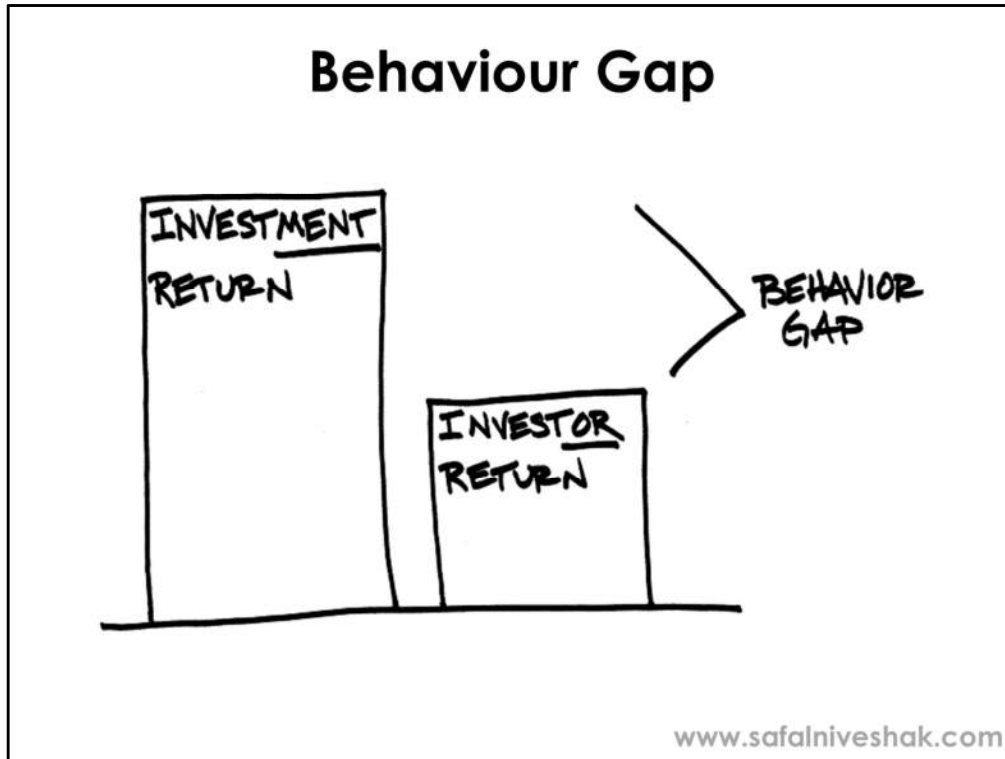


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In other words, if you have to get better at anything, you must do two things:

1. Don't screw up; and
2. Get cool ideas that work.

We've learned some cool ideas that work in investing. Let's now look at where we screw up.



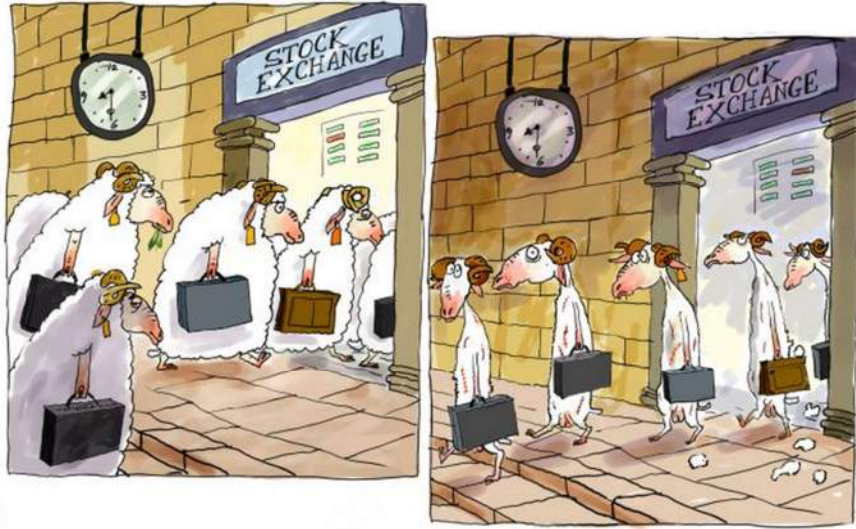
Investment return and investor return are two different things. So, while an investment may multiply 100x in 20 years, very few investors stick for such long and actually earn the 100x.

And why do investors behave that way?



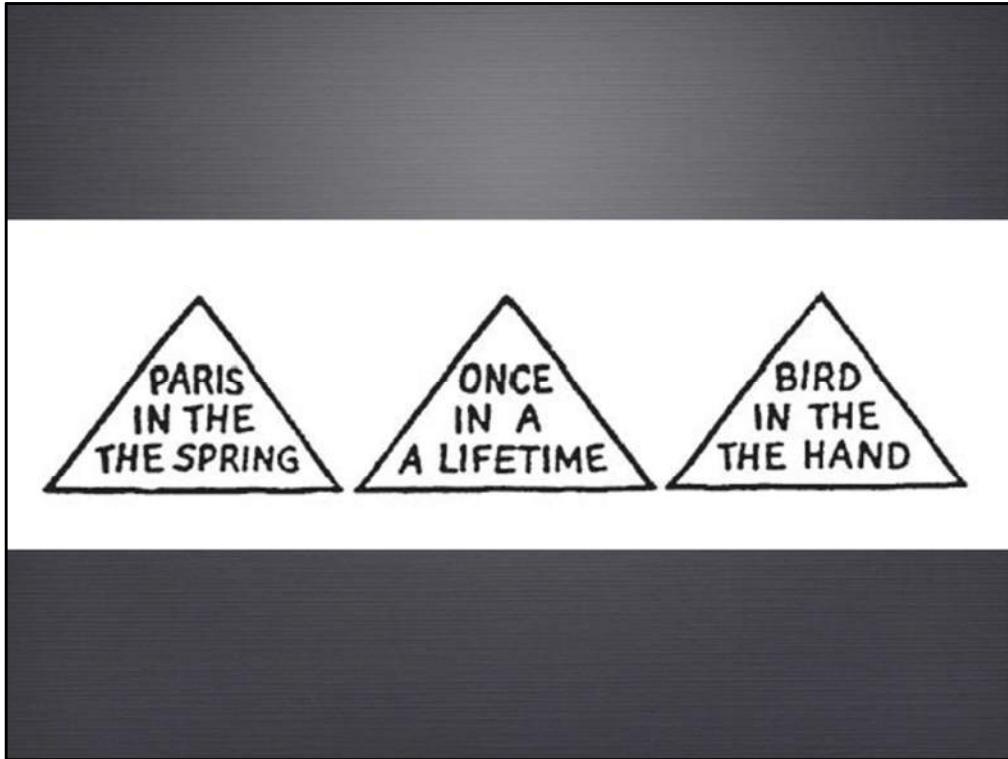
**Investors
Behave Like
Lemmings...**

...And Also Like Sheep

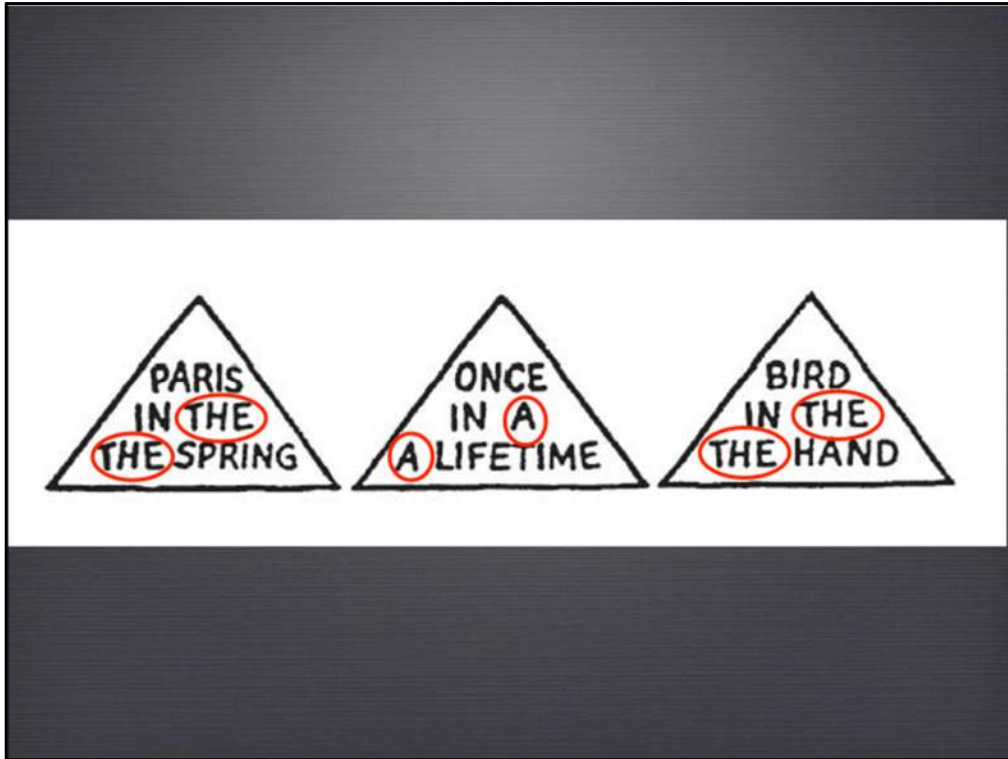


But Why?

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Read aloud quickly what you see on the screen. Do it twice.



Most of you got it wrong! Why?



The reason why people get it wrong is because they “jump to conclusions” using the reflexive parts of their brains.

Reflexive Brain



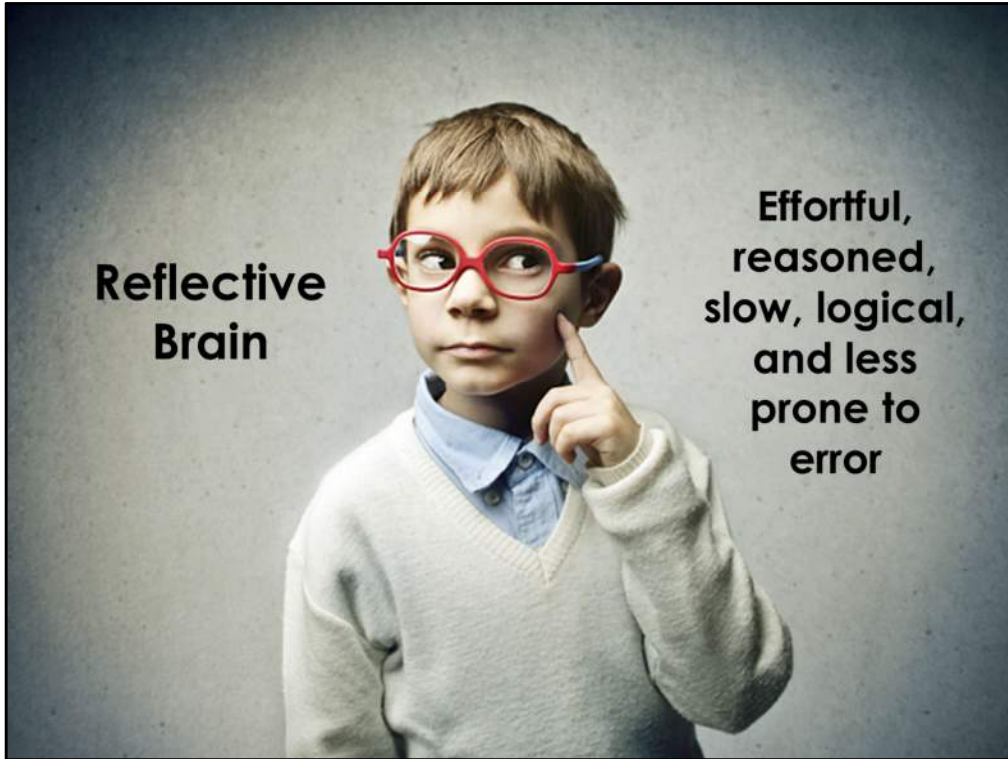
**Effortless, automatic, fast, but
can lend itself to errors.**

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Reflexive Brain is effortless, automatic, fast, but can lend itself to errors.

It's also the reason why you are alive today. Your ancestors, who learnt to run away at the first sign of danger, were able to increase their chances of survival until at least they procreated. If even one of your ancestors had died before pro-creating, you won't be here today. But you are.

Reflexive brain is VERY useful. But it also leads to mistake.



Reflective Brain is effortful, reasoned, slow, logical, and less prone to error.

How to Reduce Errors While Using Our Mostly Reflexive Brain?

“If you wish to avoid irrationality, it helps to understand the quirks in your mental wiring and then you can take appropriate, precautionary measures.”



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Those quirks in our brains are known as Cognitive Biases, which are tendencies to think in certain ways that can lead to systematic deviations from a "standard of rationality" or good judgment.

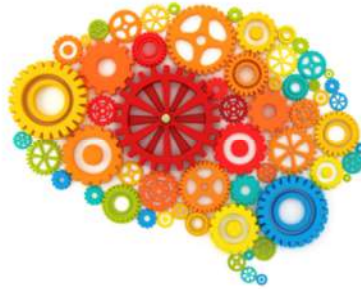
Simple Words Mein Bole Toh...



Biases = Chemical Locha in Our Brain

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Some Big Biases In Our Brains



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These type of monumental screw ups (about 25 of them) are avoidable, at least up to a point. Avoiding them completely won't be easy, however, for reasons you'll soon discover.

1. Availability Bias (WYSIATI)

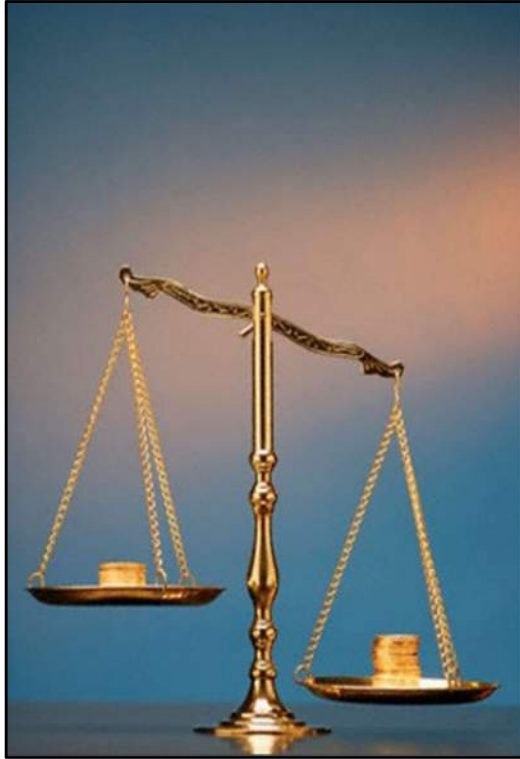


WYSIATI - What you see is all there is. The human brain tends to drift into working with what's easily available to it.



**The brain
can't use
what it can't
remember.**

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The result?
Mind tends to
overweigh
what's easily
available to it.

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What sort of things tend to be more **available** in our minds than others?

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Vivid Images



People remember vivid images.

BALANCE SHEET

AS AT 31ST MARCH 2009

Particulars	Schedule	As at 31st March 2009		Rs.
SOURCES OF FUNDS				
Shareholders' Funds :				
Share Capital	A	251,421,000	251,421,000	
Reserves and Surplus		2,153,061,465	2,404,462,465	1,826,994,761
Share / Convertible Warrants	C	146,000,000		204,562,500
Application Monies				
Loan Funds :				
Secured	D	1,118,332,844		2,383,067
Unsecured	E	1,081,749	1,087,147,593	368,870
Total		3,637,630,058		2,034,309,198
APPROPRIATION OF FUNDS				
Fixed Assets :				
Gross Block	F	1,185,048,011		857,367,898
Less : Depreciation and Amortisation		232,854,962		144,418,916
Net Block		952,193,052		712,948,982
Capital Work in Progress		32,585,630	9,778,682	12,828,254
Investments :	G	280,333,859		1,855,000
Deferred Tax Assets :		42,603,553		1,355,746
<small>(Refer Note No. 15 on Schedule VI)</small>				
Current Assets, Loans and Advances :				
Current Assets, Loans and Advances :				
i) Inventories	H	600,661,093		10,127,635
ii) Sundry Debtors		2,593,567,557		703,189,022
iii) Cash and Bank Balances		13,822,100		12,880,752
iv) Loans and Advances		331,999,050		610,480,031
Total		3,540,049,800		1,656,722,440

Companies use vivid images and words in annual reports to “hide” the harsh truths – bad financial performance.



**Approx. 3,000
people died in
Sept. 11 attacks.**

**An additional
1,500 died due to
increased ROAD
travel due to
mass fear of
flying. Vivid!**

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Vividness in financial markets

“An idea or a fact is not worth more merely because it is easily available to you.”



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2. Recency Bias



Our most recent experience tends to carry more weight in our heads than old experiences.

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Recency bias is the tendency to think that trends and patterns we observe in the recent past will continue in the future. Predicting the future in the short term, even for highly changeable events like the weather or the stock market, according to events in the recent past, works fine much of the time.

Recency + vividness = lethal combination And if you get this idea right, you'd understand the importance of taking the opposite view of the crowd when the crowd is obviously wrong. AFTER the event the RISK went DOWN

Source: Prof. Sanjay Bakshi's BFBV lecture

Natural Disasters & Recency Bias



Purchase of earthquake insurance increases greatly after the occurrence of an earthquake and declines steadily as the memory of the event fades. Similar behavior has been observed for floods and food insurance. Notice this combines with VIVIDNESS.

Stock Market Disasters & Recency Bias



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The best time to buy is when there is blood on the streets. It's good to have a DCF frame of mind, and ask – would this event negatively impact the CF or cash flows of the business I own, or am considering buying? If not, it spells OPPORTUNITY.

Biggest losing days in stock markets typically mean lucrative opportunities to invest.

3. Kantian Fairness Tendency



Monkey Fairness Experiment Video – <https://goo.gl/117hzF>

The inability to deal with the fact that life isn't fair. I'm sure this one hits home for many of you. The fact of the matter is that the universe could care less about your feelings, and you must deal with it.

One of the ways this bias comes into play in investing is when people expect that they should make the money in the same way they lost it, i.e., they focus on individual stocks to make money for them.

Of course, that's what the idea is when you choose the stock to begin with. But expecting fairness in returns from the stock is a fallacy. Instead, you should make sure that you don't lose money overall on your portfolio of stocks. No matter how much margin of safety and rigorous analysis you employ, you are bound to find (time to time) that you have a loser in your portfolio.

A natural reaction is to say, "It's not fair. I have put in so much effort, analysis and money in this stock. It shouldn't lose money."

Being aware of Kantian Fairness Tendency can save you some unwanted heartache.



Consider the example of Hawkins Cookers, which recently cut its dividend from Rs 60 per share in FY14 to Rs 45 in FY15 due to slowdown in growth and pressure on cash flows.

“It’s unfair!” lot of investors in the stock seem to be saying. “Did we pay 60x for this?”

And, when a lot of investors start singing the *unfair* song, this is what happens to the stock.

On the surface, this may seem fair on the part of the management, who wants to protect precious cash that would help them tide over the immediate slowdown in business. But to most people who bought the stock with unfair expectations, it’s the management and the business that now looks unfair to them!

4. Overconfidence Tendency



Overconfidence can lead to straying beyond circle of competence and excessive leverage, trading

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Entrepreneurs and those wishing to marry also deem themselves to be different: They believe they can beat the odds.

Overconfidence bias also applies to forecasts, such as stock market performance over a year or your firm's profits over three years. We systematically overestimate our knowledge and our ability to predict—on a massive scale.

82% of people say they are in the top 30% of safe drivers

Be aware that you tend to overestimate your knowledge. Be skeptical of predictions, especially if they come from so-called experts. And with all plans, favor the pessimistic scenario. This way, you have a chance of judging the situation somewhat realistically.

5. Authority Bias



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Ask yourself two important questions...

1. Is this authority truly an expert? This question helps to enquire the credibility of the expert.
2. How truthful can we expect this expert to be? This question should help us understand his incentives, interests before we give any credence to his words.

Even if we get satisfactory answers to both the questions above, it's imperative to remember that experts can be wrong and badly too.

Benjamin Franklin – *“It is the first duty of every citizen to question authority.”*

6. Bias from Commitment and Consistency Tendency



Salman Khan – “Ek baar jo maine commitment kar di, fir main apne aap ki bhi nahi sunta.”
(Once I have committed something, I won’t listen to even myself)

Robert Cialdini – “Once we have made a choice or taken a stand, we will encounter personal and interpersonal pressures to behave consistently with that commitment. Those pressures will cause us to respond in ways that justify our earlier decision.”

In corporate mergers and acquisitions, the same bias forces managements to keep on allocating more capital into a recent merger in an attempt to revive it. Investors often face this bias in two ways. First, it is very difficult and time consuming to change the stance on a particular stock in the light of new information. Most successful investors are able to change their views with great aplomb without getting affected by their primitive need to be consistent. Second, it creates mental difficulties in capital allocation in a portfolio, especially if the new stock is going to replace an old stock.

What are the antidotes? How can we avoid the traps and exploit this bias for our benefit? One, don’t be a defender of ideas. Two, do not make absolute statements in public. Three, practice being a destroyer of your ideas.

Learn from Keynes who when criticized for changing his position on monetary policy during the Great Depression, replied – “*When my information changes, I alter my conclusions. What do you do, sir?*”

7. Bias from Envy & Jealousy



If I got a 20% salary hike, it made me very happy. If my colleague got 21%, I was ruined!

“Someone will be getting richer faster. It’s not a tragedy!” ~ Charlie Munger

8. Loss Aversion

Choose between:

A. An 85% chance of winning Rs 100
(the gamble); or

A. A sure gain of Rs 85 (the sure
thing)

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Most people when given these choices, pick B because they think of themselves as conservative and after all a bird in hand is worth two in the bush, right? So why gamble?

Now choose between:

A. An 85% chance of losing Rs100
(the gamble); or

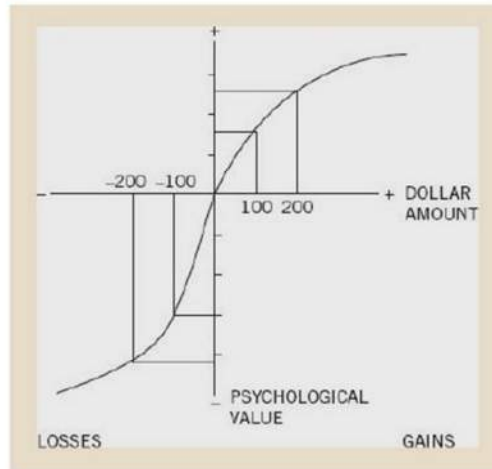
A. A sure loss of Rs 85 (the sure thing)

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Almost everyone now switches from the sure thing to the gamble because they hate taking losses.

Notice what just happened here. Just by changing a few words, you can turn people from conservative to gamblers. It turns out that the quantity of a man's pleasure from a Rs 100 gain does not exactly match the quantity of the misery from a Rs 100 loss.

The quantity of a man's pleasure from a Rs 100 gain does not exactly match the quantity of the misery from a Rs 100 loss.



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Loss aversion results in dumb behaviour like averaging down when the most sensible thing to do is to take a loss and live to fight another day. It makes us hold on to things, long after they have become toxic, because we hate losing them.

9. Inattention Blindness Bias



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Test your awareness – You are not good at seeing things you are not paying attention to.

See video – <https://goo.gl/CJ4zDa>

10. Impatience



Marshmallow Test Video - <https://goo.gl/Upd0rc>

If you seriously want to build wealth from the stock market over the long run, take this advice from Thomas Phelps (author of 100 to 1 in the Stock Market) to your heart – *To make money in stocks you must have “the vision to see them, the courage to buy them and the patience to hold them.”*

Patience is the rarest of the three, but it pays off in the long run. That’s how fortunes are made in the stock market.

Warren Buffett – *“The stock market is designed to transfer money from the active to the patient.”*

Charlie Munger – *“We don’t feel some compulsion to swing. We’re perfectly willing to wait for something decent to come along. In certain periods, we have a hell of a time finding places to invest our money.”*

11. Do Something Tendency

“All men’s miseries derive from not being able to sit in a quiet room alone.”
~ Pascal



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Short term fluctuations in the stock prices is a noise that you are supposed to ignore. If you start reacting to every small portfolio fluctuations and churn your portfolio frequently, in the long run your performance will be poor.

Making too many decisions also introduces something called decision fatigue. The more decisions you have to make lower the quality of each decision. Too many decisions and over activity increase the odds of failure especially in stock market investing.

12. Contrast Effect



Meet Sharon

Chemistry – F
Psychology – A+

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Sharon's letter to her parents (Source: Influence – Robert Cialdini) –

“Dear Mother and Dad, Since I left for college I have been remiss in writing and I am sorry for my thoughtlessness in not having written before.” I will bring you up to date now, but before you read on, please sit down. You are not to read any further unless you are sitting down, okay?

Well, then, I am getting along pretty well now. The skull fracture and the concussion I got when I jumped out the window of my dormitory when it caught on fire shortly after my arrival here is pretty well healed now...

I only spent two weeks in the hospital and now I can see almost normally and only get those sick headaches once a day...

Fortunately, the fire in the dormitory, and my jump, was witnessed by an attendant at the gas station near the dorm, and he was the one who called the Fire Department and the ambulance...

He also visited me in the hospital and since I had nowhere to live because of the burnt-out dormitory, he was kind enough to invite me to share his apartment with him. It's really a basement room, but it's kind of cute. He is a very fine boy, and we have fallen deeply in love and are planning to get married. We haven't set the exact date yet, but it will be before...

...my pregnancy begins to show. Yes, Mother and Dad, I am pregnant. I know how much you are looking forward to being grandparents and I know you will welcome the baby and give it the same love and devotion and tender care you gave me when I was a child...

The reason for the delay in our marriage is that my boyfriend has a minor infection which prevents us from passing our premarital blood tests and I carelessly caught it from him...

I know that you will welcome him into our family with open arms. He is kind and, although not well educated, he is ambitious...

Now that I have brought you up to date, I want to tell you that there was no dormitory fire, I did not have a concussion or skull fracture, I was not in the hospital, I am not pregnant, I am not engaged, I am not infected, and there is no boyfriend. "However, I am getting a "D" in American History and an "F" in Chemistry, and I want you to see those marks in their proper perspective. Your loving daughter, Sharon.

BEWARE of SLOW Contrasts – MTNL, Nokia.

How to Clear Our Brains from These Biases?



**But you can minimize them by
doing these things...**

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1. Be Humble

- Avoid leverage
- Diversify
- Avoid trading



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2. Be Patient

- Don't try to make money quick
- Tune out the noise
- Make sure time is on your side



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3. Have Reasonable Expectations

“Blessed is he who expects nothing, for he shall never be disappointed.”

~ Benjamin Franklin



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If we don't hope for much, reality often beats our expectations. If we always expect the best or have unreal expectations, we are often disappointed. We feel worse and make bad judgments.

Here's Charlie Munger's iron prescription for life – *“Whenever you think that some situation or some person is ruining your life, it is actually you who are ruining your life...”*

“Feeling like a victim is a perfectly disastrous way to go through life. If you just take the attitude that however bad it is in any way, it's always your fault and you just fix it as best you can – I think that really works.”

4. Admit and Learn from Mistakes

“Mistakes are always forgivable, if one has the courage to admit them.”

~ Bruce Lee



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In Janet Lowe’s book *Damn Right: Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger*, Munger addresses the issue of losing investments by saying – *“I’ve been through a number of down periods. If you live a long time, you’re going to be out of investment fashion some of the time.”*

In his 2003 letter to shareholders, Buffett echoed Munger’s view, writing – *“In buying businesses, I’ve made some terrible mistakes, both of commission and omission.”*

Munger and Buffett’s comments often remind me that mistakes should be taken in stride and shouldn’t distract from the bigger picture of long-term success.

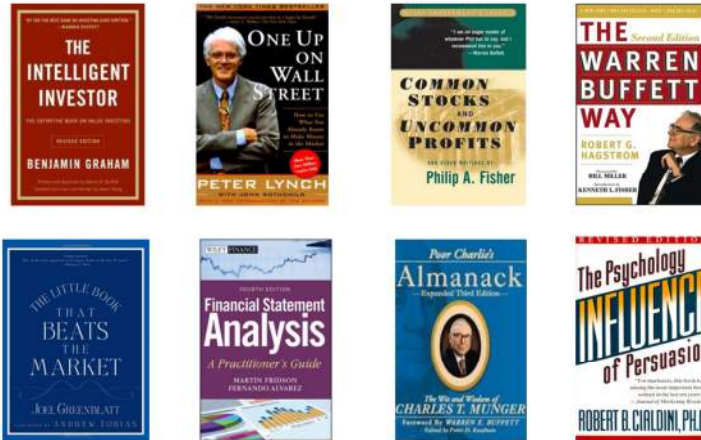
5. Avoid Financial News



Almost none of it is good!

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6. Read, Read, Read



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But...You'll Still Make Mistakes

“There is no way you can live any adequate life without making many mistakes. In fact, one trick in life is to get so you can handle mistakes. Failure to handle psychological denial is a common way for people to go broke.”



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I don't want you to think we have any way of learning or behaving so you won't make mistakes. I'm just saying that you can learn to make fewer mistakes than other people – and how to fix mistakes faster when you do make them.

But there is no way you can live any adequate life without making many mistakes. In fact, one trick in life is to get so you can handle mistakes. Failure to handle psychological denial is a common way for people to go broke.

And by the way, a wise man told me – “There are no mistakes. Only lessons.”

Finally, The 3 Golden Rules of Investing



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1.
**Look at Stocks as
Part-Ownership of
a Business**

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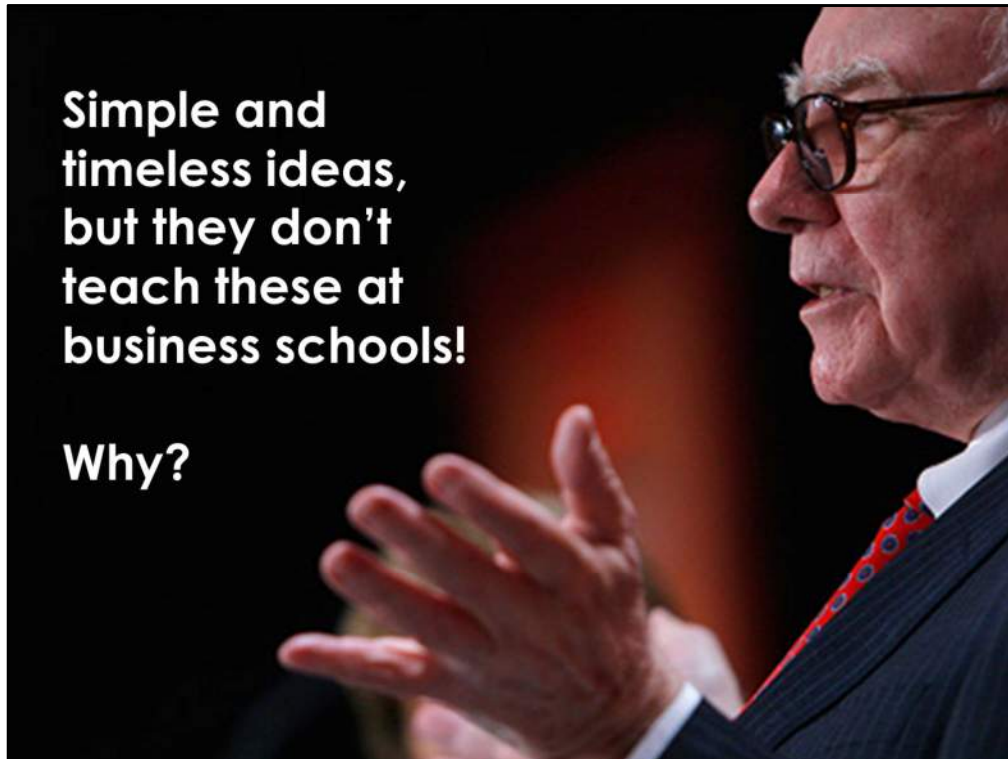
2. **Make Mr. Market Your Friend**

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Profit from folly rather participating in it.

3.
**Never Forget –
Margin of Safety**

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Buffett says...

Although they sound so simple and commonplace that it kind of seems like a waste to go to school and get a Ph.D. in Economics (or for that matter, and MBA in Finance) and have it all come back to that.

It's a little like spending eight years in divinity school and having somebody tell you that the ten commandments were all that counted.

There is a certain natural tendency to overlook anything that simple and important.

Why You Must Start Saving & Investing Early? Here's a Small Story...



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God created Donkey...



"You will be a donkey...work un-tiringly, carrying burden...will have no intelligence. You will live 50 years."

"To live 50 years is much. Give me only 20 years."



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God created Dog...



"You will guard the house of man...eat the scraps. You will live 30 years."

"To live 30 years is too much. Give me only 15 years."



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God created Monkey...



"You will be a monkey...swing from branch to branch doing tricks.
You will live 20 years."

"To live 20 years is too much.
Give me only 10 years."



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God created Man...



“You will be man...the only rational creature on earth. You will dominate the world. You will live 20 years.”

“To live only 20 years is very little. Give me the 30 years that the donkey refused, 15 years that the dog did not want, and the 10 years the monkey refused.”



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The Result?



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20



+

30



+

15



+

10



=



75 (What a life!)

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That's Life!

**Save and invest...
so that you don't
have to depend on
anyone for your
living when you are
old...not even your children.**



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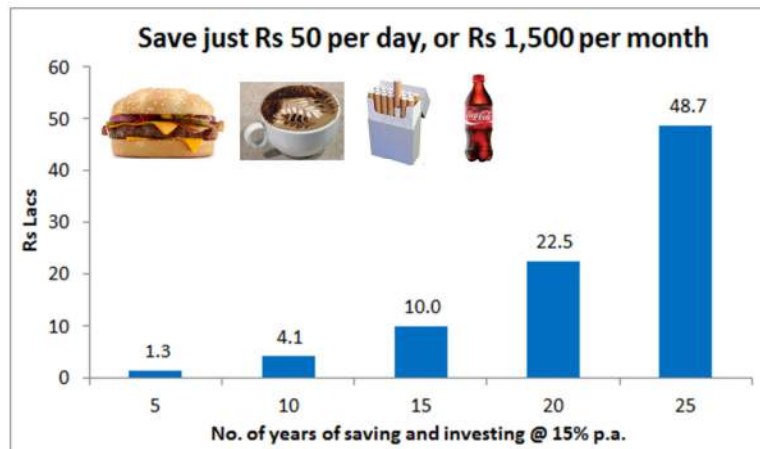
It's Up to You!

**When it comes to money,
you will not get what you want
or what you expect.**

You will get what you deserve.

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The Power of Compounding



"If you know how to spend less than you get, you have the philosopher's stone." ~ Benjamin Franklin

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Story of Jai & Veeru



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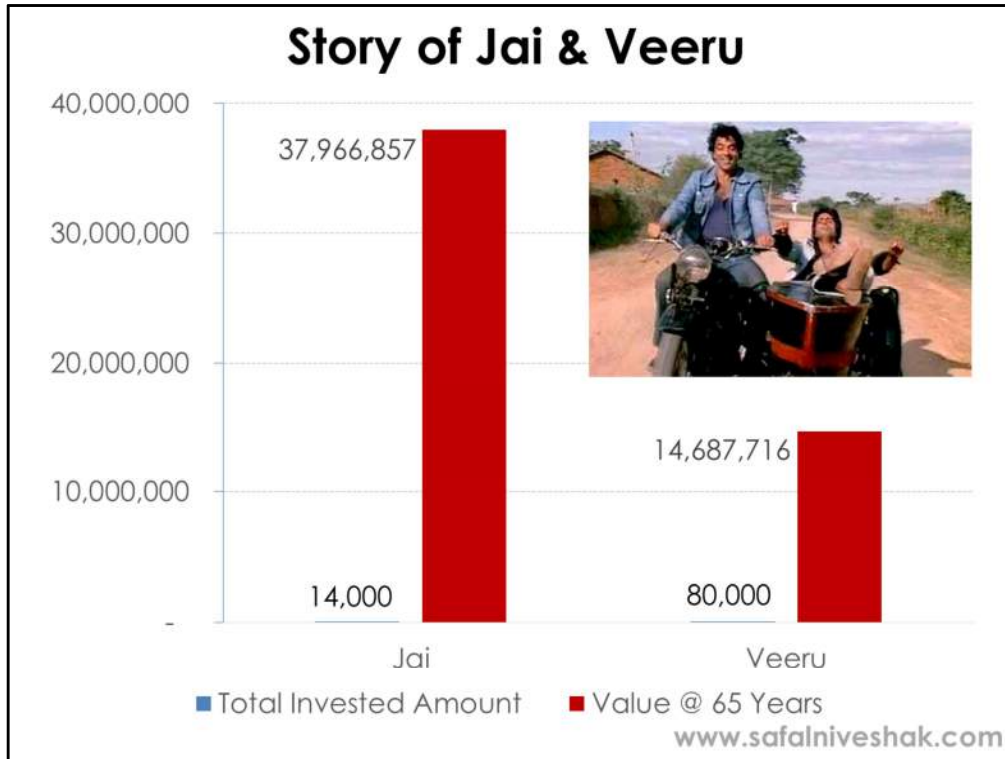
Jai and Veeru are 18 years of age today.

Jai starts today (at 18 years) and invests Rs 2,000 every year for 7 years, i.e., till he is 25. So, his total investment is Rs 14,000. He then leaves his investments to grow and does not invest a single new rupee. He earns 20% return every year till he is 65.

Veeru, the happy-go-lucky guy, does not invest anything till he is 26. And then he invests Rs 2,000 per year for 40 years, i.e., till he is 65. So, his total investment is Rs 80,000.

Who will have a bigger portfolio at the end of 65 years?

Let's see how their investment value looks when they are 65 years of age...



Starting early pays off handsomely for Jai!

That's the mantra you should have – start early, keep compounding.

**If you were to remember just
TWO things from today's
Workshop, they should be...**

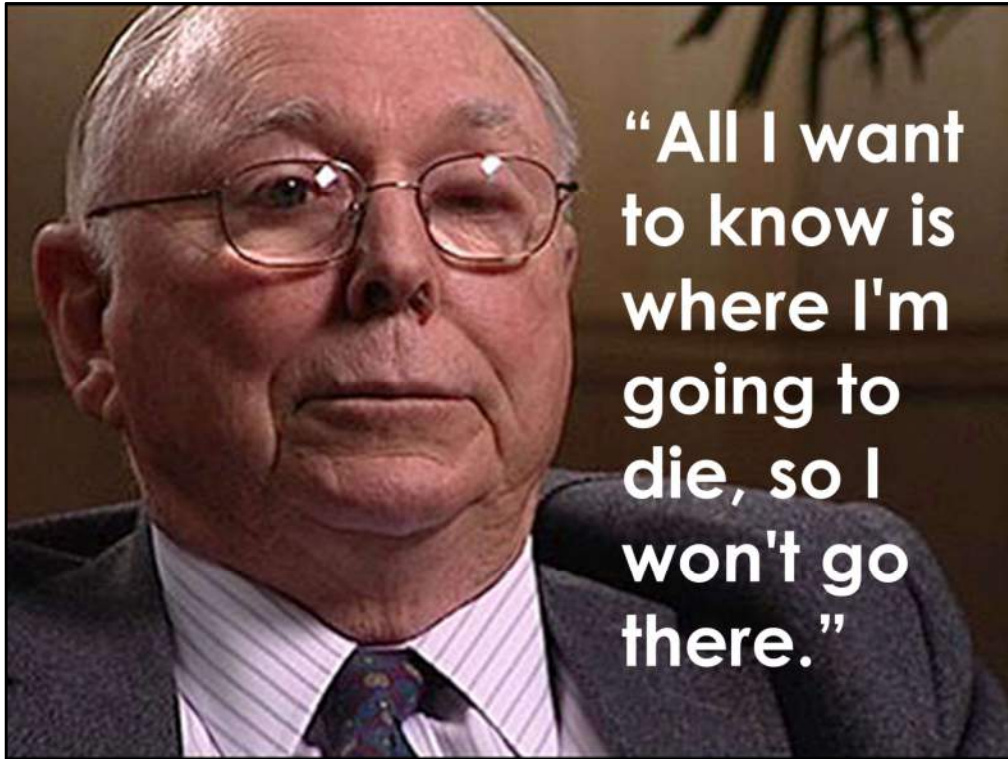


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**Rule #1: Never
lose money.**

**Rule #2: Never
forget Rule #1.**





Acquire worldly wisdom and adjust your behaviour accordingly. If your new behaviour gives you a little temporary unpopularity with your peer group...

...then too hell with them."



Thank You!

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About Vishal

Vishal Khandelwal is the founder of [Safal Niveshak](#). He works with small investors to help them become smart and independent in their stock market investing decisions.



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