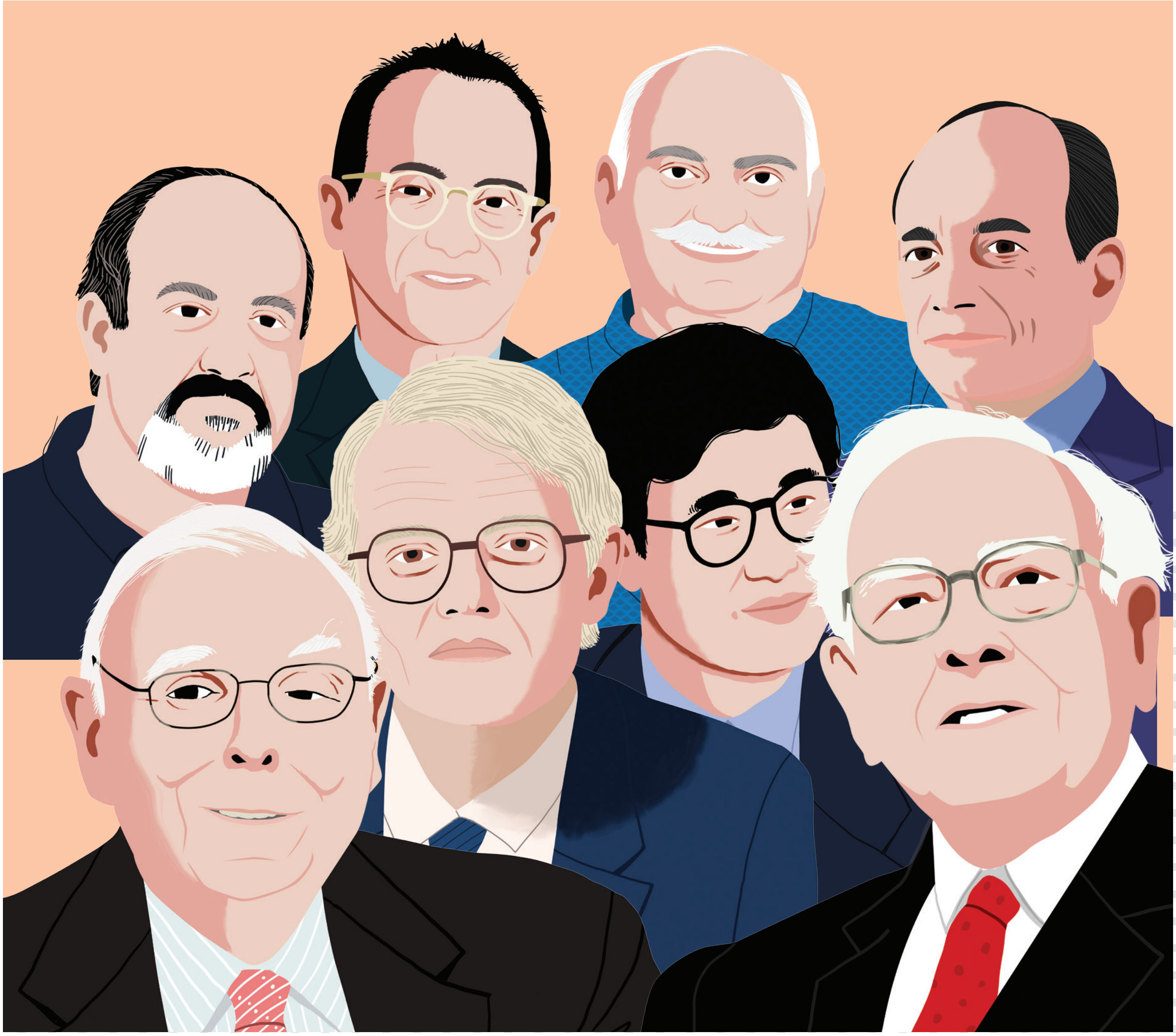
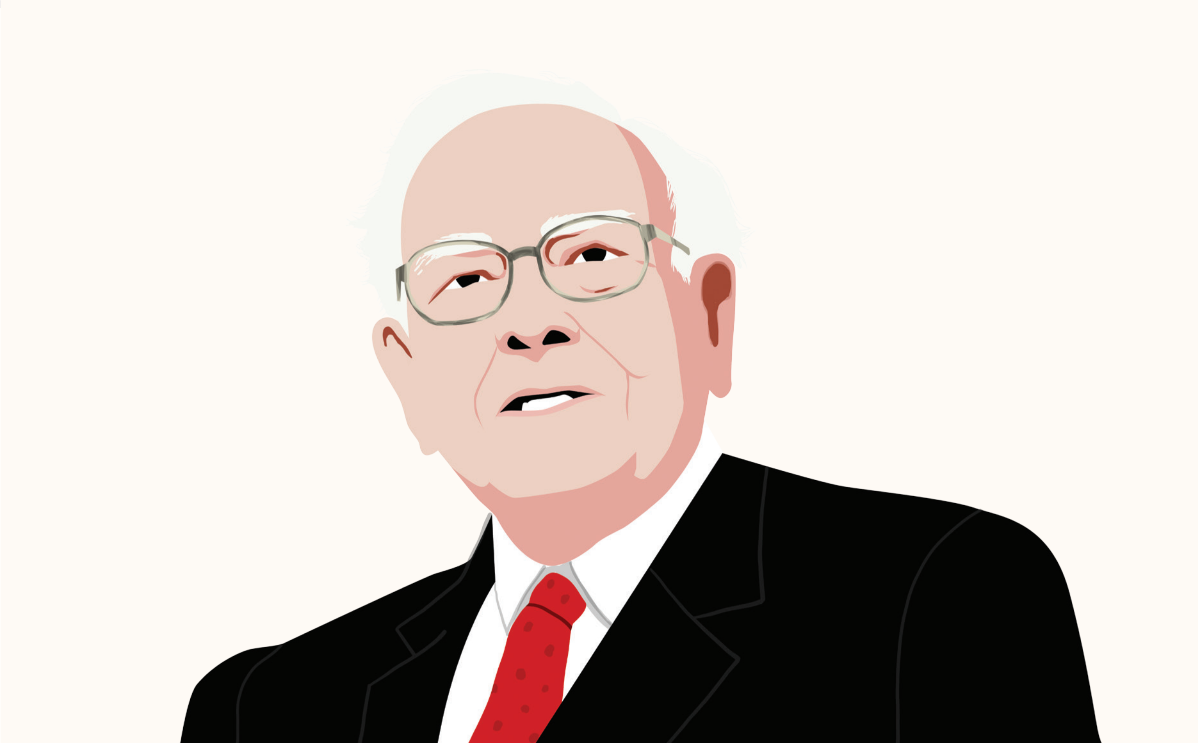
TIMELESS WISDOM

Investing insights from eight masters to help you stay ahead





WARREN BUFFETT

‘Be in a wonderful business because time is the friend of the wonderful business’

Warren Buffett, also known as the Oracle of Omaha, is the chairman and CEO of Berkshire Hathaway. One of the most successful investors in history, Buffett received investment education from Ben Graham at Columbia University. Berkshire Hathway boasted 20 per cent annual returns from 1965 to 2020, outperforming the S&P 500’s 10.2 per cent gains, including dividends, during the period. Here we look at Buffett’s 2001 talk at Terry College of Business (https://bit.ly/3iIBLqi).

Integrity matters

In today’s connected world, it isn’t hard to find intelligent and motivated people. But what separates big winners from smaller ones? Buffett answers, “Three things when we hire people we look for – intelligence, initiative or energy and integrity. And if they don’t have the latter, the first two will kill you.” Certainly, that is what separates a Narayan Murthy from a Nirav Modi.

Circle of competence

Buffett advises that investors should have their circle of competence, which means having an in-depth understanding of the economics of particular sectors or companies. He says, “When I say I don’t mean to understand what the product does or anything like that, I mean understand what the economics of the business are likely to look like 10 years or 20 years from now." Stocks undergoing bankruptcy, such as DHFL, Jet Airways, etc., have seen huge volatility in the recent past. However, investors with zero knowledge of investing in such special situations should stay away and invest only in companies that they understand.

Buffett advises that investors should have their circle of competence

Sunrise sectors don't mean sunrise returns

It is tempting to invest in companies belonging to growth sectors, however, Buffett expresses caution by giving an example of the automobile sector in the US. He says, "At the start of the 20th century, you had seen what the auto sector was going to do...but of those 2000 auto companies, three basically survived and they haven't done that well. So, how do you pick three winners out of 2,000? It's not so easy to do."

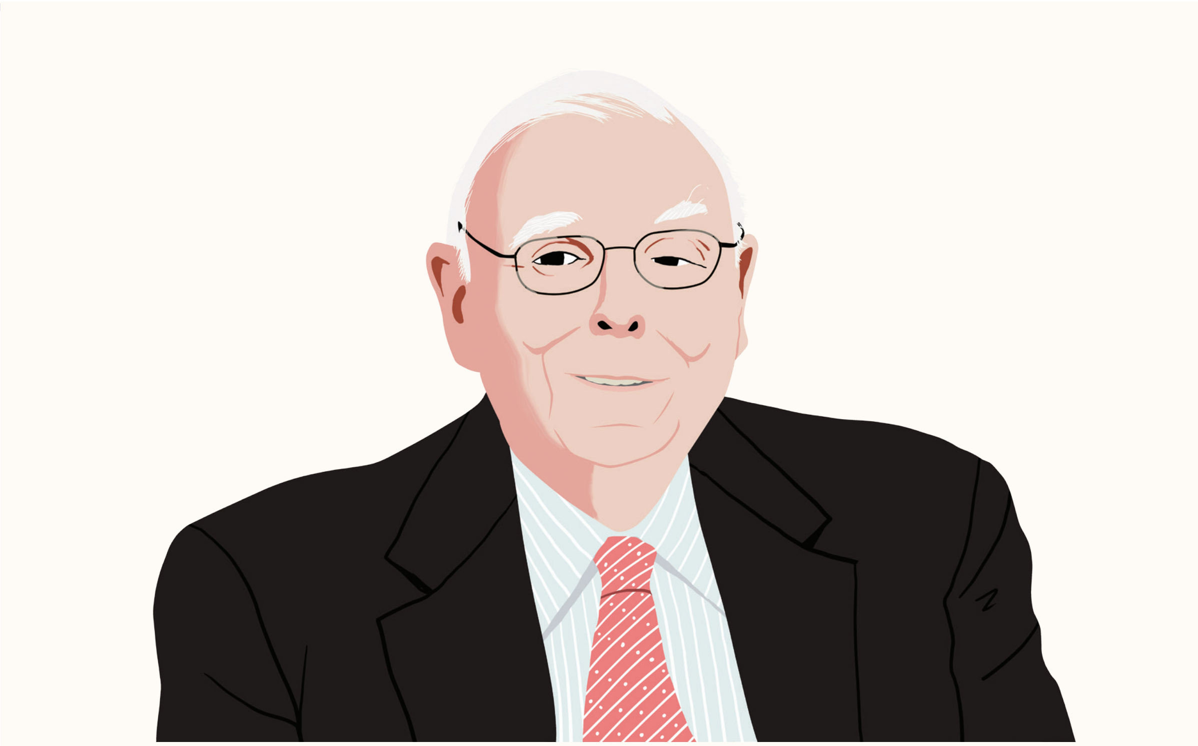
The telecom sector in India has seen similar faith. The 2000s saw an unprecedented growth of phone users, attracting new players, such as Tata Teleservices, Reliance Communications, etc., to the sector. However, the sector today is primarily left with three players, with one of them having an uncertain future.

It pays to invest in wonderful businesses

Although Buffett started his investing career by buying stakes in lousy companies trading at dirt-cheap valuations, he soon realised that investing in good businesses makes more sense. He explains, "You want to be in a wonderful business because time is the friend of the wonderful business, you keep compounding, the company keeps doing more business and you keep making more money. Time is the enemy of the lousy business." As investors, we are tempted to invest in lousy businesses such as DHFL, Jet Airways, etc. However, it is better to stay with Asian Paints, HDFC Bank and HUL.

Avoid acts of omission

In the stock market, one may not get many opportunities to invest wherein one may get a wonderful business at a fair price. However, when it does, investors should seize the opportunity. Buffett explains, "The biggest mistakes I've made by far are the mistakes of omission and not commission. It's the things I knew enough, they were within my circle of competence and I was sucking my thumb."



CHARLIE MUNGER

'I think I've been in the top 5 per cent of my age cohort all my life in understanding the power of incentives'

Charlie Munger is the partner of Warren Buffett and the Vice Chairman of Berkshire Hathaway. Munger is often credited for changing Buffett's investment approach right from buying cheap stocks trading at very low valuations to buying quality stocks trading at fair valuations. He is widely known for his superior thinking skills. In this article, we delve into some of the points that he discussed in his 1995 speech on the psychology of human misjudgment at Harvard Law School (https://bit.ly/3cUPHJQ).

Power of incentives

Incentives are a powerful tool to understand the outcomes of the situation. Describing its importance, Munger says, "Well, I think I've been in the top 5 per cent of my age cohort all my life in understanding the power of incentives and all my life I've underestimated it." Our visits to banks are an illustration of wrong incentives wherein relationship managers at banks are paid based on how much financial products they are able to sell. But this leads to mis-selling.

No matter whether it's a company, a brand or a person, we all want to be associated with good things

Staying in denial

The inability to face reality and remain in denial could do great damage to us. Munger describes why we do it, "The reality is too painful to bear, so you just distort it until it's bearable." After a fall of more than 50 per cent, we still cling to our stocks even when corporate governance issues are right in front of us.

Changing one's point of view

As humans, we tend to reach a conclusion and stick to it even when new information emerges and contradicts it. Munger gives a vivid example, "The human mind is a lot like the human egg and the human egg has a shut-off device. When one sperm gets in, it shuts down so the next one can't get in. The human mind has a big tendency of the same sort." Consistently updating your investment thesis with new information can help you become better investors.

Your association matters

No matter whether it's a company, a brand or a person, we all want to be associated with good things. Munger explains, "I'd say 3/4th of advertising works on pure Pavlov. Think how association, pure association, works. Take Coca-Cola company (we're the biggest shareholder). They want to be associated with every wonderful image." Probably, that's the reason the last Maggi ad is associated with instant noodles, Bournvita with motherhood and Coke with happiness.

Invest through rationality and envy

Envying others is one of the most damaging biases that can cause irrational thinking. Munger describes Buffett on envy, "I've heard Warren say a half a dozen times, it's not greed that drives the world, but envy." Isn't it the envy of profits made by friends/colleagues through trading activities that make us forget the basics of our own value investing?

Going beyond what's available

Suppose you invest in a company and thereafter, it takes steps that go against minority shareholders' interest. On asking, the management regrets the happening and insists it won't happen again. Based on this much information, would you still stay invested? If you were Munger, then you would not. He believes, "Well in the history of the See's Candy Company they always say, 'I never did it before and I'm never going to do it again.' And we cashier (fire) them. It would be evil not to because terrible behaviour spreads."

PETER LYNCH

'The single most important thing to me in the stock market for anyone is to know what you own'

Known for his famous book 'One Up On Wall Street', Peter Lynch managed the Magellan Fund at Fidelity Investments between 1977 and 1990. During the time, he averaged an annual return of 29.2 per cent and made it the best performing fund in the world. In this story, we share insights from his 1994 lecture at the National Press Club (https://bit.ly/35nEPjG).

Brainwashed by the media

Made to believe by the media that they don't stand a chance against institutions, investors do funny things, such as buying options, buying stocks for a week, etc. Lynch says, "Small investors have been convinced by the media, the print media, the radio-television media that they don't have a chance, that the big institutions with all the computers and all their degrees and all their money have all the edges and it just isn't true at all." His point stands true even today, as several business channels give buy and sell calls throughout the day, while gullible investors act on them without doing any research.

Stocks go up and down in the long run for a reason and that reason is earnings.

Know what you own

If you can't explain why you own stock to a 10-year-old, then you shouldn't own it. Lynch says, "The single most important thing to me in the stock market for anyone is to know what you own."

Stock returns are not magic

Stocks go up and down in the long run for a reason and that reason is earnings. Lynch states, "I'm trying to convince people that there is a method, there are reasons for stocks that go up." In fact, stock returns often overshoot earnings. In the last 10 years, HUL's earnings per share have grown by 3.2 times, while the stock price has grown by 6.9 times (as of October, 2021)

Macro predictions = Waste of time

According to Lynch, there is no point in trying to predict macro indicators like interest rates, stock market, economic growth, etc. He says, "If any of them predict interest rates right three times in a row, that'd be a billionaire. Since there's not that many billionaires on the planet, that means there can't be that many people to figure out interest rates."

Insiders have an edge

Who knows the best about a company or an industry? The employees themselves. Lynch insists people working in a particular sector have an edge in understanding the trends. "There are good stocks out there looking for you and people just start listening to that but they're just not watching it and they have incredible edges."

Institutions create opportunities

Is institutional presence beneficial? Lynch describes its importance as, "These institutions push stocks on usual lows, they push them on usual highs. For someone who can sit back and have his own opinion and know something about the industry, this is a positive." Infosys fell by more than 15 per cent in 2019 following alleged whistleblower complaints. As institutions exited, investors who understood Infosys well could have invested in the company and reaped good returns.

HOWARD MARKS

'Stocks, bonds, buildings and companies have cash-flow-generating capabilities and can be valued intrinsically'

Howard Marks is the co-founder of Oaktree Capital Management, which is the largest investor in distressed securities worldwide. Marks is admired in the investment community for his 'memos', which highlight his investment strategies and insights into the economy and are posted publicly on Oaktree's website. In this investor insight, we share his 2021 talk on value investing at Ben Graham Centre (https://bit.ly/35t9BaL).

The value lies in cash generation

Can you value a diamond necklace? As per Marks, you can't value it but only price it. He says, "Stocks, bonds, buildings and companies have cash flow-generating capabilities and can be valued intrinsically but paintings, oil, diamonds and art do not have intrinsic value because they don't produce cash flow." So remember, next time when someone says the value of some painting is good, it is not the value but the pricing.

Finding an investment edge

In today's connected world, it is very difficult for an investor to have any information edge and thus, Marks recommends, "In this environment, we have to look further ahead and that investment superiority has to come from either a better understanding of the significance of the current qualitative factors or a better understanding of the likelihood of success in the future." Intangible assets, workforce knowledge, technological disruptions and other qualitative factors have become important.

Evaporating moats

Rapid technological changes are fast diluting competitive advantages, also known as a moat of companies. Marks remarks, "The moats as we say have evaporated and many businesses have fallen prey to tech-savvy newcomers." The newspaper business is a prime example of technological changes.

Something never changes

Bull markets tend to make even a lousy business appear as a great one. Marks contends, "Some things certainly haven't changed; one is the tendency of the bull markets to value all competitors as if they'll be successful." The current bull market in India is painting almost all chemical companies with the same paint, however, for investors, it's important to discern the good ones from the average ones.

Lifelong learning, along with changing perspective, is what separates a good investor from a great one

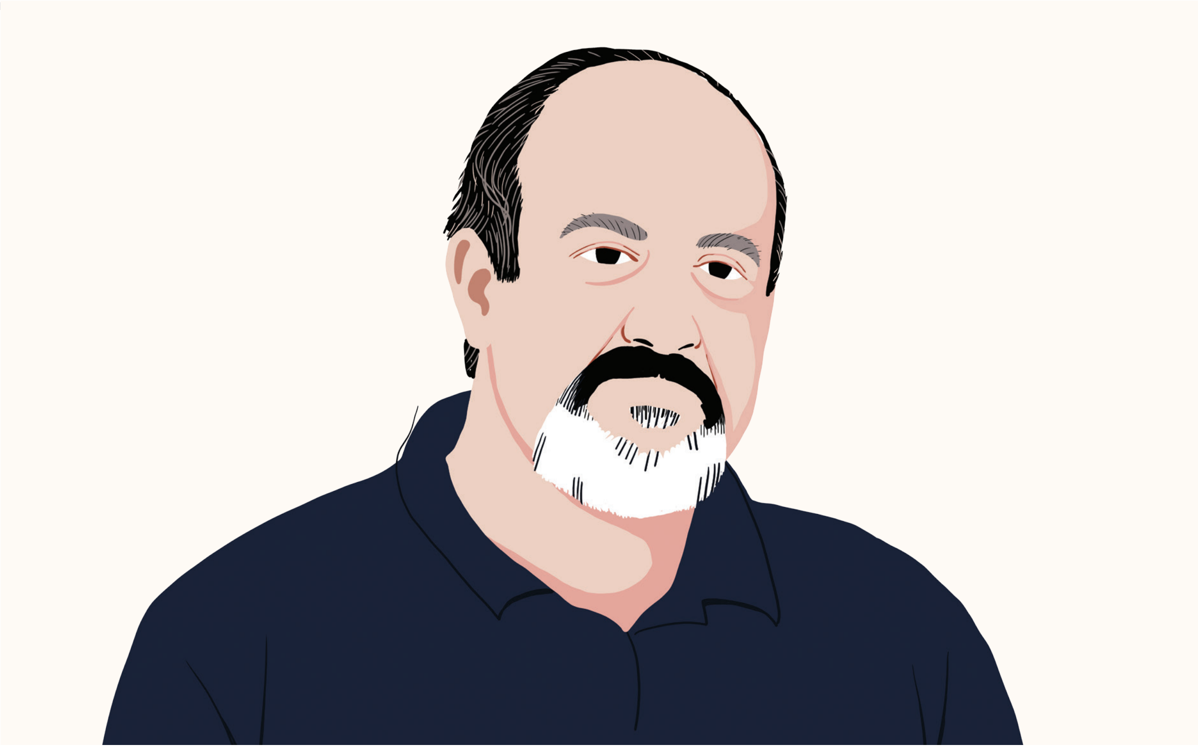
High P/E doesn't mean rejection

As value investors, we have a filtering process, at least mentally, which automatically filters out companies having a high P/E. Marks advises otherwise, "If you see a company, a growth, technology or an innovative company with an absolutely high P/E ratio that in itself is not a reason for dismissing, maybe the potential of technology is as great as something."

Nothing as value vs growth

As investors, we have conditioned ourselves to belong to a certain camp. These camps range from value investors to growth investors and from small caps to large caps. However, Marks says, "Open-mindedness is something we should strive for. There shouldn't be a big distinction between value and growth, certainly not as wide a gulf as there is today."

Lifelong learning, along with changing perspective, is what separates a good investor from a great one. Warren Buffett's investment in Apple (a tech company) bears testimony to that.



NASSIM TALEB

‘You know a dentist will be an expert, but an epidemiologist will not be an expert because there is no feedback’

Nassim Taleb is a former option trader whose work revolved around randomness, probability and uncertainty. He is well known for his 2007 book ‘The Black Swan’ and other books like ‘Fooled by Randomness’ and ‘Anti Fragile’. In this investor talk, we look at his 2018 Google talk about his book ‘Skin in the Game’ (https://bit.ly/3wAlUy1).

Recent is more vulnerable than old

Taleb says that something that is recent, for example, an idea or technology, is more likely to be displaced as compared to their old counterparts. He says, “You can’t predict what new will happen, but you can predict something, which is that what is recent will be replaced by something more recent.” For example, Plantbased meat products are more likely to see changes than a regular chewing gum.

Reality approved or peer-reviewed

Who reviews the work of a plumber? The client. However, who reviews a movie, restaurant, etc? Many times, a critic or an expert reviews them. Taleb says this contrast is wrong as, "So it tells you the following, any business where you're judged by your peers and not by some contact with reality is going to rot eventually." In the world of investments, peer reviews through price multiples such as P/E, P/B ratio across companies in a sector can give incomplete information about the business.

The expert problem

The spread of social media has given rise to several experts. However, Taleb contends that a true expert is one who gets the feedback of his work there and then. He says, "You know a dentist will be an expert, but an epidemiologist will not be an expert because there is no feedback." Financial experts appearing on various media platforms rarely get feedback for their work.

Skin in the game

Highlighting the importance of having your skin in the game, he remarks, "You make the upside when you're right. And when you're wrong, who pays for the losses?" In recent years, investors paid the price for high promoter pledging. While promoters took a loan for personal investments, shareholders were left with deteriorated share prices, as promoters were not able/willing to repay loans.

Scale matters

Watching your small-cap investment turning into a large cap in a few years is the best-case scenario. However, this phenomenon occurs rarely. Why? Because it's the scale of operations that matters. Taleb says, "You cannot turn the dynamics of a hamlet into a small village. And a small village cannot be turned into a very small town. You have some kind of a scale transformation that happens when groups become larger."

Bottom to top and top to bottom

The longevity of companies is decreasing day by day. Taleb explains, "When I was an MBA student, the company spent about 50–60 years in the S&P 500. So it was stable at the top. How stable is it today? 10-12 years." However, what is also happening is that the time a company takes from a start-up to a full-fledged business and from a full-fledged business to a failed business is also decreasing.

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JOEL GREENBLATT

'I am really looking down, not up, when I take a big position'

Known for his books like 'You Can Be A Stock Market Genius' and 'The Little Book that Beats the Market', Joel Greenblatt is a value investor and runs Gotham Funds. Greenblatt teaches value and special-situation investing at the Columbia Business School. Here we delve into his 2021 talk on 'What makes a great investor'. (https://bit.ly/3pRDw5W).

Adjusting your glasses

Most of the time, the stock price is believed to provide an accurate reflection of the company. However, it does not hold true all the time. Changing the way you look at a company may be of great help, as Greenblatt says, "When you recognise that you have this other way to look and that makes total sense to you and all the pieces fit when you look at it that way, I think those are the great opportunities."

How to avoid mistakes? Learn from others

Time is a commodity that each one of us has in limited quantity. Hence, we can only learn as much as we experience. However, a better way of learning is to learn from others' mistakes. Greenblatt contends, "The more you can learn from other people's mistakes and the things that you know and learn from the past and reading how smart people think, it's only helpful." Reading autobiographies of successful smart people can help you learn from their mistakes so that you don't repeat them when faced with similar situations.

Managements can build great new future stories about their businesses to entice investors into buying the stocks of their companies

Asymmetric returns

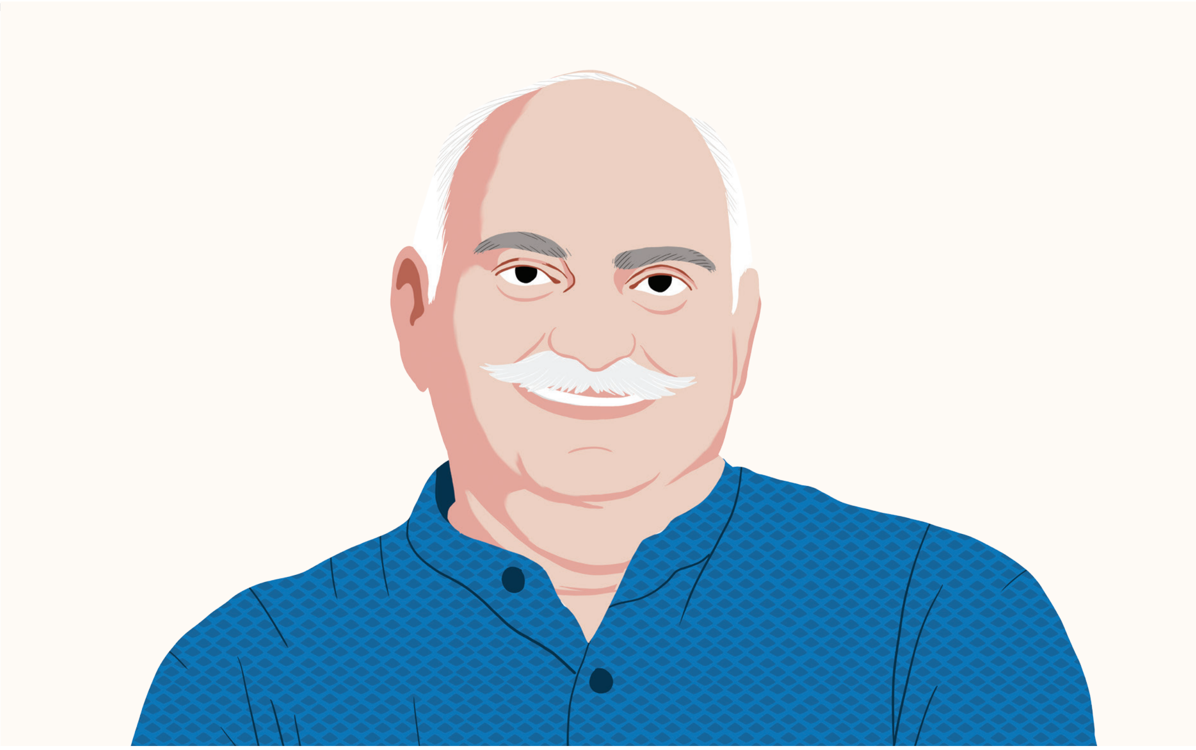
It is a concept wherein the chance of suffering large losses is very less as compared to the chance of getting high returns. Greenblatt achieves this by, "The biggest positions I've had are not the ones that I think will go up five or 10 times. I am really looking down, not up, when I take a big position. So in other words, I will seize the position larger if I don't think I can lose much money."

The evolving face of businesses

Investors today generally disdain new-age businesses that generally are loss-making. However, Greenblatt offers a different insight into it, "The business world has changed in this way that many of these businesses are investing in their future but it looks like not an investment, it used to be you build a factory or you invest in capital equipment and you could see it on the balance sheet but here a lot of that gets expensed." A good example of this can be Amazon's Prime service wherein the company spends on content to gain more users with the expectation that the total profits to be generated over a period of time from these users when they shop on Amazon will take care of these costs. However, such costs are expensed and not reflected as capital expenditure.

Assessing managements

Managements can build great new future stories about their businesses to entice investors into buying the stocks of their companies. However, Greenblatt has a simple rule of assessing management, he says, "If this management team was good at allocating capital before I walked in the door, the assumption that they would continue to be good was a really good assumption." Kishore Biyani, in 2017, unveiled a 30-year vision with the expectation that by 2047, his company would earn a revenue of more than $1 trillion. However, poor decisions related to capital allocation forced the company for a sell-out.



MOHNISH PABRAI

'The size of the circle of competence that we have is irrelevant. What is more relevant is that we stay within the circle.'

Mohnish Pabrai is a US-based Indian investor. Pabrai is known to follow the investment style of Warren Buffett and Charlie Munger. Apart from the US, Pabrai invests around the globe and in India, his investments include Rain Industries, Edelweiss Financial Services and others. In this investor insight, we take a look at a new investment approach that Pabrai described in his lecture at Peking University in 2020 (https://bit.ly/2S4pMrX).

The Spawn approach

Pabrai believes that his investment approach has the potential to deliver multibagger returns. He says, "Spawners are companies that have the DNA to keep adding and incubating new businesses that have the potential to be massive growth engines." Such businesses are rare, however, are able to generate a long runway for growth.

Think of Reliance Industries which has incubated new businesses over the years, with telecom and digital businesses being the latest ones.

Where to find multibaggers?

Where should you hunt for stocks? Large caps, mid caps, small caps? It depends on your return and risk expectations. Pabrai gives a clue, "Make an assumption that no business you invest in will ever exceed a $50 billion market cap and so if you want to make 10 times your money, you're going to buy below $5 billion."

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Compounding works when you let it work

Usually, investors end up making multibagger returns not in the stocks that they keep tracking but in the ones that they forget they had. Pabrai says, "If you find a long runway and you are a little late at getting off the bus, it is not going to be a problem. The important thing is not to get off the bus for a temporary hiccup."

Selling involves several reasons

Usually, we lose our confidence in our stocks when we see some big investors trim their position in that particular stock. However, this shouldn't influence us. Describing this, Pabrai says, "Investors buy stocks for only one reason but they sell stocks for 100 reasons. So, we cannot tell anything about what someone is thinking when they sell a stock."

Staying within your circle

Suppose investing in financial stocks is your circle of competence. Will a bull run in chemical stocks push you to increase your circle of competence and start investing in chemicals? Most investors may start doing just that. However, Pabrai advises otherwise, "The size of the circle of competence that we have is irrelevant. What is more relevant is that we stay within the circle." Venturing out of your circle of competence can result in costly mistakes, especially when the tide turns and you don't know whether it's time to stay put or something fundamental has changed in the business.

LI LU

'You want to really wait for extreme situations before you really make a bet'

Li Lu is the founder and chairman of Himalaya Capital and popularly called the Chinese version of Warren Buffett. He is the one who introduced Chinese battery and automaker BYD Company to Charlie Munger and Warren Buffett (https://bit.ly/3iHNSnd).

Are you really a value investor?

Lilu argues that although the attributes of value investing like the margin of safety, investing being equivalent to business ownership and others are fairly well known, value investing is rarely followed. Why? He gives reasons, "Stock is first and foremost a piece of paper you can trade all the time and therefore, it follows that successfully investing lies in the successful guessing of the stock price movement and the market needs to be respected because it is through the market that you can buy and sell." His theory stands true as most of the time, investors buy or sell stocks based on price movements instead of the company's fundamental performance.

Bet rare and bet big

Are the financial markets efficient? This is an age-old question. This is what Li Lu believes, "You just have to refrain yourself from betting too often, knowing that the financial market doesn't really work too well but a lot of the times, it works reasonably well. So you want to really wait for extreme situations before you really make a bet." It's interesting to see that after correcting by more than 30 per cent last year, the Sensex has almost doubled from the bottom in a little over a year that, too, amid COVID-led economic disruption.

Stocks for lifetime

What type of stocks should one hold and never sell, irrespective of the market conditions? Li Lu answers, "If you can combine the cheap price on the asset, the quality of the asset and the ability to consistently generate cash earnings on a compounded growing basis, that is the holy grail that you can hold for the longest period of time." Such stocks are rare, however, companies like HDFC Bank, Asian Paints and few others have managed to do it in India.

Learning from history

Li Lu insists that the best way to learn about value investing is to delve into the history and study the periods when the market went to one extreme in a particular sector. In that situation, you should check which companies provided the maximum margin of safety and yet came out on the top. Learning from such activities can be used to identify the stocks that are trading at low valuations today.

How much margin of safety is good enough?

Often, we look at a P/E or a P/B multiple of a company and determine if it is under or overvalued. Our margin of safety, hence, is determined just by looking at such valuation multiples. However, Li Lu defines his margin of safety as, "If the quality of the asset is very high, your demand on asset basis will be low. You have to have an insight as to what those assets could generate for you." In other words, what he means is that investors need to have a unique understanding of the business to determine its fair value correctly.

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