The Low Stress Way to Research Stocks - Safal Niveshak

This issue of Outside the Box newsletter is authored by *Jatin Khemani.* Jatin talks about his equity research process and how he tries to balance the stress part of the equation that it involves. Over to him.

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by Jatin Khemani

Six years ago, Prof. Sanjay Bakshi published a blog post where he suggested looking at returns from a very different perspective – Returns Per Unit of Stress.

One of the key points he made in the post was –

> For proprietary investors (and maybe for all investors), stress should figure in one's investment strategy, much more than it does, perhaps, even more than financial risk, because stress is a killer and high-stress situations – whether they carry high or low investment risk – will always carry a high risk to one's health. In fact, one can now measure how many years of one's life is cut short by being exposed to a high-stress life.

In this post, I take that idea further with my own experiences of being a full-time value investor over the better part of this decade.

My Equity Research Process
I divide the entire equity research process into two phases –

1. **Initial Research (IR) or building a thesis,** which is the time and effort involved in understanding a business in order to form an informed opinion and accordingly decide whether to invest or give it a pass.
2. **Maintenance Research (MR) or tracking** is the time and effort involved in ensuring the initial investment thesis is on track and also updating it as it evolves.

Initial Research involves understanding the business and finding answers to multiple questions, some of which are –

- What product/service does this company offer to its customers? Do I understand these?
- What are the raw materials used? Are material prices very volatile? Are they available domestically or imported?
- What is this company's value-addition?
- Is there pricing power in this business?
- What is the frequency of customer purchase? Is it a consumable or a capital good?
- Can a mobile app kill this business? Is e-commerce negative for this business model?
- Are customers likely to switch to competing offerings or is there some stickiness?
- What is the source of this competitive advantage?
- How does it fare on Porter's Five Forces model?
- How have similar businesses fared in the western world?
- How difficult is it for competitors to take away market share if they had deep pockets?
- Does the industry compete with Chinese imports?
- How does currency fluctuation impact this business?
- Is this industry prone to disruption?
- What is the level of regulation/government interference?
- Is it likely to be in existence a decade down the line?

IR depends on one's circle of competence. For someone with a medical background, the IR to understand a pharma company may be a fraction of what it would be for a layman. Similarly, for a software engineer, understanding an IT company's business model would be quicker versus someone like myself (with a commerce background).

But then there are FMCG businesses like Nestle which are simple to understand for everyone – being everyday consumers of those products, we are naturally able to get a lot of answers without doing any 'dedicated' research.

MR, on the other hand, involves ensuring our original thesis is on track. This depends on the number of moving factors as well as how frequently they move – product prices, raw material prices, currency volatility, government policies, competitive intensity, customer preferences, demand, and supply etc. It is high for cyclical and commodity businesses. It is also high for businesses where the rate of change is high and ones which are facing the risk of being disrupted.

Again for businesses like Nestle, it may not take more than a few hours per quarter for an investor to assess if company is on track to deliver its promise of double-digit growth, to ensure if new products are being launched, judge their acceptance in the market and keep track of market share in existing product categories.

That would be truly a form of passive investing as it leaves you enough time to read, pursue interests (other than investing) like traveling, social work etc. and letting money and management work for you so you enjoy the process in relatively a stress-free way. The financial returns could be lower than other strategies, but the return per unit of stress could be much higher.

The reason behind such low MR in Nestle is the business model resilience. The Maggi fiasco is the perfect testimony to that – it was the worst that could happen to a brand and yet within a couple of years it has regained all the lost market share. There is 'continuity' in such business models – when Maggi 2-Minute (instant noodles) became a hit, the company leveraged the brand name to build new categories like Maggi Ketchup or Maggi Oats on top of that, which all contribute to further growth.

VIP Industries and Safari, which are leading luggage brands, have been getting additional growth via backpacks. Similarly, Amrutanjan which is among leading brands in the head balm category has also been growing via body care products. In all these examples, you get new business without losing the existing base business.

That isn't true for most of the other businesses, which don't enjoy continuity, and are on a treadmill; they've got to run even to stay at the same place.

For instance, consider **Indian pharma** companies which have to keep filing for new molecules (a.k.a ANDAs) as profit pool from existing generic molecules keeps shrinking. The product itself is extremely technical to understand, add to that strict regulation from the likes of US FDA and complexity of global distribution system.

Real estate companies, too, live from project to project. Developers are interested in launching big projects to enjoy economies of scale but one such mega-project that fails can take a company behind by a good 4-5 years or sometimes into bankruptcy (if funded via debt).

It takes decades to create brand equity in a region, however, every time a realty company tries to expand geographically, it literally has to start from scratch in terms of brand awareness and customer trust. The fact that DLF failed when it stepped out of NCR is a testimony to that. The same is true for developers that try to expand from Mumbai to Pune (just 150 km away) or vice-versa, but find it difficult to get a foothold.

Movie production is no different. Every project (movie) is independent and can either be a hit or a flop. Which is also true for **Capital Goods** companies which live from order to order; they are totally dependent on their customers' expansion plans.

Contrast this with companies supplying consumable goods (a.k.a **Fast Moving Industrial Goods** or FMIG) which enjoy continuity. A company like Thermax gets orders only when new steel plants are built, but a refractory supplier (refractory is a consumable used in steel production for thermal insulation) continues to enjoy a profitable base volume across the cycle and grows further when new capacities come on stream leading to volume growth.

MR is high in cyclical and commodity businesses as they demand close tracking of domestic and global factors. Especially in case of agricultural commodities like sugar or tea where the situation can move from one extreme to another very quickly and given high regulation and government involvement in these sectors, the news flow on a daily basis can be overwhelming.

Sugar would be a relevant example to illustrate this. In Sugar Season (SS) 2017, we had a deficit of 3 million tons. Sugar was trading at a price of Rs 37/kg against the cost of production of Rs 31/kg. Consequently, sugar mills made super-normal profits.

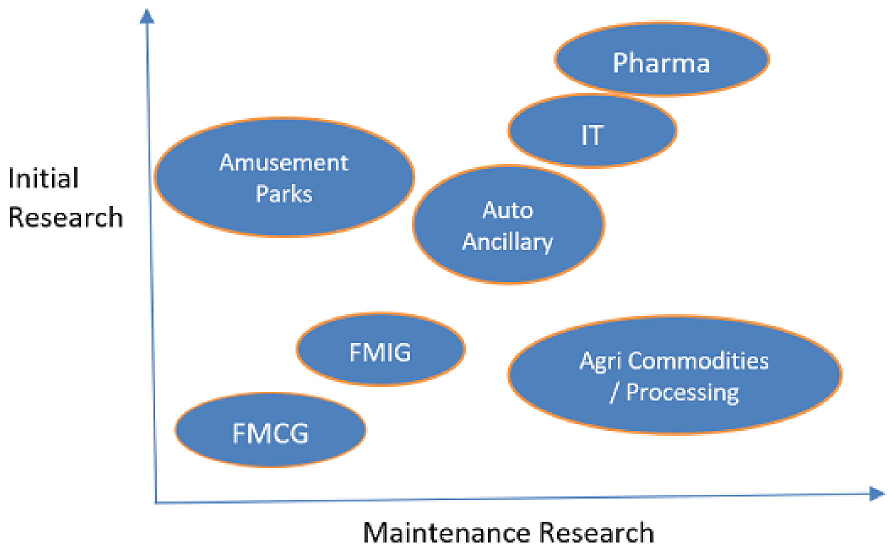
In SS 2018, suddenly we have a surplus of 6 million tons due to which sugar price tanked to Rs 25/kg. Those same companies could now be losing a huge amount of money. Sugar stocks have taken a massive hit, with some crashing as much as 60-70% within a matter of few months. Add to it the government's interference in terms of dictating cane pricing, setting export quotas, controlling ethanol blending and pricing – it's just too much to handle for an ordinary investor.

Emotionally, it gets too stressful to keep up with what's happening. Even the promoters aren't sure of what's going to happen next, a minority investor can only feel helpless when stuck in such wild swings.

MR is relatively lower for manufactured commodities like cement or steel because one can still have some visibility on the supply side. These plants cannot be constructed overnight, it usually takes 3-5 years for a greenfield capacity to come on stream, so the supply doesn't swing so frequently.

Having explained IR and MR, there could be four combinations of stock opportunities – those which require high IR but low MR, those with low IR but high MR, ones with both being low or both being high.

Consider this chart –



I have placed Pharma and IT on the top right as they fall outside my circle of competence and so IR would be high for me whereas MR in both these sectors is anyways extremely high for everyone. Not to mean I would never touch it, I do hope one day I gather courage and patience to read enough on the sector so as to develop some understanding and conviction.

FMCG, which is simple for everyone gets a spot on the bottom left as both IR and MR are relatively low. I am also comfortable with FMIG so that's also placed near FMCG. Everything else falls somewhere in the between.

This graph would vary from person to person based on his/her circle of competence. It's important to know this for ourselves so that we don't end up stretching too thin i.e., getting into too many positions which all demand high MR as that would only cause stress and may even dilute returns.

This is applicable to not just individual investors but also to boutique money management and advisory firms, given their limited bandwidth, which is best channelized into what one is strong at.

There are investors who love to do in-depth research, enjoy the process of slow-thinking, and prefer to make very few but high-quality decisions. They are better off sticking to compounders and not give in to peer/client pressure during periods of underperformance like 2017 when commodities and cyclical made a killing.

On the other hand, those jumping from one sector to another looking for the next cyclical turnaround or complex/nascent businesses, have to be on their toes, stay agile and also be willing to accept some wrong bets (at a loss) – when the number of decisions goes up, the error rate is bound to go up. One major downside of this strategy is reinvestment risk, so one should be comfortable sitting on cash when unable to find screaming opportunities.

At the end of the day, it simply boils down to how much time an investor is willing to devote to active research and how much stress he/she is willing to take while investing. Both strategies make money – holding quality compounders like Nestle, Britannia and HDFC Bank for long-term, or investing in those with high MR (like cyclicals) or even a combination of the two.

It's just that both require a very different temperament and mindset.

About the Author: *Jatin is the founder and CEO of Stalwart Advisors, a SEBI registered investment advisor.*