The Knowledge Project presents

# Sanjay Bakshi

PODCAST TRANSCRIPTS

**In this episode, which was recorded live in New York, I have on the show one of my favourite people: Sanjay Bakshi. Sanjay is one of India's best-recognised finance professors. He teaches a course entitled Behavioural Finance and Business Valuation at the Management Development Institute. And while he probably doesn't want me to mention this, not only is he a teacher; he is also a practitioner. He is one of the most successful investors you will ever come across. In this interview, we talk about a host of things, including why he prefers to read on a Kindle; how he incorporates multi-disciplinary thinking and mental models into both his investment decisions and life decisions; and how his approach to investing has changed over time.**

**I hope you enjoy the conversation with Sanjay. If you enjoy it, please let me know your feedback: I'm @farnamstreet on Twitter, and thank you for listening.**

**Shane Parrish: I'm here with Sanjay Bakshi, self-described as an 'opinionated professor of value investing' at the Management Development Institute in India. Welcome!**

Sanjay Bakshi: Thank you, Shane.

**How are you?**

I'm well, thank you. Thank you for coming all the way from Canada to meet me here in this lovely hotel in New York. It is such a pleasure to meet you - I've known you for so many years, and I'm so glad that I'm meeting you now.

**It's a pleasure to meet you as well. Sanjay and I have been emailing back and forth for years now, and being here in person and meeting him, it's an amazing experience.**

I have to say that I'm envious of you for many reasons. One of them, of course, being that you have a library much bigger than mine - and I have a very large anti-library thanks to you, because I end up buying virtually all of the books that you recommend! And the list keeps on growing - and in order to find time, I have to compromise many things. But it's really worth it.

**I appreciate that. I definitely have— my bookshelves are starting to overflow, so it's getting to be a bit of a problem.**

How can I persuade you to get into Kindle then? [laughs]

**Actually let's talk about the Kindle vs the physical book. What do you prefer and why? And how do you use that?**

"I realised that these are prejudices that should be let go of ..."

Well, I used to prefer the original one, of course, because you can underline; you love the smell of the paper; and you have nostalgic associations with the physical book, which looks like you have read it, which you lose when you do it on a Kindle. But over time, I realised that these are prejudices that should be let go of, because there are other things that are possible with the Kindle, which are not possible with the physical book. And for me, as a professor, it really helps me to be able to know that I've read this somewhere. The kind of associations that occur in memory as you experience something - you know that you have read about this particular aspect in some book, but you don't know which one. And if this was all with physical books, you would go crazy looking for that book. But if you just do a search for a term across all your books in your Kindle library, it comes up in a flash.

And the interesting thing is that you sometimes discover things that you didn't know existed - the serendipitous discovery of wonderful words of wisdom about a certain topic in your Kindle library is amazing, and when that happens, I have my eureka moments. And the other reason I love Kindle is that you can underline stuff and write your own notes, and they get synced to the cloud, and once they're in the cloud you can copy and paste, and use them for your lectures. It's very helpful, so I'm very grateful to Amazon. And of course it's environmentally friendly: you don't have to waste paper.

**Do you read exclusively on the Kindle now?**

Yes, I like to but only for books. Of course there are annual reports, and there is a lot of wisdom in annual reports of businesses that I like to study, and those you don't get on Kindle. I don't like reading on computer monitors - it's very strenuous to the eye. Kindle, therefore, is much better because it doesn't have any eye-strain. Then, of course, there are letters written by investors that are not usually available on Kindle. So I read on Kindle any book that it is available on Kindle. Some books are not - then you have to buy the physical ones.

**You're a prolific reader, so do you—**

About 5% of what you are!

**[laughs] Do you notice a difference in what you retain when you're reading on the Kindle, or your takeaways from the book, in terms of how your brain is storing or organising? There have been a lot of studies that say that reading on a screen and reading a physical book impacts your memory in different ways and how you make connections and associations.**

Sure, that's true. But I think there's a trade off here: you might retain more when you read a physical book, and a bit less on the Kindle, but that's offset by the fact that you are creating a document in the cloud which contains the best things you have read in a book, the ones which influenced you the most; because you have underlined them, and sometimes the underlined portions of a book span many pages. And all of that gets synced to the cloud, and when you work on that particular passage again in the context of something that you're trying to evaluate, then all of that comes back. So in a sense I think there is a trade off here: while reading in a physical book you get to underline physically, and you may have a moment of reflection and write things on the side, you can do that on a Kindle as well. So net-net, I don't feel the loss of memory, compared to using a physical book.

**So what's your process for reading? You purchase a Kindle book, you get it to your Kindle... take me through how you read, in terms of are you reading one book at a time; are you reading multiple; do you put it aside at the end and then go back to it; or do you immediately take your notes out?**

"I go back ... and take out what I had underlined in that particular book, whatever notes I had, whatever annotations are there. I put them in a different document, and then I let that be."

Well, I don't like to read one book— maybe I will read 3 or 4 books at any given point of time, and when I finish them I'll pick up another 2 or 3 books to read. One reason is you get kind of bored reading the same thing, the same subject. And based on what Charlie [Munger] says, you should have a multidisciplinary mind-set. So it's good to have different books from different disciplines and read them. And then one of the amazing things that I discovered is that you then associate one thought with another one. And that really is helpful to me. So far as note-taking is concerned: I underline stuff on the fly, as I read it. And once the book is over, I go back on the cloud and take out what I had underlined in that particular book, whatever notes I had, whatever annotations are there. I put them in a different document, and then I let that be.

Because I have already studied the underlined text a second time, in a sense, I have done a second reading of the things that I like the most in that particular book. And then I let that be, to reside in my memory for some time. And then when I experience the world out there and there is a moment when I remember that there is something that relates to something that I read somewhere, then I can always go back to the document and be able to pull out whatever is useful.

**So you have a different document for each book?**

Not always. But I have a master document because once you have it in the cloud, you can always copy and paste any annotations, any underlined text for that particular book, in a different document. I do that for some books, though not all of them.

**That's a really good way to do it. Do you use Evernote or anything?**

I do, I use Evernote; that's been helpful to me. I use other tools like The Brain, which is a wonderful piece of software available.

**What is that?**

It kind of replicates what a human brain does. It helps you create thoughts, and it helps you connect different kinds of thoughts. And you can put your emails in it, and you can put your sound files in it, any kind of document in it, and then you can look at any particular topic from the perspective of a thought. So you have all these thoughts which are connected - and this is exactly how the human brain works. New associations are created. So when you're looking at The Brain screen, and your actual brain is thinking about those associations, new associations get created. So in that sense, it's an external brain that is working for you, and the size of which keeps on growing - it's virtually infinite; you can keep on adding stuff to it.

**How do you go about teaching that to your students: the multidisciplinary thinking, and connecting, and synthesising, and distilling—**

Well Charlie already taught us how to do that; we just follow what he says. We try to look at a problem from multiple perspectives. That's, I think, the correct way of doing it. When you are trying to evaluate something you are trying to ask the question, 'why?'. Why did this happen? And when you reflect upon it, you find that the answer sometimes comes from multiple disciplines, and you get down to that and try to figure it out. It is very enjoyable to do it in that way. The process for me has always been to ask the question 'why?', and wait. Because the mind will tend to jump to a certain answer, and that's not the only answer.

"Wherever there is a complex question I am trying to answer, I always start with the words 'part of the reason is this' - which means there must be other parts too."

So the way I think about it is wherever there is a complex question I am trying to answer, I always start with the words 'part of the reason is this' - which means there must be other parts too. I'd like to think about what those parts might be. There don't have to be twenty of them - even if there are three or four of them, that's better than one. So it helps me to ask the question 'why?', and then look for answers.

**Do you think that's like a mental trick as well, where when you respond you're saying that's part of the answer, you remain uncommitted in a sense to a firm and definite answer; and therefore you're more willing to be open-minded at the end?**

Absolutely. And the way to do that is to always answer the question 'why?' with that phrase, 'part of the reason'. Because that removes the availability heuristic, the first conclusion bias, because in a world that is full of complexity, there are multiple answers, there are second-order effects, third-order effects. And you can think of those, I think especially well, if you start your answer with the phrase, 'part of the reason'.

**Multidisciplinary thinking is incredibly popular in the value investing community, in the sense that people look up to Charlie Munger, Warren Buffett and yourself, and they try to bring that approach to their problems. Do you know anybody outside of value investing who's taking that sort of approach, and how they're applying it to broader policies, or anything - or do you think it resonates with people in this particular context?**

"I think it's wrong to assume that the idea of multidisciplinary thinking that Charlie Munger talks about should be applied only to investing."

I think it's wrong to assume that the idea of multidisciplinary thinking that Charlie Munger talks about should be applied only to investing. In fact, you should use investing merely as an excuse to be able to illustrate the idea that you can use multi-disciplinary thinking in pretty much everything that you do. And I think that's a very useful skill to acquire, and Charlie offers you a way to do that. And of course the way he has done that is to be able to invest successfully. But if you read through his letters and his talks, he is really only talking about things which are to do with investing. There are other applications, and if you look around the world, the really good thinkers, they do think in terms of multi-disciplinary applications. I do think that there are a lot of Charlie Munger fans out there, even if they don't know of Charlie, and I think there is an important role that people like you are playing in bringing that kind of knowledge to the world out there. It's not just about investing - you have to be able to apply it in other disciplines as well.

**So not only are you a professor - you're also a prolific and world-renowned investor. You started in 1996, I think—**

1994.

**Did you originally take the multi-disciplinary approach?**

“I was a one trick pony at that time.”

Not at all. I had no idea about all of that. Not until 2004. I was a one trick pony at that time - I was an accountant. I knew how financial statements get created from transactions. I knew all of that. But I had no idea what is a good business, what is a bad business, and what is a mediocre business, and why. I was studying at the London School of Economics in 1998 when I chanced upon an article on an obscure guy who operates out of Omaha, has a wonderful track record, says the markets are quite inefficient, which was quite the opposite of what I was being taught at the LSE. So I found that very interesting. And that particular article also said that he writes wonderful letters, and you can get them for free if you write to him. So I wrote to Mr Buffett, and within 4 days I got those annual reports. Debbie, his secretary, wrote a letter to me saying that you have to send the postage, which was probably the best investment I ever made!

Berkshire Hathaway Letters to Shareholders
BY WARREN BUFFETT

So I got those annual reports and letters of Berkshire Hathaway. I read through them and discovered [Ben] Graham. And I picked up on Graham because I was an accountant, as I mentioned earlier, and I could relate to what Graham was saying. Up until then, I knew how financial statements were prepared; what book value is; what profit and margins are. I knew all of those things. But I had no idea what was cheap or expensive. And Graham provides a very good framework for people who are good at accounting to be able to figure out fairly quickly whether something is cheap or expensive. So I found that very interesting, and started practicing Graham-style investing from then onwards.

It was much later that I chanced upon the idea that there could be different kinds of businesses - that some businesses could have remarkably good quality, and that you should ask why they have this good quality. And then, of course, once you start talking about that, you end up discovering Charlie Munger. And once you pick up Charlie Munger, you discover the power of multi-disciplinary thinking. So all of that happened, but it took me about 10 years to get there. So I started practising value investing in 1994, but I discovered Charlie’s talk on multi-disciplinary thinking only in 2004. And that was a very significant event in my life. Because, as it happens, that was the year my family was coming to the United States for a holiday, and I came across this talk. My course was due to commence in September, and this was in June or July. And I told my family: I’m not coming with you, please leave. And they were supportive and left me alone... and that’s how I decided to change my course and turn it into what is now called Behavioural Finance and Business Valuation.

So that particular idea of the psychology of human misjudgement, and the mental model talks, they helped me a lot.

**Was it as simple as coming across that talk and being inoculated and changed forever? Or was there something else going on?**

"There was nothing else going on; I was alone."

Absolutely. There was nothing else going on; I was alone. It was stupendous to be able to read it over and over again, make notes, and try to relate to the power of the ideas that he laid out in those couple of talks. It was so powerful for me, and I had the conviction to teach it, and learn it through teaching. It's been very helpful for my students, and for me. My journey as a value investor is not complete unless I bring up my discussion on mental models.

**So what was the course you were teaching before?**

It was pure Graham-style investing, called Security Analysis, and I would mostly talk about risk arbitrage, about bankruptcy investing, about amassing cash bargains, statistical screens that Graham used to create and talk about in his books. It was purely that. The idea that there could be a great business out there and the idea that there could be a competitive advantage out there wasn't even known to me at that time. Most of the discussion revolved around financial statement analysis, instead of going to the reasons why this business is successful. And when you go to the question why, the answers come from many sources. Why does a customer buy this product? What is it that the customer likes? Why does he not buy somebody else's product? Why would a competitor not enter this market? Why wouldn't they even try? Those are very profound questions. And you won't know the answers to these questions unless you ask them, and the answers come from different disciplines.

**So the role of mental models and multi-disciplinary thinking has played an incredible role in investing for you and changed the way that you teach. Has it changed the way you live outside of those domains? How so?**

Yes, it has in many ways. When you look at the world out there, you can't think about it without thinking about incentives. That's one of the most important lessons that Charlie has given: that you must have a two-tier system in trying to understand the world out there. You talk about economics, but economics is incomplete without psychology. We had all these notions about the rational man, models of economics, and most of economics is based on the idea that human beings are rational. Most of social psychology actually tells you that we are quite dumb! Very often we make very foolish mistakes. And I think both the disciplines of economics and psychology are connected, and if you put that in context... let me give you an example:

> "There is a point in a business's life when you should shut it down ... (and) you should shut it down well before it makes sense to shut it down, because you have to think about opportunity costs."

As an accountant, I learned about the idea of the shutdown point. There is a point in a business's life when you should shut it down. But if you study Charlie and you study Warren Buffett's life, you find out you should shut it down well before it makes sense to shut it down, because you have to think about opportunity costs. A lot of people will not shut down, even if it makes sense to shut down, because they figure out that the other guy is going to blink first. So they operate in a competitive market... and we see that right now, in many industries, looking at what is happening to shale and oil production, even in Canada and the US, compared to what is happening in the Middle East. People will keep on producing things, even though it doesn't make sense for them to produce it, because they think that somebody else will shut down before they would. Sometimes they're right and often they're wrong. And when they're right, often they're right because they have the backing of somebody who is going to fund them, and in today's world you have these markets which will fund you. And we see that in India: we have an e-commerce bubble going on. There are three or four players, and they are essentially giving huge discounts to consumers to purchase their products and to not go to bricks and mortar stores. And people are doing that.

But all of these e-commerce companies are bleeding cash, but they have rich investors who are willing to give them money to gain market share. And as long as that money keeps on coming, it's going to be very difficult for the bricks and mortar players to be able to effectively compete. So we see a kind of situation, where if you want to understand a situation, you can't understand it without thinking about psychology. What gets a business to continue to operate, even though it doesn't make economic sense? Why does that happen? That helps.

**You mentioned the shutdown point: do think that transfers to relationships and friendships and books and a whole bunch of other things? The concept that there's a point at which you should stop reading, there's a point at which a relationship becomes unhealthy? Do you think about it in those ways, or do you approach outside relationships differently, or do you always have that multidisciplinary, mental model filter on?**

I think there's something to be learned on that, from the experience of Charlie and Warren. I think we all know this: that they rarely sell out of a business, even though it's not doing well; even though economically it should be closed, but the— why don't they shut it down? Why don't they get a rougher business? Usually they don't. And I think the reason is that they created a culture where they want to be a natural partner for a business to be owned, by Berkshire. And you don't get to that state if you start treating businesses as a game of rummy. You don't discard your least performing businesses. And I think they've done that, and done that over decades, and have created a position in the minds of the owners of admirable businesses out there that there is a place where I can give my business to somebody, and it's not going to be sold off to a private equity investor, or be liquidated, because it doesn't make sense. Even though in the short term it might cost Berkshire some money, in the long run it has created a huge reputational advantage for them. And of course that has helped Berkshire.

I think there is something to be learned from that, but when you're running a fund, when you have investors who can pull the money out at short notice, you probably cannot think along those lines, which is something Buffett and Charlie are familiar with, and they don't have those structural disadvantages. So you have to be very careful about these notions, because you have to have the structural advantages that some people have to be able to have the privilege to think along those lines.

**How conscious are you about setting up your environment to allow for that?**

It's a journey. And there were times in my life when I did not have that privilege. As I evolved over the years, I think I am closer to that utopian situation where I can say that I can truly think long-term. I am not fully there yet, but I think it's important to think really long-term, but you cannot do that unless you are financially independent. It's one of the big lessons that I have for my students - that the first thing that they need to get is financial independence. Once they have that, they can look at the world the way it really is, and they can perhaps think much longer term. But things could be a lot better, I have to admit.

"It's one of the big lessons that I have for my students - that the first thing that they need to get is financial independence. Once they have that, they can look at the world the way it really is, and they can perhaps think much longer term."

**So outside of those structural reasons, how do you set up your actual physical environment to encourage rationality, or better decisions, or so on? Buffett is the one who moved from New York to Omaha in part because he felt someone was always whispering in his ear. Reading between the lines there, I think they [Berkshire] are more conscious about how they set up not only the structure of the company, like when he and Munger own almost 40% of Berkshire, but also their physical environment to maximise their personal ability to make rational decisions. I'm wondering what yours looks like.**

Yes, I think that's absolutely the right way of thinking about it, and I completely agree with you that you have to have a physical environment. One way I have done that is to give up on television - so I don't have a television. The other thing I did recently was to remove Yahoo! Finance from my bookmarks on my browser. So I don't get to see stock prices as often as I used to, and it does look a bit odd in the beginning. But after doing this long enough, I'm more at peace. Apparently there is a lot of volatility in the markets, as we speak right now, but I have no idea as to what has happened to a specific business, as I have not looked at the stock price. I think that's very helpful to me.

*The Education of a Value Investor: My Transformative Quest for Wealth, Wisdom, and Enlightenment*
BY GUY SPIER

Guy Spier has written has a marvellous passage in his book where he wrote about creating a physical space where you shut out a lot of the distractions of life. He writes in his book that there is a room where he has no electronics. He cannot be disturbed when he's in that room. I think that's a very useful way of doing things. I'm not there yet, but that's one of my aspirations to have a room where there are no electronics, and no distractions, and there's a big 'Do Not Disturb' sign outside, and where you can just sit and think, which is exactly what I think Buffett does or what [Charlie] does, and what I think most successful investors do. And it's not just about investing, it's about everything in life. If you want to make decisions, you need to shut out a lot of the noise. You have to really focus on things that really matter. And sometimes the things that really matter are far fewer than it appears.

"That's one of my aspirations to have a room where there are no electronics, and no distractions, and there's a big 'Do Not Disturb' sign outside, and where you can just sit and think."

**How do you go about determining what matters and what doesn't? I mean, we live in a world where everybody, including Farnam Street, competes for eyeballs and attention, and those are scarce resources for people. And it seems like the pace and the velocity of that information coming at you is increasing. People feel overwhelmed; they feel like they can't separate the signal from the noise. Is there anything that you do that helps you eliminate, reduce, filter, sift?**

Yes. It depends on what context we're speaking about, but let me pick up the context of analysing businesses. You have all this data - I mean, there is real-time information out there. There is Bloomberg (and I don't have Bloomberg); there is CNBC (and I don't have a television). So there are all these sources of so-called information, but most of it is, in my view, noise, so if we shut down all of it, you filter out a lot of the noise. But there's more: as you go through analysing a business, you come across data - for example, quarterly results.

You start thinking about See's Candy. See's Candy loses money, if I recall correctly, about 8 months in a year. 4 months in a year it makes money.

And it's a fabulous business; we all know that. So here is a business that is a fabulous business, and which has created wonderful cash flow that has helped Berkshire become what it is today. But it loses money eight months in a year, which means there are several quarters when it is loss-making, and there is one big quarter when they make a lot of money. I think that's a very powerful way of thinking: that there are these businesses out there that not going to do well, and therefore if you put a lot of emphasis on short-term quarterly results, you are really looking at noise. Therefore, you should focus on what really matters. If you focus on the idea of competitive advantage, the idea of what Buffett likes to call a moat - by definition, a moat is not going to get eroded in a day, nor in a quarter. So in effect, if you are focussed on investing in a business which has a durable competitive advantage, then quarterly results are going to be almost insignificant. What really matters is the durability of that advantage over a long period of time, and how the business can scale. I think those are two or three things you have to focus on. If you do that, you don't need to focus on a lot of things that are irrelevant, but which are available to you. You can remove them from your screen.

"What really matters is the durability of that advantage over a long period of time, and how the business can scale."

**There are different types of moats. I think you teach— I forget how many you distinguish between (low cost, differentiation). Do you find that any are more sustainable in general, all things considered? Which would be the best moat to have, if you could have one moat? Would it be a product differentiator; would it be a low-cost provider?**

It would be a low-cost provider. If you think about it, the reasons why brands are successful are because they give you scale and a cost advantage. I think the low cost model is a far more sustainable model, and actually a very admirable model in capitalism, because there is less wastage. If you look at Costco, which we both know is a very admirable business model, then why is it an admirable business model? Because it deals with the paradox of choice. You don't need 50 ketchups. Why do you need 50 different kinds of ketchup? It's not good for civilisation, if you think from Charlie Munger's perspective, for consumers to get 50 kinds of ketchup. Three or four are good enough. And when you have only three of four, in a business that has scale, then you can offer them at a lower price, because you're buying them in large quantities - much larger than other vendors that have 50 ketchups.

So I think that's very admirable from a civilisation point of view. But if you could have something that will be good for civilisation, which means enough choice but not so much that it creates a paradox of choice, and at the same time earn a high return on capital, and also pay your employees well, which

“So in a sense, when you have scale, you have a low cost advantage, you pass on most of the benefits to your customers - that creates loyalty, they want to come back to you again and again, and they don’t mind paying you an annual fee to get a chance to shop with you.”

is what Costco does, I think that’s an extremely admirable combination of things that is happening there. And when you combine that with the fact that customers are funding a lot of that business because they pay an up-front fee to get the privilege of shopping with you, that gives you float, which I think is another aspect of a wonderful business. I think all of that combines together to produce something that I think is absolutely fabulous. So in a sense, when you have scale, you have a low cost advantage, you pass on most of the benefits to your customers - that creates loyalty, they want to come back to you again and again, and they don’t mind paying you an annual fee to get a chance to shop with you. And with the cash flow that you generate, you have a system where you keep employees very happy. You pay them more than your competitors pay their employees, and that creates a wonderful culture of meritocracy. It has a nice karmic feeling about it, that you’re doing good, you’re doing something pro-social for civilisation, and in the process, you’re not compromising on creating wealth for your owners. I think even if you make slightly less money, net-net I think civilisation is better off having businesses where you have low-cost advantages.

Now, we’re not very far from 5th Avenue, which is a place where you go to buy all those wonderful, over-priced brands. But if you think about it, the consumers who buy those $5,000 bags are really paying a price that is way more than the cost of manufacturing that bag. So you have huge gross margins in those businesses. And they use that extra gross margin to advertise, to create a perception that you really do need that bag - because if you don’t have that bag, then your life is not full, not complete. You’re incomplete without that bag. I don’t think of that as a very admirable business model. I’m not being very judgemental here; I’m just saying things from my own perspective: if you have a business where you have a low cost advantage, or you’re selling something that is really good, and cheap, and it has a brand, and creates brand loyalty, and you’re selling it at a low price and in the process you can still get a high return on capital, I think of that as far more admirable as a business model, than where you are selling at ridiculous prices because you’re creating a perception in the minds of the consumer that this is worth a lot more than what it really is.

**Do you think that that’s a short-term strategy, doing that? Long-term that’s not a win-win relationship. As you said that, it struck me that if you’re creating unhappiness in my life, because I don’t own your product, and I buy your product and I’m still unhappy, and you’re still creating that unhappiness… how can that take advantage of compounding on a long-time scale? Whereas Costco, for instance, is a much better model in terms of the consumer wins, the employee wins, the shareholders win. It seems pretty win-win for everybody involved… the suppliers win… I don’t know if I get the same feeling**

**as when you were talking about the high-end brands on 5th.**

You're right. But I don't think we can say this is short-term or long-term. Because, clearly, many of those brands have been around for a long time, and they are very successful businesses. It's just that, if you notice, you don't usually find a Berkshire Hathaway owning them. Why? Why don't they own any of that? Why do they have something that gives genuine happiness? Why do they own business that provide something genuinely useful to society? I think there is something to be thought about on that.

There's a saying that there's a sucker born every minute, and there are all these people who believe that if they have become wealthy, then they need to have certain products, even though they are indistinguishable from something else that is far cheaper. And the supply of those people is actually going to increase over time. So I don't think we can say that those businesses are not going to thrive in the long run; they probably will.

But to me, that doesn't matter, because I am much more in awe of businesses that do something pro-social for society, and also make money for the stockholders. There's no trade-off there... you're not really doing charity. You can do something good and still make money. I think that's far better than a business where you're making a fool of somebody, and a business model which essentially involves making a fool of somebody who in this case is your customer. I don't think that's as admirable as a business model where everybody goes home happy.

**As you were talking about Costco, it sounded a lot like Amazon up until you get to company culture. But the other thing I think that Costco does, which plays to psychology a little bit, is when I go in there and buy my ketchup, I have no idea what eight litres of ketchup should cost, because I have no reference point. Whereas—**

“You have a reference point. It's called trust”

You have a reference point. It's called trust. It's a business model which, as Charlie keeps on saying, is a seamless web of deserved trust—

**Which I completely understand. I know if I go to Walmart and I go to a grocery store, they're selling the exact same bottle of ketchup. So I have a general sense of how much that should cost when I go into Costco. I've looked at the financial statements, so I know they're not making a tonne on this stuff - they're making enough to pay their employees, basically, and then they try to make their money, if I understand it correctly, through the memberships.**

Costco makes, I think, about 20% return on equity, which is actually quite healthy if you look at the industry in this part of the world. And it has a PAT margin of less than 2%. So it has very high capital turns. And it can do that only because it has scale. And it can get scale only because it has fewer SKUs. So I think it's a nice virtuous circle; a nice positive feedback loop at play here.

**And do you think that that's more resistant to some of the types of e-commerce that you were talking about before, in terms of not only the physical bricks and mortar stores, but against the online efficiencies that Amazon— I mean it seems like they're not really impacting Costco as much as other stores like Walmart.**

Yes, that's true. In a sense, Amazon has picked up some of the best of Costco's ideas. If you look at Amazon Prime - that takes money from customers up front to give you certain privileges. That's an idea that I think they copied from Costco. But it has certain other advantages: it offers you an amazing amount of availability, which Costco doesn't. And it has one shop - it doesn't have a lot of the costs that Costco has. So clearly, I think that in capitalism you keep on finding all kinds of businesses that evolve over time, and I think the Amazon business model is misunderstood, particularly people who think that they don't make any money. I don't think that. I think Amazon makes money. You can't just go by reported earnings. Amazon's true economic earnings are significantly higher than reported earnings. I think it's a superior business model over time. But that doesn't have to mean that Costco is going to go out of business.

"Over a period of time, as you experience something and you find answers to the questions that keep on occurring in a manner that provides you with answers that are different to what you thought earlier, then you might have chanced upon a new model."

**Let's switch gears just a little bit here from investing to acquiring, organising and synthesising knowledge. As a prolific reader, you read a lot, you integrate that into the Word documents afterwards. Do you also integrate it into your courses? And how do you go about connecting the different ideas? You mentioned the Kindle search earlier, but how do you go about refining the mental models you have in your head, and adding new mental models? And how do you know you've come across a new model?**

Over a period of time, as you experience something and you find answers to the questions that keep on occurring in a manner that provides you with answers that are different to what you thought earlier, then you might have chanced upon a new model. You never know for sure, of course, and it's just a way of organising your thoughts. You're trying to evaluate a situation, and maybe 5 years ago you looked at it differently. Today you look at it differently because you've read so many things and you have a better understanding of the world, and maybe some answer to that question will help you figure out the problem better than 5 years earlier. I think there's a good reason to give a name to that. And that's how I go about doing that.

Charlie has provided you with a framework. There are all these disciplines and all these names. He uses things like the boiling frog syndrome, which is a model that deals with the low contrast effect, which talks about the idea that slow changes tend to go unnoticed. That's a very powerful notion if you think about it. Because if you look at a business - a hugely value-creating business, or a value-destroying business - if you look at their financial statements over a quarterly period then you miss a lot of the change. But if you put gaps in between, if you look at data five years ago and today, you will see huge change, and that tells you why you notice change - because you removed a lot of the columns; you removed a lot of the quarterly information.

Charlie likes to give a name to models like the boiling frog syndrome. I think we already know that there is this myth that if you put a frog in boiling hot water, it will jump out and escape; but if you put a frog in lukewarm water and boil it slowly it will stay there. It's absolutely a myth. But the human equivalent of the boiling frog is there in all of us. Therefore, if you can notice change, over a period of time, by removing periods where change was not likely to be noticed, it will be very very helpful. So I use that a lot. So in a sense, I like to look at a business twenty years ago, fifteen years ago, ten years ago, five years ago and today. That helps me understand what their competitive advantage could be and whether it is increasing or reducing over time.

So it's useful to have these models and to give them names, which are very useful for recall. You can give a technical name to the boiling frog, but I think it's very important to have these notions in your head, because you can retrieve them very quickly. Once you have names for specific models, which you can recall immediately, it will be very helpful. So I like that particular point that Charlie makes. You can give them your own name. And Charlie uses things like 'deprival super-reaction'. He doesn't use the phrase 'loss aversion', because that's a technical phrase to illustrate a very powerful point that he makes about deprival super-reaction. When you read through his letters, whenever he talks about deprival super-reaction, it immediately hits you, and of course Charlie has filed models away in his head by giving them these descriptive names. And I find that very useful.

**And for Charlie, and for you, you can probably just mentally go through this list. How do you feel about checklists, or how do you make sure you have thought about things from— it seems like ever since Atul Gawande's book The Checklist Manifesto there's been a movement not only in the value investing community, but a movement in hospitals, a movement to go back to— maybe the airlines are doing something right: maybe the low fatalities and the very methodical approach to things has an advantage. How do**

*The Checklist Manifesto: How to Get Things Right*
BY ATUL GAWANDE

**you make sure that you're capturing all the mental models that you have? And bringing them to bear on a particular problem?**

When you think about checklists, I think what you're trying to do is to reduce your rate of error. And there's a trade-off here. I think what Atul Gawande has done - he's done a marvellous service to civilisation by giving us a framework for how to reduce error. And it doesn't have to be domain-specific. It could be flying a plane, as he talks about in Chapter 1 in that book. It could be about running a hospital operation. It could be also be about running an investment operation.

"Reducing error is not always the most optimal thing to do. "

But all of that is focussing on how to reduce error. But that's just one aspect of it. Because reducing error is not always the most optimal thing to do. You also have to be creative. If you're going to be creative, you're going to make mistakes. If you look at any business which has been innovative, you'll find that they have made mistakes. So there are two things here: you need to have the framework to create insights, which means you need to have a creative mind-set, which means that you should be willing to experiment, and sometimes make mistakes. At the same time, when you're actually making big decisions, you also need to have a framework to reduce error. I think Atul Gawande's work, and the movement that he has created that you are referring to, deals very well with that aspect. It doesn't deal at all with the idea that you want to be creative. You need both. You need to have the ability to have unique insights. And you also need to have the ability to reduce your error rate.

**So there's a tension between those two. But when you go inside an organisation, and you're, say, a mid-level manager, your job is almost effectively reducing error, reducing variance—**

True.

**— which, you know, is at odds with creativity and possible— I think there was an article in The Atlantic that put it really well about creativity. I'm kind of going off the cuff here, but they basically said that creativity is connecting things that other people haven't connected before, and if it works, you're a genius, and if it doesn't, you're basically in the madhouse, because people think you're crazy. So when you're trying to get promoted, and the psychology of being that mid-level manager in an organisation – who's very career-oriented and has a lot at stake - how do you go about implementing creativity? How do you balance that tension? Some companies do it really well, and I have no idea how they do that.**

That's a great question, and I've thought about that over the years, and over the years I've come across a few entrepreneurs who have been, I think, what I was describe as (and what Charlie would call) learning machines. They made mistakes, they learnt, and they haven't made those mistakes again. As a financial analyst, I do know a few things about risk management, so the way I think about it is that I'm looking for businesses that are risk-averse but not loss-averse. And those two things are very different.

"What you're really looking for is somebody who doesn't mind making a few small bets."

What you're really looking for is somebody who doesn't mind making a few small bets. Many of them will go bad, but they have potential. And if they pay off, they'll pay big. And if none of them pay off, it won't impair the company. It won't impair the business. And that's exactly how Buffett thinks. When he is in a position to write an unusual insurance policy, which will maybe pay off... but if he has to make good on his promise, he may have to pay a couple of billion dollars, or even more than that. But the premium that he receives in return on that promise is several times more than the actuarial value of that bet. The reason why he can do that is that nobody else is willing to make that bet. And the reason why nobody else is willing to make that bet is because of the point that you just made - people who have to make that bet have career issues. They have career risk associations. So they are loss-averse. And they're risk-averse. They don't want to take a chance. But Buffett doesn't mind looking foolish so long as he has not acted foolishly.

I think that's very interesting, because you can use that in analysing a whole variety of businesses out there, and find entrepreneurs who in aggregate are not taking a significant risk because if all of these bets don't work out, you're still fine. And the way to think about that is to look at quality of the balance sheet. If, for example, you're not borrowing money to expand, and if you're doing multiple expansion projects, you're introducing different products in different markets, in different geographies, and you know that each and every one of those bets has great potential. But it's a probabilistic world out there: you have no idea whether they will work or not. So you're giving a lot of respect to uncertainty. You don't know what will work. You're just being driven by data, which is exactly what happens in Amazon. You're trying to do a lot of experiments. You don't know which ones will pay off. But even if none of them pay off, it won't ruin the company because it has got other earning streams, it has zero debt on the balance sheet... I think that layer of financial discipline, when you combine that with an innovative culture, is a very good mix. I think you find that in some entrepreneurs. And when you find them, you should look at it with a bit of admiration.

**That's really good way to think about it. I was trying to think about the differences between Jeff Bezos and Steve Jobs. One would be, if you had to categorise him, purely analytic, and the other would be driven by an intuitive sense of design. And yet, they're both, or**

**were both, incredibly successful. I think, often I'm wondering if we just straddle, we try to be a little bit of both, and that that strategy is effectively ineffective. Instead of trying to compete or better yourself in one area, you're trying to better yourself in two areas, by which you can't be an expert at both. Or maybe you can be, and we just haven't come across examples of people. How do we move forward with that tension? Is it better to pick one? I know myself, and you know you can't really make these decisions until you know yourself. Therefore, do you think, "I will be a data-driven person and therefore make these decisions", or "I know myself and have an intuitive sense of design, and that's the path I want to pursue", and then burn your bridges to the other one? How would you approach that?**

I would do that from a data-driven perspective. There are these intuitive people out there. In capitalism, we have found Steve Jobs, who can create something beautiful that people relate to, and they become price-insensitive and just want what he is offering to the world out there, and it is beautiful. But you can't spot these people at the beginning of their careers. You can spot them maybe in the middle of their careers. So there has to be a past track record of somebody who is intuitive and right, over and over again. Once you have found that, that is based on actual data. On the other hand, you have these other kinds of entrepreneurs, who are like Jeff Bezos, who are data-driven, who have no idea about what will happen, but who don't mind making a series of small bets on hundreds of experiments, and have the ability to be absolutely unbiased about where to put money. And they will bet heavily once they know this bet is likely to pay off. If there are bets that are not paying off, they won't hesitate to withdraw capital from them. In capitalism, as investors, we shouldn't have - at least I don't feel the need to have - a preference for one or the other. If you can find both kinds of entrepreneurs, it's wonderful, because you are trying to build a portfolio.

**That's a really good way to think about it. There are three questions I do at the end of every interview... we're coming to the end so I want to ask you these three. The first one is: what book has influenced you the most in your life?**

*Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*
BY PETER KAUFMANN

That's easy: Poor Charlie's Almanack. It never stops influencing me. Every time I pick it up and read it, it gives me something more to think about.

**How often do you re-read it or go back and think about it?**

I read it about three times a year. For some talks, I end up reading it more. Every year I teach a course on behavioural finance, and the talk on The Psychology of Human Misjudgement is helpful. Every time I read that talk I come up with new examples and learn something else. Every time I read that book, that particular speech he gave helps me come up with new associations, new examples, and I think I'm a better thinker after having read what Charlie had said so many years ago. And I can relate it to my new experiences, and be able to teach them, and in the process learn more through teaching. For some talks I will read more, and some I will read less. But I will pretty much read that book over three times in a year.

*The Psychology of Human Misjudgment*
BY CHARLES T. MUNGER

**With the talk, The Psychology of Human Misjudgement, do you listen to it or do you read it?**

I read it. I know there is an audio version of the first talk. But I prefer to read it. Because it's so profound: you have to pause. If you are listening to it on audio, then I guess you need to constantly pause and think about it. Maybe you can do it but I don't find that very easy to do, so I'd rather read it and then let it be. Read a passage, and then think about it. Maybe spend a few hours thinking about it.

**And is your copy of Poor Charlie's Almanack marked up?**

Oh yes.

**What book are you reading right now that you're really enjoying?**

*Pebbles of Perception: How a Few Good Choices make All the Difference*
BY LAURENCE ENDERSEN

I'm reading so many of them. I picked up one book that you recommended a few weeks ago, which I find very useful: Pebbles of Perception. That's a book you wrote about in one of your posts. I picked it up and I'm reading that, and it's a fabulous book. I've read about 30% of it - I think it's a fabulous book.

*Seeking Wisdom: From Darwin to Munger*
BY PETER BEVELIN

**It's an amazing book - I think what I said is it deserves a place on everybody's shelf besides Seeking Wisdom. He [Laurence Enderson] is an amazing person. The final question is: who, if you could have anybody else interviewed on The Knowledge Project, would it be? Who would you like to see me interview?**

Charlie Munger!

**I'll try to make that happen! Sanjay, thank you so much for your time; I really appreciate it. It's been an amazing experience meeting and speaking with you.**

Thank you, Shane, it was a pleasure meeting you as well.