Evolution of an amateur value investor: Key lessons learnt over last few years

Investor's Carnival: 24th -26th November, 2017

Presentation By: Dhwanil Desai

Disclaimer

The views expressed here are my personal views. It is a safe to assume I am personally invested in some of the stock ideas that may have been referred to in the presentation. It is also possible that I may have exited or may exit from these positions in future without prior notification. My views are likely to be biased so do take than with handful of salt! This is NOT a stock recommendation. Kindly do your own due diligence and/or consult a registered investment advisor before making any investment decisions

Investment Journey: Evolution

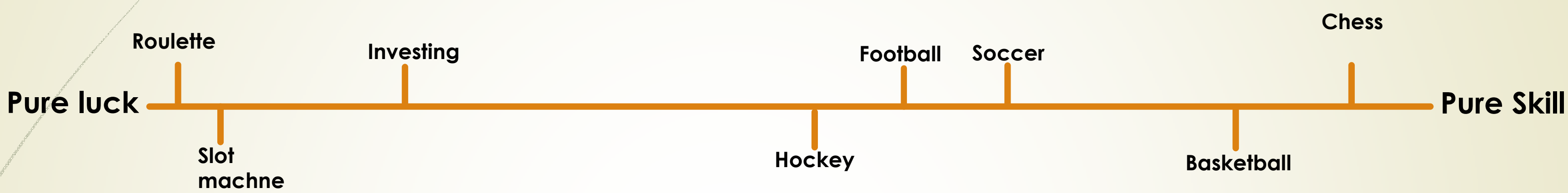
- Started serious investing around 2009-10 – stumbled upon value investing accidentally and got hooked on to it
- Initial learning through reading some of the classics: Intelligent investor; Warren Buffet's letters and Peter Lynch's "One up on wall street"
- Started looking for "deep value" – following Ben Graham's style/matrix
- Beginner's luck around 2011-12
- In next 2-3 years understood how combination of "re-rating" and earning growth can create immense value in relatively short time
- Started writing blog around 2011 on investing- positive feedback loop
- Inflexion points in investment journey:
  - Importance of owning a high quality franchise
  - Capital Allocation framework
  - Behavioural aspects of investing
- Power of vicarious learning

Cultivate your own investment Philosophy

- Why do we need an investment philosophy?
- Learn/Understand the investment philosophy of Gurus but do not blindly follow them as investment philosophy may change based on following
  - Amount of capital
  - Business environment
  - Investment goals/personal finances
  - Psychological set up
  - Family background/circumstances
- Applying Graham's investment philosophy of buying statistically cheap stocks in Indian context- Possibility of value trap is quite high
- Warrant Buffet's investment philosophy: Buy wonderful businesses at great price for intention to hold them forever: Context is very important
- Acknowledge that with new learning/experience- one's investment philosophy may change

Never confuse between process and outcome

- Michael Mauboussin – Luck versus skill



- Process-outcome possibilities
  - Good process; Desired outcome: Delivers investment objectives
  - Good process; Undesired outcome: Black swan; unanticipated change in industry/business dynamics
  - Bad process; Desired outcome: Sheer luck; Can breed overconfidence
  - Bad process; Bad outcome: Fait accompli!

- In all probabilistic fields, even though right process may not always result in successful outcome, it increases the odds of success over a longer period of time

Write an Investment thesis and develop a check list

- Investment thesis documents the thought process/rationale for investing- which one can review periodically to decide whether the rationale still remains valid or not
  - Investment thesis should be brief – a one pager with 3-4 para and should be able to make sense to anyone who is not conversant with the business
  - Apart from why one is buying, important to include what is the expected returns under various scenarios and probability of each outcome
  - What is the variant view of the market
  - Key risks to thesis
  - Suggested allocation
- Develop a checklist and invest only after you have filled it up for an investment idea
  - It helps one bypass the System 1 thinking and forces one to objectively analyse key aspects of the business
  - Keep it comprehensive but manageable- do not make it too complex
  - Helps one identify key risks
  - ENIL- Checklist

"Successful investing professionals are disciplined and consistent and they think a great deal about what they do and how they do it." Benjamin Graham

Second level thinking: extremely useful in generating Alpha

- Second level thinking: Looking beyond obvious and thinking critically

"For your performance to diverge from the norm, your expectations- and thus your portfolio- have to diverge from the norm, and you have to be more right than consensus. Different and better- that is a pretty good description of second level thinking"

Howard marks' memo "It's not easy"- September 2015

- Key questions to ask for second level thinking
  - What are the Potential outcomes and pay offs? What is the probability associated with each outcome?
  - What scenario is the market consensus building in price?
  - Is my assessment of most likely outcome different than the one presumed by consensus? If so, why am I likely to be right and market wrong?
  - In case if I am right, what is the upside and if market is right what is my downside?

"The real money isn't made in buying what other people like. It's about buying what others underestimate. Buying that kind of thing can be a lonely business"

Examples: Jubilant foodworks; Just dial; Shemaroo?

Understand the power of operating leverage

- Operating leverage can be extremely powerful driver of earning growth/degrowth
- Even though most of us have heard about operating leverage- we may underestimate the mathematical significance and hence impact on numbers
- Key characteristics of Operating leverage
  - Higher the fixed cost in the operating expense, higher the operating leverage
  - Operating leverage is a double edged sword- it cut both ways
  - Any reduction in top line will have magnified impact on bottom line
  - Typically, businesses with high gross margins may have high operating leverage

Case 1: 60% operating expense is fixed

	Base Case	10% drop in topline	20% drop in topline
Revenue	100	90	80
Operating expense- variable	30	27	24
Operating expense- fixed	45	45	45
EBIDTA	25	18	11

Case 2: 70% operating expense is fixed

	Base Case	10% drop in topline	20% drop in topline
Revenue	100	90	80
Operating expense- variable	22.5	20.25	18
Operating expense- fixed	52.5	52.5	52.5
EBIDTA	25	17.25	9.5

While valuing companies, look beyond P/E multiples

- Valuation of the company can not be looked at in isolation- the context of business/industry environment is very important
- One of the key reason why in some situations, P/E becomes less relevant is because "E" does not represent the true "earning power" over time
- Why would "E" may not represent true earning power
  - During business lifecycles…businesses do go through years where margins fluctuate
  - Businesses need to invest in single shot. While benefits from the investment accrue over period of time
  - The business model- is fixed cost heavy- while the demand/top-line may fluctuate based on external environment
  - In few cases, future business earnings can grow exponentially because of the small base with respect to extremely large opportunity size
  - When business models are in transition. Where past may not mirror the future
  - When earnings are not present or too little to be meaningful. Typical for companies going through industry down cycle

In Order to create serious wealth, one must understand the importance of capital allocation/portfolio construction

"Proper allocation of capital is an investor's number one job." **Charlie Munger**

- Picking a winner is only half the battle won, real wealth gets generated when one allocates significant capital to the winning idea
- Key objective of capital allocation/portfolio construction is to ensure one optimizes the risk/reward trade-off
- Key questions to be answered in capital allocation
  - How many stocks to have in portfolio? Concentrated vs diversified
  - How do you divide capital between number of ideas in portfolio? Top 10 ideas + Tail
  - What criteria will decide the allocation to each idea in portfolio? Conviction/Valuation matrix
  - If the position of an ideas goes above certain threshold- should one trim or not? Risk vs return trade off
  - How do you reallocate the capital to new idea?

“Selling” decision contribute as much to investment success as the “buying” decision

- Once we buy stocks, we have two decisions to make Hold(Not Sell) and Sell. Both of them contribute immensely to our investment returns

When NOT to sell

- Stock has not done anything for sometime and hence is pulling down the overall performance of the portfolio
- Temporary headwinds/challenges to the business- natural to most of the businesses
- On the notion that the stock is fairly valued/overvalued- Exception- bubble zone?

When to Sell

- When we realize we have done a mistake!
- When the investment thesis is no longer valid
- Weight in portfolio becomes disproportionately high
- Alternative opportunity that provides SIGNIFCANTLY higher expected returns

Envy is as injurious for wealth creation as greed

"I have heard Warren say a half a dozen times, 'It's not greed that drives the world, but envy.' And you go through the psychology survey courses, and you go to the index: envy, jealousy, in a 1,000-page book — it's blank! There's some blind spots in academia, but it's an enormously powerful thing" **Charlie Munger**

- Envy plays as important part in "misleading" us to wrong investment decision as does greed. However, the influence of that is highly under appreciated in the world of investing
- Typical situations where envy manifested itself in the past to me
  - After research we have given a miss to an investment idea due to some reservation, while in your circle people invested in it an making big money! – Avoid Deprival super reaction?
  - Market has caught fancy of certain sectors/stocks and hence they continue to run abated while your portfolio barely crawls! – You can't have a portfolio that performs all the time- one must learn to live with underperformance
  - Staying in cash due to lack of opportunity- while market/stocks continue their upward journey taking high valuation even higher!
  - We avoid IPO while others continue to make hefty listing gains with astronomical IRRs

Questions?

Thank You