



Notes on The Thoughtful Investor by Basant Maheshwari

☰ Category	Investing
➤ Mental Model	
☑ Optimized?	☑
☰ People/Website	Basant Maheshwari
▼ Status	Read
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Part A: The World of Investing

▼ The Business Of Investing

An investor has to be lazy in taking profits and agile in cutting losses.

The process of getting rich for a big everlasting smile entails sacrificing a lot of small happy moments.

To attain financial freedom one must have a corpus of fifty times their annual expenses.

The fight remains between a bird in hand and several in the bush.

▼ Magic Of Compounding

A great idea does not come often and when it does the need of the hour is to bet big and hold it for its up move.

Long time can compensate for little less return rate. Being in the game matters more.

▼ Equities Don't Outperform All Asset Classes All The Time

Index Investing

In India index is market cap weighted instead of being price weighted as it is in the USA.

Which means Indian index gives more weightage to few stocks

But I think the same thing is happening in US market too, FAANG

▼ Attributes Of A Full Time Investor

When work becomes passion - wealth follows.

If you don't know why you should be buying a stock then this is not your cup of tea.

Its the research that needs the passion not the minute to minute outcomes

Some advise:

1. Look for a group of serious investors
2. No substitute for reading
3. Make Notes
 1. Read past experiences of others P
 2. Put real money
 1. Avoid mocking trading: You don't face the joy of winning or the fear of losing the money.

▼ The Pain of Losing

Companies don't grow at 40% on an individual basis. There has to be a sector tailwind for which such stocks are leaders.

Market tops and bottoms are caught by two people: fools or liars.

Basant suggests that one should not buy immediately when the market crashes and should wait on the sidelines and wait for the 'blood to dry'.

An investor who buys stocks on borrowed capital is less likely to make a mistake than the one who buys it on borrowed conviction.

▼ Risk vs. Return

Most investors get rich by avoiding risk and not by taking it.

▼ Buy What You See

In the long run shareholder's return is determined by the ROE only

▼ Macro Numbers - How To Analyze Them?

A trader in Chandini Chowk would do nothing differently just because a macro number has come in a certain way but the passive owner of much larger and efficient business will be tearing their hair trying to forecast the actual impact of these number

Any even that affects all the players of an industry should in most cases be ignored

Part B: Bull Market, Trends and Economic Bubbles

▼ Identifying Tops and Bottoms

Signs of a bull market:

1. Launch of fresh mutual fund schemes

2. Inflow of Foreign institutional investors (FII)

3. Maximum Leverage

1. That is when participants of the market are full in and has also taken leverage with their position

Why market falls suddenly:

Just a little drop in prices leads to leveraged people getting margin calls which further leads to a chain reaction of selling further dropping of the prices. This further creates fear in the market and the weak players start selling.

I feel one must remember that even though a bull market will raise the prices of the stock, a company would take its own time to perform.

Signs of bear market:

1. Valuations are most reasonable
2. Public participation is minimum
3. Leverage is very small
4. Sense of uneasiness around

Sectors that recover first(In order):

1. Auto Companies: As people who were delaying their purchases have now started buying.
2. Banking Sector: The probability of bad assets reduces and businesses start to perform. An increase in economic activity also encourages expansion which leads to further loans.
3. Industrial companies: For expansion you would need to buy machinery
4. Cyclical

▼ Identifying The Next Big Trend

Most investors remain focused on trying to find the next big trend rather than participate in the ongoing one.

Here are some trends:

1. There is always a bull market somewhere: in some asset class
2. Whatever happens globally happens in India
3. New Sector for each bull market
4. Above average growth of company and industry
5. Scale of opportunity
6. First generation entrepreneurs
7. Stocks hitting all time high
8. Small Market Cap
9. Relatively Expensive Valuation
10. illiquid and unpopular
11. Lack of entry barriers
12. Bear market IPO's
13. Pickaxe and Shovel Theme
 1. If ecommerce increases Blue Dart, Gatti like companies will benefit

Part C: Company and Financial Analysis

▼ Understanding Business Models

A good business is which purchases on credit and sells on cash

Purchasing on credit shows competition among suppliers

Selling on cash shows buyers are weak and dispersed

This also means that business is running on float money: Negative working capital

Business Models:

1. Entry Barriers
2. Brands
3. Market share vs Mindshare
 1. Mindshare means the customer itself comes to buy the product

4. Franchise led growth
 1. Such businesses need less capital
5. Changing the metric of measurement
 1. Buying commodity and selling brands
6. High gross margins
 1. But we need to remember as Prof. Sanjay Bakshi said in his lecture a high gross margin could also make a business fragile as it could sooner or later attract competition and kill those margin.

Fragility & Optionality in Business Models

7. Government Lease
 8. Patents
 9. Low cost of production and economics of scale
 1. Ex: Walmart
 10. Large Upfront Capital Expenditure
 11. Network Effect and Switching costs
 12. Product Penetration and Distribution Network
 13. Low Priced Items
 14. Possibility of Postponements
 1. Products whose buying cannot be postponed
 1. Ex: Toothbrush, medicines, etc.
- ▼ Growth, ROE with DuPont Analysis
- ▼ When Does an Acquisition Work Out & When It Doesn't
- Acquisition generally signal that company is moving towards slow growth phase
- The ROCE gets diluted because the cash held under investments do not form part of the capital employed whereas if this cash is used in an acquisition it will included.
- Therefore, if a business has less ROCE than the current one the ratio will fall.

▼ Is Your Company Taking Up The Market Share?

If your company is has a revenue growth more than the competitor and the rate at which the market is expanding then your company is eating up market shares of competitors

But do keep probability in mind

If there is growth at the cost of dilution of equity then its not a good sign

The Leader is always first to gain market share when new competitor spreads the product awareness.

An unorganized sector suffers from lack of operating efficiencies, financial support and are generally family business who don't want to expand.

▼ Evaluating the management of a business

Buying an expensive business managed by an honest management fetches better results then one managed by suspicious people.

Importance of being with a good management diminishes in a bull market but increase manifold in a bearish one.

A dishonest management never runs a debt free company.

Some ways to evaluate management:

1. Over ambitiousness of the management can be understood if they bring a lots of IPOs from the group company. Like: Kishore Biyani's Future Group.
2. Mergers or takeover of companies that are related to the promoters
3. Honest management always pays taxes and keeps a good dividend payout
4. Exorbitant salary payments
5. First generation promoters
6. Transparency in the AR

7. People seldom change: Avoid management that was fishy once but now is showing a clean chit

▼ Operating Leverage- Looking For Margin Expansion

Operating leverage: When a company expands output it adds less to its fixed costs and hence the increase in revenue creates a more than proportionate increase in profits.

Companies with a high gross margin and a low net margin are more likely to experience an expansion in margins.

▼ How Companies Cook Books Of Accounts?

A company which manipulates its numbers would generally show either lower revenues, higher expenses or a larger block of fixed assets.

The fixed assets are valued at higher rates due to over invoicing of assets.

Dividends and taxes are good indicators for quality of earnings as they need to be paid in hard cash.

Beware of frequent equity dilutions

The rate of increase in inventory and receivables should not exceed the rate of increase in revenues

Change in auditor or too many related party transactions are also red signs

▼ Stocks To Avoid

It is more important to avoid losers than finding winners as if a stock that halves in price needs to double up for the investor to break even.

Chances of making money multiplies manifold with a focused company rather than one which is running multiple businesses under one roof.

Stocks to avoid:

1. Growth through repeated dilution of equity or debt
2. Unnecessary diversification
3. Lots of acquisitions
4. Large Market cap in relation to the size of the sector
5. Stocks making new lows

6. Untested business models
7. Cheap second line stocks in later stage of bull market
8. Leading stocks from the leading sector of previous bull market
9. Cyclical that are performing too well
10. Wide coverage relative valuation and priced for perfection
11. Too much showcasing

▼ Drivers Of A P/E Ratios

Businesses that get higher PE:

1. Having predictable and sustainable earning
2. High entry barriers
3. Positive cash flow

▼ Should a small investor always stick to small cap stocks

If buying small and micro caps is the way to riches it is also the path to bankruptcy

But if one finds few good small caps they could change one's life.

Getting out of small cap becomes a huge problem unless you are a investor with small corpus

Part D: Buying and Selling Strategies

▼ Should a Small Investor Stick to Small Cap Stocks?

- Small cap companies without entry barriers are not suitable as these companies don't have the ability to become a large cap.
- A company must have revenues of at least Rs.100 cr as it works as a proof that their business model works.
- It is very difficult for small caps to survive a pandemic.
 - But what if it does? CCL is one of the companies which were not significantly affected by COVID.

- You must figure out whether the small cap company has the ability to scale its business.

▼ Multibaggers From Small and Mid Cap Stocks

The number of times a stock could go up in the future is dependent on its earnings growth and not on the number of times it has moved up in the past.

- The trigger for multibaggers will be **growth and scalability** of the company and not at what valuation is it available.
 - For example: when a company keeps taking away market share from the organized sector. VIP Industries or Safari could fall into this.
- Small cap companies that are not leaders in their sector have a risk of slipping down the delivery and execution of earnings.
 - But if the sector itself is very huge then you might not need a leader.
 - Ex: SUN TV vs ZEE
- No equity dilution + less/no debt and increases revenue with operating leverage is sure shot multibagger.
- You need to check whether the management is competent because often small cap don't have resources to hire professional managers.
 - A promoter whose incentive is not management compensation but company's performance would be the best one. Ex: Ambika Cotton Mills
- Temporary down in profitability due to advertising or capex done should not be given much importance.
- Checklist according to Basant:
 - ROE > 30%
 - I disagree with this one. I feel 30% is too high and if a company earns such ratios it will definitely will be face with competition in the future as it would attract other players.
 - Refer to:

♥ Fragility & Optionality in Business Models

- No dilution of equity and less/no debt
- Debt should be less than 50% of the net worth
- Positive cash flow
- Dividend yield is 1.5 to 2%
 - But this won't apply for illiquid stocks.

Small cap companies are the ones which could lead you to early retirement but such companies also have potential to put you back to work from retirement.

▼ When to Catch A falling Knife and When Not to?

The argument that an investor should buy stocks on a decline isn't as important as the argument as to what stocks he should actually buy

- He divides stocks into three categories
 - A high quality company in a low quality sector(Infrastructure)
 - A high quality company in a high quality sector(consumer)
 - A low quality company in a low quality(Real Sector)
 - An investor should always stay away from this one as it has the potential of maximum damage.
- Having a part owner mindset sometimes backfires and you tend to not sell when the fundamental starts deteriorating and you start to rationalize it.
- Basant had taken a long position in Voltas and the stock was falling. So, he used to go on long walks and used to count the number of Voltas AC around his area. which gave him confidence not to sell.
 - But it was a mistake as he realized that AC contributed only 30% of the company's revenue.

- A high growth company rarely goes back to the high growth stage after it starts to slow down on the growth curve
- High quality stocks rarely become cheap so trying to buy them as bargains is a strategy that never works out as much as it is debated.
- The believers of a story generally get in early before the bottom and have to bear the pain before the gain.

It is always easy to bring down a house than to build it up!

▼ The Ones I Saw And Missed

An investor who always regrets his misses is like a person who repents about every girl he saw but did not marry!

- United Spirits
 - Lesson: Even though this stock went up 50 times Basant would still not buy a company with a shady management
- Nagarjuna Construction
 - Lesson: If a stock moves up like 15% it does not mean it can't move further.
- Aban Offshore
 - Lesson: It is better to buy a mediocre business with lots of tailwind than a great business with lots of headwinds
- Bharti Airtel
 - Lesson: If there is a problem like company not being profitable, you could enter when the company becomes profitable.
 - It is never too late to buy a good stock or sell a bad one.
- Kaveri Seeds
 - Lesson: If the financials are good and the business is debt free with high ROCE and promises average growth then one can buy a little without trying to understand a great deal about the business.

- A debt free business with high ROCE is the first signal to a robust business model.
- A person learns more about a business after he has bought the stock than he does before buying it.
- One should not worry about missing an opportunity as if one goes the next one will come earlier than you expect.

▼ When To Sell and When Not To?

| Love your family not your stock

- Selling is making an educated guess.
- Reasons to sell
 - Opportunity Cost
 - As money is finite
 - Extended valuations
 - If market cap of a company is low compared to growth opportunity ahead then a high P/E does not matter.
 - A bull sector loosing favour
 - To make money it is not necessary to buy at the bottom or sell at the top.
 - But if someone gets stuck in the fall, it is better to fall with the leader rather than with a laggard.
 - Change in original thesis
 - Change in fundamentals, management not executing, or Government policy
 - Take immediate action - irrespective of your purchase price.
 - A question to ask is whether you would have bought that stock if you would have had this information at the first place.
 - New competitor
 - General business slowdown

- Portfolio Skewness due to movement of one stock
 - I disagree with this one. As long as one believes in the stock and the fundamentals are good the holding period should be forever and not selling just because of too much exposure or volatility.
- One should not look at the price of after selling a stock as it could affect you emotional.

Part E: Analyzing Sectors and Industries

▼ Basic Economy Stocks, Diversified Businesses and Spinoffs

- Basant considers Tea as pure commodity play but with an exception.
 - If the company gets into branding its product and making value products like green tea or herbal tea.
 - CCL Products (India) Ltd is exactly what he is talking about.
 - They are getting into branded business
 - They are making products like Freeze Dried, Spray Dried, Premix, etc.
 - Similarly like in Textile industry, unless the company gets into branded business getting a high valuation is difficult.
- Basant warns about investing in companies who sales depend on others. Like Munjal Showa
- Power Sector is highly regulated which makes it difficult for the company to generate high returns. Therefore, if someone want to play power sector theme then one must bet on equipment manufacturers.
 - Similar to the story of selling Shovel when everybody is digging for gold.

▼ Analyzing Companies With Cash on Balance Sheet

- Why market discounts cash?
 - Due to questionability on existence of cash
 - Earn less than the operating business

- Holding cash is a double edge sword. It saving you during bear market but pulls you down in bull.

▼ Analyzing Holding Companies

- If you want to make money in holding company then you need to be bullish on the subsidiaries'.
 - The gap between them them should be large enough because holding companies always remain undervalued.
 - Unless it owns a private company which is doing quite well like, info edge owns stake in Zomato.

▼ PSU Stocks

- You need two things in PSU
 - Cheapness
 - Tailwind

▼ Analyzing Secular Growth Stocks

- Pricing power
 - If a company can increase its price every year 6-8%
 - or, retain its price with the input cost are low
 - I think CCL Products cannot do this. As it takes 30% margin on whatever is cost but still it has the power to command 30% margin and the economy behavior does not matter.
 - But business growth is more important because prices can be raised only till a certain point.
- Breaking the product into smaller sizes is an amazing way to retain customers. As the products becomes affordable.
- Some Traits of a secular growth company:
 - Expensive
 - Long business life
 - Generating free cash flow

Part F: Constructing a Portfolio

▼ Portfolio construction strategies

Large wealth creation opportunities don't come too often and when they do they should have the power to make a difference on investor's balance sheet.

▼ Diversification vs Concentration

- Concentration:
 - Advantages
 - Reduces chances of making wrong decision as you chose your investment very carefully
 - Better risk management as you bet large on few stocks, you tend to be alert and move out with the first sign of trouble.
 - I would change this to 'permanent' trouble.
 - Disadvantages:
 - It sometimes becomes difficult to get out of the stocks due to illiquidity
 - But if you have a small portfolio then this should not be a problem as big money is made here.
 - Needs confidence and good knowledge about the company, as you cannot afford to lose.
- Diversification
 - Advantages:
 - It provides you with higher level of excitement as there are many companies about which you need to keep yourself updated with. On the other hand having few stocks means most of the times you need to do nothing which makes it boring.
 - Not sure if this is an advantage, seems like a disadvantage.
 - Can compensate any of your mistakes made as you can afford to lose here.
 - Disadvantages:

- Lowers the average quality of companies you hold.

▼ When and How to leverage

My thoughts:

Price and not valuation affects your decision to take leverage. I follow valuation approach and my guru's warn me of taking leverage. Hence, I have no takeaway's from this chapter.

A leveraged portfolio will give me sleepless night and you need to constantly track your position as if they go down you need to cut your losses as to not over leverage.

┃ Don't loose out what you need for what you want