What Does
“Bullet-Proof Investing”
Mean to Me?

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TIA
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Thanks for inviting me here. It’s always a pleasure to come to this wonderful city. So many old friends here and lots of wonderful memories. Indeed, my journey as a value investor started in mid 1990s when I made some fabulous friends in this city, some of whom are in this audience today. I regard myself as very lucky to have met them when I was just starting out, and for them to take me under their wing. Those early years have been very helpful to me.

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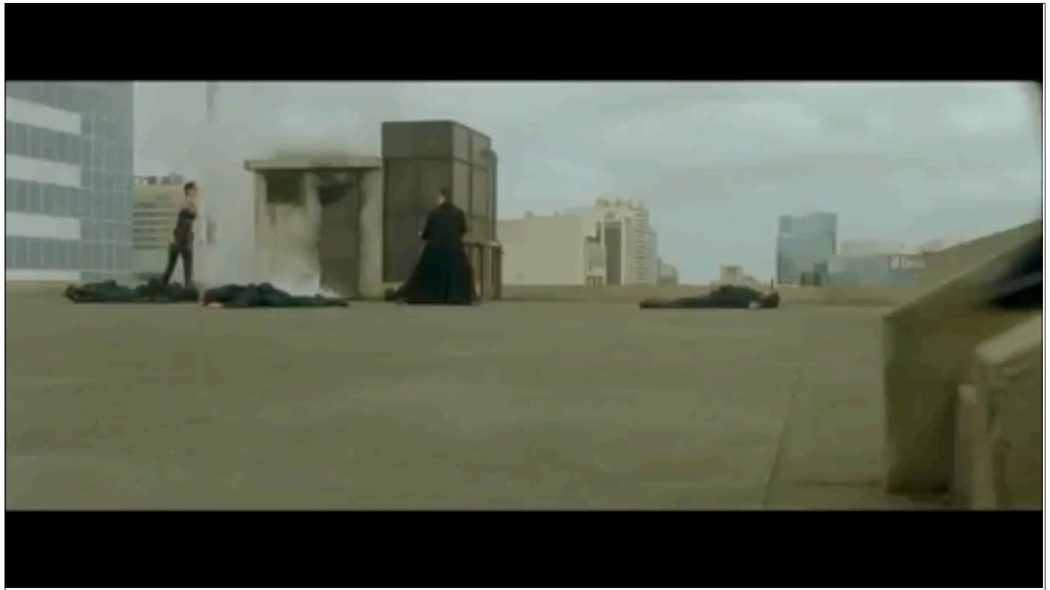
About the topic - I found the phrase “bullet-proof investing” very interesting but when I read it, I immediately recognized that it means different things to different people. And so, I decided to title my talk as “What Does Bullet-Proof Investing Mean to ME.”

But before I tell you about what bullet-proof investing means to me, I want to confess that I have many wounds on my “body” and I continue to get wounded year after year. But I have, so far, survived those wounds, although I must admit that there were times and incidents, when it seemed that the chances of survival were slim. Indeed, those times and incidents have been most instructional.



https://www.youtube.com/watch?v=xZ0OUq_kDh8

So what does bullet-proof investing mean to me? It means that not only will I not die, I will also not get seriously hurt. And by “I” I am referring to my investment portfolio.

And when I would not get get seriously hurt, I am NOT talking about two things:

What Does
“Bullet-Proof Investing”
NOT Mean to Me?

1. Impairment in the fair value of any specific security in the portfolio; and
2. A significant decline in the market value of the entire portfolio

let me elaborate on these two things which do not, to me, mean bullet-proof investing.

Impairment in the fair value of any specific security in the portfolio is NOT Bullet-proof Investing to me

- Impairments in the fair value of individual securities is OK
  - It's ok to lose 100% of your money in any given stock because the the potential upside is huge
  - Asymmetric payoffs in equity
- But a significant impairment in the fair value of the PORTFOLIO is NOT OK
  - You do not ever want to go to zero, or close to zero or in fact have a permanent impairment of a significant part of your wealth

A significant decline in the market value of the entire portfolio is also not Bullet-proof Investing to me

- Nothing can prevent a significant decline in the market value
  - Remember 2008?
  - Shorting stocks is certainly not my way of doing it
- Market value declines are outside your control
  - You can't control the behaviour of others. You only get a shot at controlling YOUR behavior
- Graham - Mr. Market.
- Focus is on earning power of the PORTFOLIO and not its market value
- If earning power is high in relation to price, and it will grow significantly over time, then you can afford to ignore the market

The single most important factor that will determine the market value of your portfolio in the long term is the quantity and quality of earning power over time. If the quantity is large in relation to price (which means low multiples) and if earning power will grow significantly over time, then you have a bullet-proof portfolio.

So when I talk about
Bullet-proof Investing,
I am referring to four
conditions

Condition # 1

Large Earning Power in Relation to Price

which basically means a low multiple.

Condition # 2

Large Earning Power in Relation to Capital Invested in the Business

which basically means a high returns on capital

Condition # 3

Portfolio's Earning Power Protected from Destruction

Condition # 4

Growth in Earning Power Over Time

If these three conditions are met, at the PORTFOLIO level, then I believe I have a bullet-proof portfolio.

Now let me elaborate on each of these conditions.

Condition # 1
Large Earning Power in Relation to Price

- Earning Power
  - Reported Earnings vs. Economic Earnings
  - Earnings vs. Earning Power
    - Untapped Pricing Power
    - Camouflaged earnings
    - Sustainable vs. One Time

Condition # 1
Large Earning Power in Relation to Price

- Large Earnings Power In Relation to Price
  - Low earning power multiple
  - How Low?
    - Graham’s Pre-tax AAA Bond Yield Idea
    - Bond Component of value
    - Speculative Component of Value
  - Multiple re-ratings are not in our control
  - If a large part of an excellent return on a stock has come from multiple expansion as opposed to earning power growth, then the stock is vulnerable

The stock is vulnerable because, for whatever reason, if the embedded growth expectations in the valuations do not materialize, then value will get impaired, and quite likely, so will will the market price.

Our concern here, of course, is impairment of value.

Condition # 1
Large Earning Power in Relation to Price

- Large Earnings Power in Relation to Price But At the Portfolio Level
  - Why?
  - Because it gives you a chance to buy high growth stocks at multiples that look expensive but will turn out to be cheap if earning power grows strongly for a long time
  - Even though such stocks are vulnerable to multiple derating if earnings growth does not materialize, by keeping control of the multiple at the PORTFOLIO level, you create a bullet-proof portfolio
  - This kind of approach allows you to have some “rollercoasters in your portfolio without compromising on its overall safety

Remember, we are trying to seek protection at the portfolio level.

So by all means, go and buy super growth stocks at high multiples but limit exposure so that overall portfolio multiple is kept in check.

This kind of approach reduces errors of omission while at the same time keeps portfolio safe in terms of value.

Condition # 1
Large Earning Power in Relation to Price

- Large Earnings Power in Relation to Price But At the Portfolio Level
  - Why?
  - Because it gives you a chance to buy high growth stocks at multiples that look expensive but will turn out to be cheap if earning power grows strongly for a long time
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One key point: Bullet-proof investing is about protection from harm. It’s not about maximising returns without any regard to downside risk. What does this mean in a practical sense? It means that if you want to be a bullet-proof investor, then you have to dynamically manage the relationship between your portfolio’s earning power and market value - its earning power yield. The closer that yield is to AAA bond yield, the more bullet-proof the portfolio in value terms. Why? Because at that value, no growth is embedded. Suppose that number goes very low at the portfolio level? That is the multiple goes way high? What are the implications? The portfolio becomes vulnerable to a value decline should you turn out to be wrong about growth expectations because higher the multiple the more the growth expectations embedded in there.

Condition # 1
Large Earning Power in Relation to Price

- Large Earnings Power in Relation to Price But At the Portfolio Level
    - Why?
    - Because it gives you a chance to buy high growth stocks at multiples that look expensive but will turn out to be cheap if earning power grows strongly for a long time
    - Even though such stocks are vulnerable to multiple derating if earnings growth does not materialize, by keeping control of the multiple at the PORTFOLIO level, you create a bullet-proof portfolio
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And so, this strategy of keeping the overall portfolio earning power yield close to AAA bond yield - the recommended strategy which makes the portfolio bullet-proof - this protection comes at a cost. You will give up some of the upside for getting that protection. An analogy with a bullet-proof vest is apt here. That bullet-proof vest will slow you down but it will protect you from harm when the bullets come.

And so you have to decide whether you want that protection or not.

Condition # 2
Large Earning Power in Relation to Capital Invested in the Business

- Self Explanatory
  - Compound interest inside a firm
  - The Mathematics of Quality Investing Lecture at Moneylife

Condition # 3
Portfolio's Earning Power Protected from Destruction

- Protection from What?
- Protection from bullets
- They will come from all directions

Dodging Bullets, Getting Hit, But Remaining Unharmed

https://youtu.be/xZ0OUq_kDh8?t=15

The bullets will come from all directions

Condition # 3
Portfolio's Earning Power Protected from Destruction

- Protection from What?
- Protection from bullets
- They will come from all directions
  - Business Bullets
  - People Bullets

Condition # 3
Portfolio's Earning Power Protected from Destruction

- Business Bullets
  - Competition
    - From existing competitors
    - From new competitors
    - From substitute products
- Dependencies
  - Customers
  - Vendors
  - Geography
  - Regulations
- Economy

Protection will come from entry barriers, low dependencies, and capacity to suffer derived from low cost advantage, liquid balance sheet, low or no debt. Makes a business anti-fragile especially in industries where other players are playing a different game.

Condition # 3
Portfolio's Earning Power Protected from Destruction

- People Bullets
    - Major Management Mistakes
        - Blowing up money on expensive acquisitions
        - Stupid diversifications etc
    - Mis-governance
        - The earning power may be there but you won't get it as minority shareholders

Condition # 4
Growth in Earning Power Over Time

- Combines well with Condition # 1: Large Earning Power in Relation to Price. Why?
- Combines well with Condition # 2: Large Earning Power in Relation to Capital Invested in the Business. Why?
- Re-investment opportunities
- What happens to your portfolio if the growth you expected does not occur?

By treating growth as a speculative factor in valuation, there are many advantages:

1. You are no longer required to make elaborate projections about the quantum and timing of growth in earnings. Why?
2. Because, you have obtained PROTECTION from low price in relation to earning power. If the growth happens, you will make a lot of money. If it doesn't, then you won't lose money.
3. And because you are diversified, hopefully you won't get it wrong in every security in the portfolio. Those which deliver growth will create value and those who don't won't destroy it. That's the beauty of low valuation. The portfolio becomes more like a convertible bond portfolio when the downside is protected, but the upside is retained.

To Me, Bullet-proof Investing Requires the Meeting of These Four Conditions

- Condition # 1: Large Earning Power in Relation to Price
- Condition # 2: Large Earning Power in Relation to Capital Invested in the Business
- Condition # 3: Portfolio's Earning Power Protected from Destruction
- Condition # 4: Growth in Earning Power Over Time

Notice all those four conditions are about the WORLD OUTSIDE

For me, to be a bullet-proof investor there's something else about the WORLD INSIDE that's needed apart from meeting these four conditions.

And that something else is about ME

ME

- Zero debt
- Being a satisfier than being an optimiser
  - Graham's definition of Investment
- A mental framework
  - View the stock market not as a place to make a quick buck, but as a means to achieve one's financial goals, which are realistic.
  - Willing to accept mistakes and fix them
- Willingness to hold cash
  - Recognizing option value of cash
  - Should make ME anti-fragile
- Ability to ignore all the noise in the market
- Ability to control envy and FOMO
- Detached and unaffected by decline in market value of portfolio because I should derive confidence from the four conditions cited earlier.

Apart from meeting the four conditions cited earlier, If I can do these things, then I will get tranquility, I will get peace, I will have no worries about my finances, and I will become a bullet-proof investor.

Thank You