Guiding philosophy

Inspired by the Berkshire Hathaway "Owner's Manual", we wrote down our principles in attempting to effectively allocate funds in our care (in our case, personal and family capital). The guiding philosophy of our principles is the following Warren Buffett quote from the Owner's Manual. Our principles are a function of our inability to do any differently.

"I've never believed in risking what my family and friends have and need in order to pursue what they don't have and don't need"

Principles of allocating capital

1. We will only invest in entities whose managers, promoters and businesses we respect. We find it important to feel gratitude in our associations with people and their firms.

2. We will own businesses well within our circle of competence. In doing so, we will keep in mind Richard Feynman's caution, "knowing the name of something is not the same as knowing something". We will always strengthen how we define "knowing". The threshold of *understandability* we require of our investments (both current and prospective) will only get higher over time.

3. We are incapable of having any meaningful views on a variety of subjects (GDP growth, industrial output, unemployment, commodity prices, interest rates, political trends, exchange rates, quarterly earnings, among many more). No point attempting to have a view on something that is far more well thought out by specialists (especially when even they agree to disagree!). We will steer clear of areas where such competencies may prove critical.

4. We are incapable of predicting the supply and demand dynamics of any asset or commodity. Hence, we will avoid owning commodity-based businesses or companies whose products or services are likely to get commoditized over time. We will fervently seek out wide-moat businesses with durable competitive advantages. We will pick only the ones whose moats we believe will be endurable over decades.

5. We will remain cognizant of the sheer longevity of "compounding machines", ie. businesses capable of exceptional capital allocation - retaining and compounding the bulk of their profits at superior rates of return for unusually long periods of time, and will be vigilant not to trade away such a business solely because it appears expensive relative to peers. Nonetheless, we will not remain irrationally committed to an investment if it condemns the invested capital to meaningfully sub-par returns over a decade.

6. We will own an asset based on its current and expected productivity. In essence, we will buy a business for its cash flow generation capability over long time periods. We will only consider a business whose free cash flow potential we can conservatively estimate and will value it accordingly. In doing so, we will remind ourselves that the quality of inputs directly affects the quality of output. Additionally, we will focus on underlying economic realities and adjust for both the positive and negative illusory effects of accounting standards.

7. We will never choose to own an asset solely on the basis of its valuation. No point bringing home junk for free - it still occupies space. Opportunity costs are very real, which we will remain acutely aware of. Gregory Mankiw wastes no time reminding Microeconomics students that "the cost of something is what you give up to get it." We take his advice to heart.

8. We will invest in a business only if we are willing to own it with a 10-year lock-in. This is important to us for three reasons: One, it ensures we focus on quality businesses whose fundamentals are likely to persist over time. As per Nassim Taleb's advice, we will think long and hard about resilience in

alternative future outcomes (say, in times of regulatory, economic or competitive stress). Second, we are not too excited by the prospect of getting rewarded on the basis of how an asset ought to be valued by catalysts in the medium term. Our decisions will always be governed by their impact on the potential for compounding capital over decades. We will abstain from activities which may be gratifying in the short-run but have little bearing on our long term success. Such activities may distract us from our real purpose. Third, we are blessed with the privilege of patience - we intend to use it by identifying franchises with immense scalability prospects over decades.

9. We will make all assessments of valuation with two considerations. First, we will make all purchase decisions on the basis of a rolling 10-year view and not from a myopic and static view of prevailing (1y/2y/3y forward earnings) valuations. The perspective of a decade makes cheap mediocre businesses look substantially more expensive and expensive exceptional businesses a little more reasonable. Of course, we will not hesitate to load up on cheap exceptional businesses! In essence, taking the long-view gives us the advantage of an uncrowded spot. Second, in euphoric environments (either stock-specific or market-wide) we will exercise vigilance to prevent being overly exposed to the toxic and debilitating duo of stalling profitability and high multiple compression by increasing dry powder on hand if possible.

10. I will make mistakes of commission but I will make many more mistakes of omission. I can deal with regret (over a missed opportunity) a lot better than guilt (over a flawed decision), and will act accordingly. I would be forlorn if I were to allow the greed of great gains to veil even mild unease.

11. We will make few decisions. In swinging infrequently we can focus on committing energy to swinging rather than double guessing whether we should have. We will use the benefit of experience to tinker our process. Although outcomes will be measured over years, we will not be stubborn and will make quick amends when we err. We will not waddle in denial.

12. Faith in another trusted expert's expertise on a particular opportunity which sits outside our circle of competence will never be temptation enough for us to make an investment decision. In true Buffett tradition, we will applaud the effort but skip the ride.

13. Besides taking the long-haul view, our focus on qualitative arbitrage will define our approach - often the most valuable characteristics are immeasurable! We are aware that companies we find worthy may not always be available at rational prices. If so, we will not change our approach. We do not expect great results in all environments. Having identified our favourites, we will prefer instead to use the free time to sit back, read voraciously and wait for bargain season to come back.

14. We will be accepting of evidence that runs contrary to our opinions and will process it patiently and diligently. To be better prepared, we will pay attention to Charlie Munger's view on the importance of inversion. We will not take undue comfort from opinions that conform to our thinking. As author John le Carre said, "A desk is a dangerous place from which to view the world." We will balance what we read with what we experience.

15. We will always remember that hoping for something doesn't improve its chances of happening. We will retain gratitude for our opportunities, integrity in our dealings, and humility in the event of our success. Our reasons are selfish, this will ensure repeatability!

While the essence of our principles will remain constant, experience may compel edits or additions.
I invite your comments (soumil@dmzpartners.in)

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