Opening thoughts

The dictionary defines investing as the "act of laying out money or capital in an enterprise with the expectation of profit". Hypothetically, the dictionary may therefore define *successful* investing as the "act of laying out money or capital in an enterprise with the expectation of *substantial* profit".

- However, does this definition suffice?

Every month millions of savers (people who earn more than they spend), pour their months' savings into assets like mutual funds, gold, real-estate funds and the like. The neurosurgeon who performs this monthly routine rationalizes his actions by thinking that just like he is an expert in comprehending the complexities of the brain, surely his money is best handled by individuals who are experts at understanding the wild gyrations of the financial markets and the broader economy. He believes he is "allowing the experts to deal with his savings and channelize them as they deem fit".

- However, are the interests of such "experts" well aligned with his own?
- Hypothetically even if they truly were, are these "experts" armed with the philosophical aptitude to allocate capital?
- How has the financial community changed its course from guiding naive savers to confusing them?

If a doctor were to continually (mis)prescribe medicals tests to his unsuspecting patients because he is the owner of a particular lab equipment that remains relatively unused, tabloids would be running front-page articles and it would dominate coffee-time chat around every office water cooler. Yet everyday brokers urge their clients (who are too busy at work all day to have some free thinking time to devote to their growing savings-pool) to first buy a large cap mutual fund and then when they think broad indices are overvalued to shift money into a debt fund and then when rates are likely to fall to shift into an aggressive small-mid cap fund and then when valuations seem stretched to shift into a balanced index fund and then when a crisis of some sort seems imminent to shift into a gold fund and then when things seem to be getting better to shift into a commodities fund and then...

- Is this the real role of an analyst? If not, what is?
- Why have analysts (excluding outliers) consistently failed to do justice to their clients' capital?
- Why do clients remain unsuspecting to the continued misconduct of their fiduciaries?
- In fact, how does it so occur that a surgeon spends hours on the internet comparing and contrasting before committing to buy a Rs. 25,000, 32-inch LCD screen but only needs minutes (or seconds) of convincing by his (high-school graduate) broker from Fancy-Shmancy Capital to regularly allocate his Rs. 5 lakh monthly savings into the Shmancy capital builder fund by means of a systemic investment plan?

The financial media also deforms the thinking of otherwise rational and thoughtful individuals. The media has an effect of dictating the line-of-thinking which the majority of capital allocators involved in the process of investing follow. They induct a particular way of thinking into young, novice participants (active or passive) by inviting "experts" to be interviewed and quizzing them on where they think markets will be in 3 months? What the broad trend looks like? Whether the index earnings growth will be 10% or sub-10% in the upcoming quarter? It would be quite the moral high-ground to take if the financial media could allocate just a sliver of viewing time to question whether any of the thousands of questions they ask "experts" everyday matter to the broad process of capital allocation for the average retail investor. Truth be told, if people were clearly watching this material for their curiosity, it would be of no concern at all. The appalling fact is that average retail investors take actions based on what they hear. Surely the sheer dominance of “irrelevant noise” on financial media channels is surprising. Certainly some amount of time could be attributed to a whole lot of interesting analysis on how average investors can compound capital over time and create wealth. However, I know of no such programs. The focus is clearly on providing opinions on every news-line and suggesting actions befitting the same. We surely may not be able to change what business channels focus on, but probably should be thick-skinned enough to not feel the need to act on everything we hear. The whole phenomena is akin to buying a brand new Audi one morning because of all the praise you heard at last night's party by another guest who just bought one.

- Why we shouldn't let financial media alter our decision-making?
- Why do we act on everything we hear in the investing-related context when we don't do so in any other context? For example, we shift our "investment strategy" in a few seconds when a popular reporter thinks it’s optimal but certainly don’t book an Audi the morning following a party where your friend was raving about it?

I don't seek to answer all these questions (to be clear, I certainly don't claim to know all the answers), I merely seek to challenge some of the pretexts on the basis of which people blindly channelize their monthly savings or re-allocate their life-time earnings. I seek to challenge what we view as "expert opinions" and who we view as "experts". I seek to challenge whether we should really consider as our fiduciaries, the institutions with which we engage in investment related commitments. I consider the current state quite appalling, especially for the unsuspecting majority that take financial actions on the basis of opinions of "experts" who preach on or off business channels day-in and day-out.

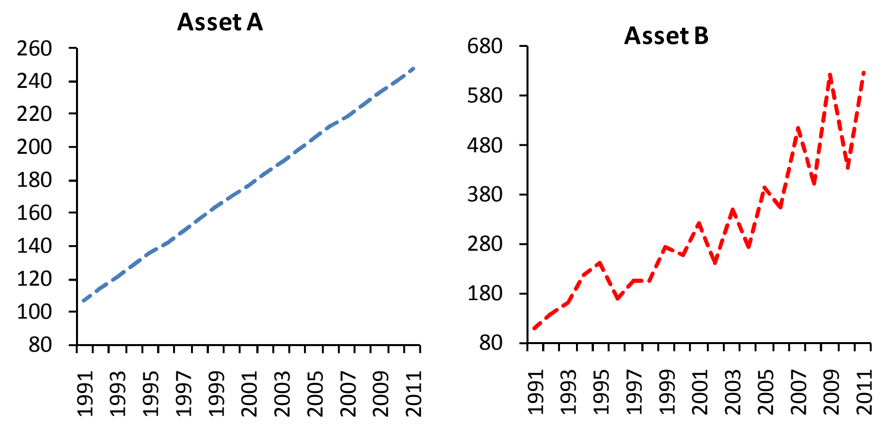
What is investing?

While the majority of retail investors may define successful investing as the act of laying out money in an enterprise with the expectation of substantial profit, this definition does not suffice. To be considered a successful investment, an asset must enhance the investor's *purchasing power* over the time-span of the investment. In other words, the dictionary definition does not take into consideration one of the most important aspects of investing, time. A "substantial profit" maybe earned over a few decades but still may not translate into an enhancement of *purchasing power* over that time period, and hence ought not to qualify as a successful investment operation.

How do we perceive risk?

Below is an exhibit of two asset prices over a period of time. Asset A is a steady fixed income instrument with guaranteed principal protection and Asset B is a volatile equity instrument. Which one do you consider more risky (please mark your pick)?

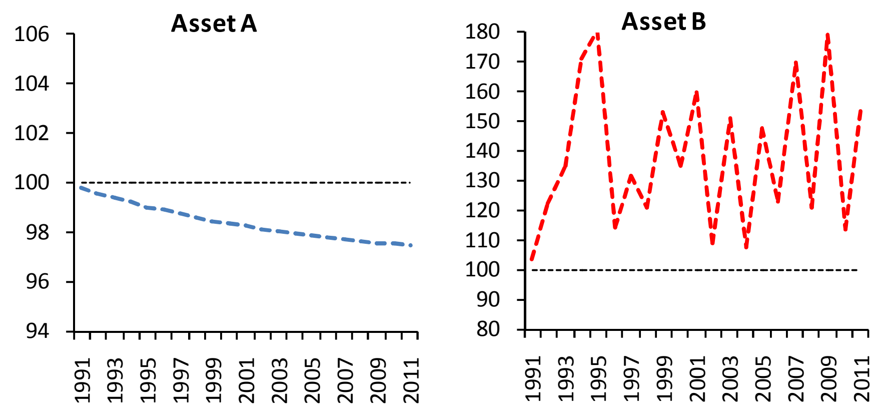
Exhibit 1: Asset price movements of A and B from 1991 to 2011



Source: DMZ Partners.

Now both asset prices are inflation-adjusted (ie. a reflection of purchasing power over time as opposed to just monetary units) at say, 6.75%. Which one do you consider more risky now?

Exhibit 2: Inflation adjusted asset prices of A and B from 1991 to 2011



If your grandmother, with the best of intentions, invested in asset A, perhaps you wouldn't be all too thrilled about her conservative nature! Asset A only had the illusion of being conservative because it didn't fluctuate much. The "steady fixed income instrument" with "guaranteed capital protection" allows for a steady erosion of purchasing power (and hence, capital) over time, as the returns fail to keep pace with inflation! On the other hand, although asset B fluctuates substantially, on an inflation adjusted basis, an investor in Asset B earns 2.1% compounded annually for 21 years (increasing purchasing power by ~56% over that time-span), whereas an investor in Asset A *erodes* purchasing power by 0.12% compounded every year for 21 years! (*reducing* purchasing power by ~4% after 21 years of tied-in capital). Asset A essentially *guarantees* a steady erosion of your purchasing power over a significant amount of time! Yet millions of individuals at countless occasions choose to commit capital to fixed income instruments because of the illusion of safety provided by "steady" prices.

How should we perceive risk?

Risk is the *probability of a permanent loss of capital*. Risk is not volatility; risk is not a fluctuation in price. Yet, like second nature the average retail investor largely views moving prices as risky. Perhaps, this attitude is sourced from the academic definition of risk, which essentially is volatility. However, it is important to note that the derivation of this definition in the academic context was for academicians and financial practitioners to be able to attempt to accurately price options and derivative instruments (the collapse of long-term capital management and the subprime financial crisis are but two examples of how this was not a successful attempt, although this concept may be undoubtedly successfully applied in certain specific contexts). For all among us seeking to successfully allocate capital with a long time horizon, risk is solely the probability of a permanent loss of capital, and nothing else.

How about a joint venture?

Consider that we were to partner in a small-sized joint venture to manufacture WR12 components for the booming recreational video gaming market. Where would we start from? I've "guesstimated" answers to a few of my questions...

- How much capital would we need? Say about 10 crores
- What are the expected margins in the business? Roughly 10% net-net
- What is the size of the industry? About 1,000 crores and growing rapidly
- What would be our competitive advantage? Longevity of our product, as most Chinese components don't last more than a year and the price of WR12 components is a very small proportion of the end-product so the Chinese will not be able to continue to compete on price
- What revenues can we expect after we commence? About 6-7 crores
- At what rate can we expect revenue to grow? Roughly 30 - 40% annually
- Will this be a high-return on equity business? research underway
- Where should we setup our factory? research underway

Source: DMZ Partners.

- What plot size will we need for the factory? research underway
- What is the machinery requirement? research underway
- How many employees & distributors would we need? maybe ~2-3 product engineers; ~20 factory workers; ~5 sales managers; ~5 administrative staff; and a handful of distributors
- How should employees be technically trained? research underway
- Where should we hire our electrical engineers from? research underway
- Will our margins in this business be sustainable? research underway
- How will we guard ourselves against new entrants? research underway
- Will we need to issue any debt in the following year for expansion or large capital commitments to machinery? research underway
- Who are our competitors? research underway
- How fragmented or consolidated is the industry? research underway
- How fast could our product become redundant in the manufacture of gaming machinery? research underway
- Will large amounts of capital be needed for technological advancements in the field? research underway
- How often will machinery need to be replaced? research underway
- How long will product cycles be? research underway
- What should the distribution network look like? research underway
- How much of our profits will we need to retain in the business on an ongoing basis? research underway
- ..many more questions to be asked and answered...

After how much thought, consideration, analysis and how many meetings, discussions, site visits and other research would you think you would be ready to allocate anywhere between Rs. 10 lakh and Rs. 5 crore of capital to our venture? Please note below roughly the amount of time it would take for you to come to a conclusion on all this (in hours/ days/ months/ years, as per your comfort)?
________________________ *(question 1)*

As a side-note, here is a quick investment recommendation

CRISIL is a global analytical company providing credit ratings, research, risk and policy advisory services. The majority shareholder is Standard & Poor's (S&P). CRISIL has rated Rs. 36 trillion of debt, 2/3rds the outstanding bonds in India, more than 50% of bank loans and the highest number of SMEs. In terms of research capabilities, CRISIL works with 10 of the top 15 global investment banks, 30 fortune 500 companies and 90% of India's commercial banks. CRISIL is also the largest independent equity research house in India and was nominated by EPFO to assist with their fund manager selection process. Given the continuous evolution of Indian financial markets and the emergence of novel financing formats, the ability to understand, quantify, and advise on the opportunities and risks such evolution brings, is certain to be of tantamount importance to investors and intermediaries going forward. The Indian bond market remains underdeveloped. The deepening of this market is inevitable as it would allow corporates to finance more efficiently, financial intermediaries to free up capital and originate more debt, and secondary market investors to participate in the prospects of assets ranging from credit card receivables to corporate debt. The US corporate bond market, for example, is $7.7Tn. The ABS market adds another $1.9Tn. The Indian bond markets in relation are paltry. To facilitate continued infrastructure growth and corporate expansion, greater issuance of all forms of credit is inevitable. Hence, on the demand side, the opportunity is very sizable. I would recommend owning CRISIL, which trades at ~25X on FY13 projections. This is not surprising for such a franchise given the earnings sustainability, high free cash flow and nil cap-ex requirements. It is plausible for CRISIL to trade above ~Rs. 4,000 over a decade and pay 60% of its current value in dividends over that time-span, returning ~18% CAGR.

How much time would it take you to come to a decision on owning anywhere between Rs. 10 lakh and Rs. 5 crores worth of CRISIL shares?
_____________________ *(question 2)*

Source: DMZ Partners.

Comparing your answers to the two questions

If your answers to question 1 and question 2 vary by a meaningful degree, something is clearly amiss. How is it that we would take potentially months before deciding on setting up a factory but are comfortable allocating the same amount of capital in a listed entity or an investment instrument in a matter of minutes? Surely, the amount of due diligence, research, analysis and thinking-time we commit should be the same. The kind of questions we may ask to better understand each investment opportunity definitely would vary but the quantity and intensity of questions and the thoroughness of analysis and research should not! (By means of fair disclosure, I fabricated the term WR12 and I know absolutely nothing about the recreational gaming industry).

In fact, often times I have seen individuals spend hours upon hours research which gift hamper they should gift their loved ones for Christmas. The Deluxe Tower Treat gift basket with 6 royal pears, 5 ounces of candy and 5 ounces of baklava or the Classic Tower Treat gift basket with 4 royal pears, 4 ounces of candy twist, 6 ounces of homemade cookie mix, 5 ounces of baklava. I have also seen individuals spend incredible amounts of time figuring out which mobile phone to purchase - the one with X many megapixels, Y amount of GB, and ABCDE additional features or the one with X-10 megapixels, Y+10 amount of GB and PQRST additional features. I have seen these same individuals trade stocks and make investments for themselves in a matter of a few minutes. They surely don't take half as much time to get convinced by a stock-pitch or investment thesis. Isn't this surprising? why is it so?

I think part of the answer lies with the fact that we view commitments made to assets which are not liquid (when I say liquid assets I refer to stocks, bonds, mutual funds etc.) as largely "irreversible", whereas we view commitments made to assets which are liquid as largely "reversible". If we think our opinions of one stock were misconceived, we can always "reverse out" by selling for cash or swapping into another stock. Hence, we conduct transactions of this nature with a limited level of diligence, when in reality, we ought to assign a much higher level of diligence to such investment-related activity. We tend to mistake the optionality and flexibility that modern financial markets provide us (being able to trade in and out of instruments and all sorts of assets at the speed of light) with the need to make use of that flexibility. That is, we tend to think of our actions, consciously or otherwise, as making full use, or taking full advantage of all the facilities and tools that modern-day financial services and products provide us with, without giving enough thought to whether it serves to do us any good!

We get fooled much like the young child gets fooled into buying the latest "Flying-wheels" skateboard with neon lights on its underbelly (which make the board heavier to use) and broad orange coloured wheels (which run slower than normal ones) made in China and expected to work for 6 months rather than the run-of-the-mill standard, high quality skateboard that his neighbourhood store sells for half the price. He is unable to consider whether the additional appointments he is paying for provide him with any utility. In fact, more surprisingly, he is unable to consider how some of the additional appointments he is paying for *compromise the long-term durability and utility of his product!* We tend to behave much the same way in financial markets - assuming that if our broker has been so grateful as to approve our account for trading of futures and options on margin we should "take advantage" of the opportunity rather than sitting down and thinking about whether it provides any utility or whether it *impairs* utility for that matter. Similarly, when our broker has been so kind to give us a call and tell us that he can allot us a couple hundred shares of a hot new IPO and give us a "piece of the pie in all the action", we thankfully accept and think of what brand of chocolates we should send him for Christmas rather than wondering whether it does us any good to be getting a piece of a potentially rotten pie.

Source: DMZ Partners.

Why are mutual funds so alluring to retail investors?

From June 2003 to June 2012, the assets-under-management by the mutual fund industry in India has swelled by ~Rs. 5.4 lakh crores. In the last quarter alone (ending in June 2012), retail investors poured ~Rs. 28,000 crores into mutual funds. Why this allure towards allocating savings to mutual funds?

In the quest for a quick answer, I stumbled upon an article hosted on a widely followed website which begins with the line: "We go to a doctor when we need medical advice or a lawyer for legal guidance. Similarly, mutual funds are investment vehicles managed by professional fund managers. And unless you really possess the skills to invest in equities directly, we recommend you use this option for investing." The article follows with two noteworthy reasons: #1 "Risk diversification" and #2 "Investing is becoming more complex".

A visit to your family doctor

It's certainly true that we go to a doctor when we need medical advice. Imagine the below scenario for a few minutes:

You woke up one Sunday morning with a sore back and figured it was because of your awkward sleeping position after a long night of drinks with college buddies. You ignore it through Sunday and go for a short run in the evening. Much to your displeasure the backache persists through Monday morning and it's quite unbearable by the time you leave your office. So you decide to visit your physician. You elaborate on the nuances of the kind of pain, the position you slept in, the long night of drinking, the Sunday run and all sorts of other details after which your physician gives his input: "Nothing too unusual" he opens with, followed by "I'd recommend you to stick to complete bed-rest for one day. Once you wake up on Wednesday, apply this balm I've jotted down for you thoroughly on the affected area, following which I think its best you also visit my colleague Dr. XYZ for an hour long session of physiotherapy, I am also putting you on some painkillers and anti-swelling drugs in case the inflammation is too much, also I think it's best we get an X-ray done at the earliest, also there is a new ayurvedic (alternative) medicine available in the market for back pain so I'll recommend you take that twice a day as it has worked very well for some people, also, just to leave no stone unturned, assuming this might be due to stress, I will prescribe you a few drugs which will serve as relaxants and loosen you up a little, also out of pure concern for your condition I'd also recommend applying hot water bags on the affected area and a daily massage to add to that."

I may or may not question the intentions of the fictional doctor of my story, but I would certainly question his capability (and perhaps his sanity). Surely, he seems well intentioned in wanting to "leave no stone unturned" and to be "purely concerned" about the situation, but this concern and alleged thoroughness in our treatment only illustrates his intentions, nothing else. To be a competent doctor you need to stick your neck out in diagnosing an illness (at the risk of being wrong) and suggesting the exact treatment for it (again, at the risk of being wrong). You certainly cannot afford to bombard a patient with all the possible treatments assuming the variety of ailments that the patient may be suffering from.

The "professional" money managers to whom we give our capital to, however, do just that! We give our money to experts only for them to do a little bit of everything with it! Fund managers refuse to stick their necks out and hesitate to use our capital to take a stand on their views. The manager fails to be bold enough to put *our money* where *his mouth* is. Consider that some of the most popular funds that I took a quick look at allocate ~75% of the capital they manage to more than 30 stocks! The remainder 25% may be spread across another 20 stocks! Isn't this akin to a doctor (an expert in his/her field) prescribing a little bit of everything? And yet we would consider a doctor behaving in this manner as insane, while an investment professional's actions will be (wrongly) rationalized as providing "diversification". Diversification is merely a

Source: DMZ Partners.

hedge against what is unknown or uncertain in an investment. Surely some degree of diversification is useful, but nowhere close to the degree that mutual funds practice - *being too thinly spread over a number of investment opportunities doesn't allow you to benefit from the enhanced prospects of any individual idea.*

There are perhaps two reasons for this - a) a fund manager doesn't want to be the one who "missed out" on an opportunity, and hence is more content to be thinly spread across a number of ideas and not being able to monetize disproportionately his views on any one. To him that's perhaps "less expensive" emotionally than being the ignorant guy who didn't see that stock XYZ was going to double. He would rather just rather own a couple thousand shares of what all other fund managers find promising around him to save himself from the disgrace of being the one who missed the boat. b) *sticking your neck out takes conviction.* Glancing at the stock holdings of funds, I feel compelled to believe that either managers don't have much conviction or they aren't able to express it freely in their holdings.

Regardless of the reasons, it doesn't do you any good. If fund managers did have high conviction why would several popular funds have exposure to three or four companies within the same sector (for example, HDFC Bank, State Bank of India and ICICI Bank in the banking space; or Tata Consultancy Services, Wipro and Infosys in the Information-technology space)? This is akin to a high-school student wanting to keep his "options-open" and applying to fifty colleges. This "optionality element" in our nature dissuades us from "closing doors" on options that may not be worth our time or money. High conviction (and capability) would imply that managers would be comfortable and confident in sticking their necks out disproportionately for their favourite pick! The inability to do this bears a jarring resemblance to the behaviour of our fictional doctor.

If we are giving our money to experts who should have views on which sectors are worth investing in and which companies within those sectors are the most superior, isn't it odd that they end up taking our capital just to diversify a large portion of it among a dozen or so front-line stocks? How is that any reflection of expertise? Consider that among some of the popular funds we looked at more than 1/3rd of the capital was locked into about a dozen front-line stocks (Infosys, ICICI Bank, State Bank of India, Reliance Industries etc.) Even though you may like to be market-cap agnostic as a retail investor (ie. indifferent to the size of the company you are investing in) you are constrained to be biased toward larger-cap ideas as mutual funds are compelled to manage large corpuses.

It's not worth falling for the "things are becoming much more complex" scare tactic - because when you see the holding patterns you notice that funds are not doing anything radical to protect from the increasing complexity of the world! They are simply, broadly speaking, locking in a large amount of capital in front-line stocks, and spreading the rest thinly among other mid-to-relatively-large-cap ideas without having disproportionate exposure (reflective of conviction) to any one stock. Additionally, on average, managers will lose money if they convert their views on the more complex and detailed news updates and headlines related to macro-economic releases, quarterly earnings releases, commodities trends, precious metals, the yield curve, weather and sports updates and the like, into investment-related actions. No one, ever, has consistently been able to make money having such short-sighted horizons. It is our inability to attribute certain outcomes to pure chance and luck that fools us into believing that there are experts who can do that. Let's say there are a thousand people flipping coins a hundred times in a room and recording their flips. Out of the thousand say one individual was able to flip a heads all hundred times! Would you consider him an expert "heads flipper"? We fail to attribute to chance and coincidence some things that we should. Instead, we give these lucky individuals titles like "fund manager of the year".

Exhibit 3: Top 30 holdings of 4 popular mutual funds of different fund houses

FUND A	
Company name	**%**
State Bank Of India	9.6
Icici Bank Ltd.	5.6
Itc Ltd.	5.3
Infosys Ltd.	5.1
Tata Motors Ltd. Dvr	4.2
Oil & Natural Gas Corp	3.1
Larsen & Toubro Ltd.	2.9
Bharti Airtel Ltd.	2.8
Bank Of Baroda	2.8
Tata Steel Ltd.	2.8
Tata Consultancy Services	2.8
Bharat Petroleum Corp	2.6
Zee Entertainment	2.5
Lic Housing Finance	2.3
Crompton Greaves	2.1
Jaiprakash Associates	2.0
Sterlite Industries	1.8
Cmc Ltd.	1.8
Oil India Ltd.	1.7
Procter & Gamble Hygiene	1.7
Coal India Ltd.	1.5
Divi'S Laboratories Ltd.	1.4
Lupin Ltd.	1.4
Balkrishna Industries	1.4
Punjab National Bank	1.3
Adani Ports And SEZ	1.3
Info Edge (India) Ltd.	1.2
Indian Oil Corporation	1.2
Jaiprakash Power Ventures	1.2
Reliance Industries Ltd.	1.1
Top 30 stocks	**78.6**

FUND B	
Company name	**%**
Divis Laboratories	7.4
State Bank of India	6.5
ICICI Bank	5.4
Infosys	4.3
Trent	3.6
Maruti Suzuki India	3.5
Shoppers Stop	3.3
Hathway Cable	3.3
Larsen & Toubro	3.2
Sanofi India	3.2
HDFC Bank	3.0
Cummins India	2.9
Persistent Systems	2.7
Info Edge India	2.5
HCL Technologies	2.4
Hindustan Petroleum Corp	2.3
Prestige Estates Projects	2.2
Ranbaxy Laboratories	2.0
Tata Motors	2.0
Reliance Industries	1.8
Abbott India	1.7
Hinduja Ventures	1.7
Bharat Forge	1.7
Rain Commodities	1.6
Bharat Petroleum Corp	1.6
Eicher Motors	1.6
Torrent Power	1.6
Kirloskar Oil Engines	1.4
MRF	1.4
Max India	1.4
Top 30 stocks	**83.1**

FUND C	
Company name	**%**
Infosys Ltd.	8.8
Reliance Industries	8.5
Bharti Airtel Ltd.	8.3
Icici Bank Ltd.	5.7
Standard Chartered Plc	4.9
Wipro Ltd.	4.8
United Phosphorus Ltd.	4.2
Sterlite Industries	3.9
Tata Motors Ltd.	2.6
Oil & Natural Gas Corp	2.5
Bajaj Auto Ltd	2.4
Cipla Ltd.	2.2
Axis Bank Ltd.	1.9
Union Bank Of India	1.8
Balkrishna Industries	1.6
Coal India Ltd.	1.6
Oracle Financial Services	1.2
Cairn India Ltd.	1.2
Glaxosmithkline Consumer	1.1
Dr Reddy'S Laboratories	1.0
Cadila Healthcare Ltd.	0.9
Biocon Ltd.	0.9
Mahindra Satyam	0.8
Tata Communications	0.8
State Bank Of India	0.8
Sun Pharmaceutical	0.8
Cesc Ltd.	0.8
Fdc Ltd.	0.7
Coromandel International	0.7
Jbf Industries Ltd.	0.6
Top 30 stocks	**78.2**

FUND D	
Company name	**%**
Itc Ltd.	5.8
Tata Consultancy Services	4.5
Icici Bank Ltd	4.5
Sun Pharmaceuticals	4.5
Hdfc Bank Ltd.	4.3
Infosys Ltd.	4.2
State Bank Of India	3.5
Reliance Industries Ltd.	3.4
Nestle India Ltd.	2.8
Cairn India Ltd.	2.7
Bharti Airtel Ltd.	2.4
Bosch Ltd.	2.2
Bajaj Auto Ltd.	2.0
Axis Bank Ltd.	1.9
Power Grid Corporation	1.9
Shree Cement Ltd.	1.8
Lupin Ltd.	1.7
Larsen & Toubro Ltd.	1.7
Hindustan Unilever Ltd.	1.7
Indus Ind Bank Ltd.	1.6
Bharat Heavy Electricals	1.5
Tata Motors Ltd.	1.5
Glaxosmithkline Consumer	1.5
Bank Of Baroda	1.4
Grasim Industries Ltd.	1.4
Ing Vysya Bank Limited.	1.4
Cadila Healthcare Ltd.	1.3
Eicher Motors Ltd	1.3
Hero Motocorp Ltd.	1.3
Coal India Ltd.	1.2
Top 30 stocks	**73.0**

Source: DMZ Partners.

Why do Indian households pour money into gold?

Investors at two extremes of the socio-economic scale are pouring money into gold. On one end are the high-net worth individuals and money managers sitting in the West who are too dazed by the economic uncertainty in their environment to put money anywhere else. On the other are individuals in deep, rural parts of India who have little or no access to formal banking and are forced to own gold to keep their savings secure. Most Indian retail investors do not fall neatly into either of these categories, and hence it seems irrational for them to continue to pour money into gold.

We define successful investing as an activity by which we seek to enhance our purchasing power over long periods of time. On what basis can we expect to do this by purchasing an asset like gold? That is, there is no reasoned probability we can apply that gold will enhance our purchasing power over a decade. I can argue that we can expect to increase our purchasing power by owning a phenomenal company which increases its profitability consistently over a decade. The key point is that the company provides us with a consistently expanding level of *utility* (the utility here being the earnings). What is the utility of owning gold? Does it produce anything? Does it earn us anything? It doesn't. So can one have an ability to apply some sort of probability-based reasoning on why the utility of gold will expand over a long time horizon? No, because there isn't any!

As an extreme example, as an asset, farmland serves as a closer example of what an investment is than gold does. Farms generate a whole lot of produce and perhaps we can expect our farmland productivity to continue to expand for a long period of time as we employ more technology and labour, and earn a greater amount of profitability per acre. Farms, unlike gold, have *utility.* The only factor that can lead to an increase in the price of gold is demand consistently exceeding supply. How long can that continue? Besides demand exceeding supply there is no other basis on which a particular price is "justified".

For example, you may argue that demand exceeding supply is the criteria for any asset to increase in price. Sure enough! However, below a particular price, other assets (like farms and stocks) become "screaming" buys for investors! Consider a packaging company that makes $100 million every year (and growing) being on sale for $80 million or a farm that produces mangoes worth $10 million a year being on sale for $7 million. Surely, the supply for mango farmland might have far exceeded demand because of which price of mango farms dropped. However, there continues to be a basis on which farms and stocks will be priced - the amount of profit they generate and their ability to enhance that profitability over time. If the fundamental utility of an asset seems disproportionately large in comparison to the price it is available for (as is evident in our packaging company and mango farm example), demand for that asset will follow, and its price will move higher as a consequence. There is no such basis for the price at which gold should trade - as there is no (meaningful) underlying utility to be derived from it.

'What you pay' (price) is not the same as 'what you get' (value)

Simply because an asset has been a successful investment for a particular time horizon, does not mean it will continue to do so in the future. We are cursed with a bias which makes us believe in the inertia of movement - that is why we tilt forward when a train we are travelling on comes to a halt and why we invest in an asset if it has been moving upwards for a particular amount of time. We expect something moving up to continue to do so and something remaining stagnant to remain that way. Why are we unable to differentiate the amount of utility something brings us from its price, or in other words, why do we blur the concepts of inherent values and market prices. Price is what we pay for something on the basis of its current demand and supply in the market place - it has no bearing on what the asset in question is fundamentally worth or how productive it is or how much money that asset generates over a year. It is simply what people in the market are willing to trade it at. Value is a function of an asset's utility - how many apples it produces or for that matter how many rupees it can earn over a decade. Value is an internal and independent measure - your judgement on the value of something may differ from mine. Price is an external measure - a (usually) monetary agreement at which an asset changes hands in the marketplace. When one's opinion on the fundamental value of an asset diverges broadly from the price market participants are willing to trade it at, an opportunity of a lifetime materializes (provided the opinion is accurate!).

Losing the home-advantage

Indians pouring money into gold is an especially unfortunate situation. Indian investors are blessed to be born and be part of the workforce in a country which is growing at well above global GDP growth levels in these extremely uncertain times. Yet, we find ourselves investing in absolutely irrational ways. The proximity bias is supposed to be helping us! That is, Indian investors should be benefitting in the most disproportionate manner by the economic growth of our country, as we are closest to the action and have a front-row advantage. In fact, this is one of the ways in which Indian fund managers based in Mumbai or Singapore (in my view, rightly so) convince sophisticated high net worth investors based in the Western countries to pass on their capital for them to manage.

The thought process is that if you were lucky to be in say, your mid 20s in the USA before a few decades, you had a front-row seat to participate in one of the greatest wealth creation opportunities of a lifetime by owning equities of some of the most successful corporations in the world (Think of Coca-Cola, GE, Procter & Gamble among hundreds of others). No doubt, American investors were the most disproportionate beneficiaries of that phase - they were closest to the action and could see the transformation happening all around. It would be a real pity if Indian investors fail to make the most of this home-advantage by misallocating capital to assets with zero utility and lots of shine. One block of gold locked away in your safe will remain one block after a decade, whereas a successful corporation may have quadrupled (or more) its earnings over that time span. Like gold, an acre of farmland will also remain an acre a decade from now. However, unlike gold, it will have produced several tons of output in that time span. The price at which that gold bar will trade in the market will solely be a function of its supply and demand at that point in time (which nobody has the ability to predict). I would note here, that the practice of trading stocks (or any other assets) over short time horizons (less than a few years) is similar to owning gold: there is no reasoned probability one can associate as to why the demand of a particular asset will be more a week from now than it is today, and hence that action does not qualify as an investment by our definition. By all means it can be pursued, but it should be considered as pure speculation or gambling as there is no reasoned probability of an increase in purchasing power over a long time.

So how should we be allocating capital?

Knowing what you know today (ie. not looking at things retrospectively a decade later), owning stocks for the long-run is one of the only ways in which you can rationally expect to increase your purchasing power over a period of time. Whether that reality materializes a decade later or not is a function of many things - the stocks you chose, the way in which the world changed etc. That is, we cannot attribute it to our investment philosophy if our expected results were compromised by our (lack of) luck or poor skills. However, that doesn't change the philosophy we must apply to investing today based on the realities of the world as it stands. Hence the words "*knowing what you know today*" are crucial.

Owning companies (or pieces of them in the form of shares) will prove to be one of the best ways of growing purchasing power over long periods of time. Successful companies will continue to find ways to make & sell more goods and services to more people by being more productive and spending less. A decade from now, Indians will be consuming more beverages, owning larger homes, buying more cars, eating out at restaurants more often and so on... The masses provide us with the best opportunity to enhance our purchasing power by owning companies that will continue to make and sell more services to more people and earn a greater amount of dime per sale. Irrespective of whether trade will be denominated in rupees or mail stamps. As an example, one HDFC Bank share was available for ~Rs. 14 in 1999. Hypothetically, if you bought 10 lakh shares in 1999 for a total of Rs. 1.4 crores, you would be pleased to know that your share of the bank *earned* Rs. 2.21 crores in the year of 2012, of which it paid out Rs. 43 lakh to you in the form of dividends. *Your portion of the company's earnings in one year would have been 60% more than your whole initial investment 13 years ago.* Additionally, your investment would be worth Rs.58.5 crores, or 42 times greater than your initial investment 13 years ago. Surely, this would be a gain sufficient enough to multiply your purchasing power several times over.

Now, you may argue that retrospectively looking at prices over the past decade cannot serve as a testament for an investing philosophy or methodology going forward. Sure enough! However, note that the focus here is not on the *appreciation in price* but on the *appreciation of utility.* Appreciation in purely price, with any degree of probability, cannot be predicted. However, increase in utility, with some degree of probability, can. An individual with an understanding of HDFC Bank's business model and some view on what the potential for banking in a billion people strong population is, could have benefitted from recognizing how much utility (in this case, earnings) this investment can generate over time.

To provide another example, it is impossible for a farmer to put a price on what one acre of farmland will cost in his village in 2030. However, with some understanding of how he plans to develop his farm (increasing the density of crops, putting in place effective irrigation, hiring more labour, encouraging labour to till the fields with more enthusiasm, employing more expensive fertilizers, buying a tractor, etc.), a diligent farmer can have a reasoned view on what the *productivity* of his farmland might be in 2030 (in this case, rice). On the basis of this productivity he can deduce whether it is worth buying a couple more acres in his village today or not. *Price will follow productivity by default.*

Where to take it from here?

If you stand convinced that owning (good) stocks for the long-run has one of the highest chances of enhancing (and at the very least, protecting) your purchasing power over decades, there are two options at hand. The most optimal option is to pick and buy companies yourself. It's certainly not as hard as "experts" make it seem. Imagine a world where you can control how much and what you eat and how much you exercise on a regular basis. Surely the profession of a dietician would become endangered. Similarly, if you recognize that the only three requirements for successful investing are: a) a very basic understanding of finance (which can be easily acquired if you don't already have it); b) lots of patience; and c) a little bit of luck, you will save yourself loads of advisory fees, account charges, and losses from speculative behaviour recommended by your broker or "advisor". Regardless of whether you choose to allocate your capital yourself or via a particular advisor whom you believe may possess the philosophical aptitude described here, the last section of this note should help you frame some of the important aspects of picking investment-worthy equities which hold the potential to enhance purchasing power over the long-run. To return to the 'doctor-prescribing-for-all-possible-ailments example', if carried out meticulously (and with a little bit of luck), picking a good stock serves as a "one-time-pill (like a polio dose)". Given a good economy (not necessarily great), a few good stock picks and plenty of time, your finances are likely to be on autopilot.

For this, either gain a good understanding of the philosophy and methodology of investing, or carry out the due diligence necessary to ensure that your advisor possesses the same. You are looking for an individual who possesses the capability to study companies with the same level of depth that an industrialist would need to make a product; the conviction to recommend them for the long-run; and the courage to reassure you to hold on to them when things get tough, knowing all-to-well the durability of the company in question. You are looking for an individual with not just the best intentions, but also the ability to successfully act on them. It is quite similar to picking a surgeon to operate on an injured knee.

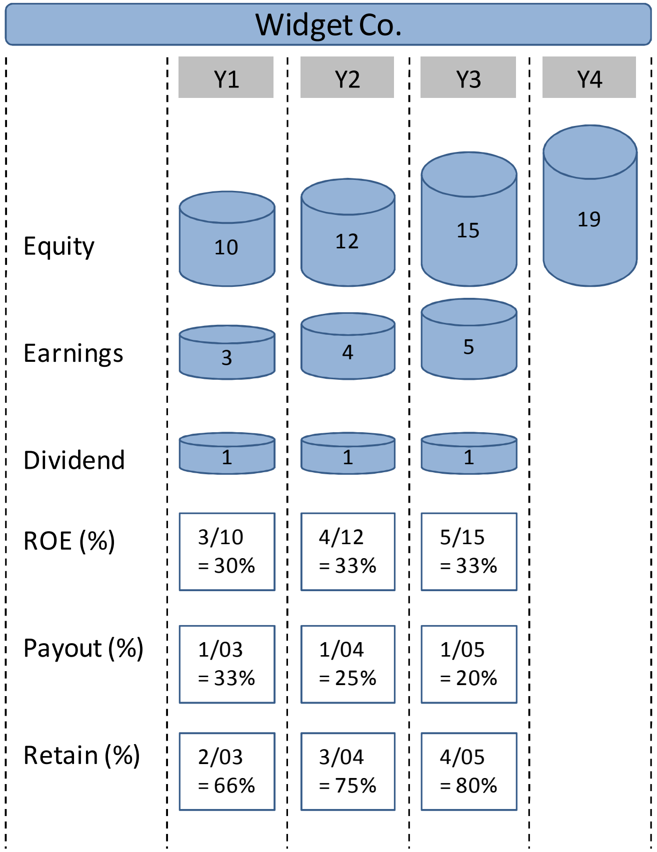
A quick refresher on equity, profits and retained earnings

Before we get into the next section, I will just provide a quick refresher on the terminology and concepts spoken about in the next section for readers who may not be too well versed with financial terms and concepts.

If you and I were to start a company, Widget Co., and invest 5 crores each, the total equity of the company would be Rs. 10 crores. If in year 1 the company earned a profit of 3 crores, the *return on equity (ROE)* would be 3 crores divided by the 10 crores of equity, or 30%. Assuming one-third of this were paid out to us as a dividend (1 crores) and the remaining 2 crores were reinvested in the businesses, the new total equity of the business would be 10 crores as per our initial investment plus 2 crores of retained earnings, or a total of 12 crores. Our dividend payout ratio would be 33% because we chose to payout a third of what we earned in year 1 and retained the two-thirds for the business. Hence the ratio of retained profits would be 66%. In the following year (year 2), we would have a beginning equity level of 12 crores. Now say we earned 4 crores in year 2 and paid out as dividend 1 crore. Now our ROE for year 2 would be 4/12 or 33%, our payout ratio would be 1/4 or 25% and our ratio of retained profits would be 3/4 or 75% and so on...

Now let's take a quick look at *profit margins*. Say that in one scenario our revenues in year 1 were 300 crores, this would mean that our profit margin, profits divided by revenue, or 3 divided by 300, would be 1%. Say, that in another scenario, we are able to earn same 3 crores of profit based on a revenue of 30 crores, this would imply that our profit margin is 10% (or 3 divided by 30 crores of revenue). Having a higher profit margin would provide us with healthier buffer if our costs were to increase unexpectedly. From this example it can be seen that higher margins and higher returns on equity make for better businesses. A high amount of retained profits can be a good thing or a bad thing depending on what the company does (or needs to do) with the retained profits.

<u>Exhibit 4: Illustrated financial snapshot of Widget Co. from Y1 to Y4</u>



Source: DMZ Partners.

The methodology of allocating capital

The best place to start before you begin to pick equities for your portfolio is to conceptualize for yourself a fictional ideal company. What are the qualities of the ideal company you would like to own? Once you have a template for this, you can start looking for companies which come close to the ideal. Here are a three key factors that illustrate what makes for an 'ideal' investment-worthy company:

1. *Pricing power* - One of the most important aspects of companies which have favourable economics and resilient business models with a real competitive advantage is *the ability to pass on costs*. For example, if the price of raw materials increase by 10%, can the company pass on that cost to consumers? or does it have to bear that cost and reduce its margins because of competitive pressures? *The reason pricing power is important is because it is representative of a solid economic moat or barrier-to-entry working in favour of the company*. That is, there is a barrier to entry for new competitors (and formidable defences which keep current competitors at bay) because of some fundamental advantage that the company has developed over time (brand name, product quality, technology, etc.) It is always best to own companies that can easily pass on costs to the consumer. This is possible for companies which have strong, entrenched brands and products (for example, Coca-Cola or Nestle) and almost impossible for companies that sell commodities (for example, cement & mining companies). Companies that sell commodities may often try to create the illusion of selling a branded product, but the fact remains that cement is just cement. Hence, the margins of commodity-based businesses usually get compromised when times get tough and when competition steps up its game, while businesses selling brands are able to retain juicy margins throughout. Glance at the list of fund holdings in exhibit 3 (page 8) again and you will be able to spot dozens of commodity-based companies.

2. *Return on equity* - Companies that can earn more money with less capital make for better investments. For example, let's say that you and I want to partner to start a business which can earn Rs. 10 crore a year. Which scenario would you prefer? a) we both need to chip in 15 crores each or b) we both would need to chip in 50 crores each? Obviously choice 'a' right? In case of 'a', we would expect a return of 33% on our invested capital [10/(15+15) = 33%]; In case of 'b', we would expect a substantially lower return of 10% [10/(50+50) = 10%]. Given an infinite amount of capital, anyone could start a business earning even a 1,000 crores a year. The key point here is that we prefer businesses which can earn the same amount of money as another while needing less capital to do so. This translates to businesses with a higher return on equity.

3. Retention of capital - how much profit does a company need to retain in the business? How is this used? Some businesses need to retain all their profits to research newer products just to protect their products from redundancy. Others can payout almost all their profits to shareholders, while retaining some just to fuel growth into newer geographies. We like companies which either a) have ultra-high ROEs and don't retain earnings or b) companies which have healthy ROEs and retain a fair share of earnings for future growth (typically, financials). Companies manufacturing fancy gadgets need to keep reinvesting their earnings to stay in the game, whereas food manufacturing companies, for example, can continue to payout a large percent of their earnings to their shareholders as their businesses require only a little bit of the annual earnings for growth and expansion and even less for upgradation. However, a caveat is due here - if a company is in a high growth phase, it would need to retain a large percentage of its earnings to continue to fuel that growth rate. One has to differentiate this from a company with poor economics which needs to reinvest into research just to stay alive.

Source: DMZ Partners.

To remind you, we are purchasing companies for the long-run to benefit from their expanding utility as assets. This is something that will happen over time, in the future. Hence, it is important to remember that historical information of how much pricing power a company has or what its return on equity has been is not going to guarantee success. The economic moat of the business and its ability to have a high return on its equity base must be *durable or sustainable over very long periods of time.* There is no benefit in purchasing a company which *was* a very high profit business with a high return on its equity base but has since faded. Hence, it is crucial to be invested in businesses that you somewhat understand. For example, I would not invest in a television manufacturer because I have no understanding of what will make the current batch of televisions redundant, which may reduce the pricing power or diminish the returns of the business I own.

To refocus on the big picture, there are two simple ways to conceptualize the process of picking a stock. First, remember that this may be a life-long commitment. This will make sure that your evaluation process is thorough and that you have followed up as diligently as you can. Second, keep in mind these two broad ideas:

1. Imagine that you are the sole heir/heiress to a particular company. Would you like that to be this one?
   This question would really help me reprioritize what I'm looking for in a stock and weed out companies with sloppy business models or dishonest management teams. For example, I would dread to inherit an airline (no pricing power, low return on equity, high percentage of retained profits sink away into capital costs or upgradation of fleet) and would much rather inherit a farm.
2. If you could have all the financial resources of the company you are evaluating, would you dare to start a company to compete with it?
   Even if I had ten times the capital base and financial resources of Coca-Cola, I wouldn't dare to enter the beverage business and compete with them. I am sure I would lose. This helps you recognize whether a company you are evaluating truly has a deep economic moat or barrier to entry, or whether the moat is just illusionary.

In conclusion, we are essentially looking for businesses with *a durable competitive advantage that can continue to earn high returns on their equity base, and find the need to allocate only minimal amounts of each year's profits to research, development or upgradation to prevent their products or processes from becoming obsolete.* With this in mind, review once again the list of fund holdings (exhibit 3, page 8). Tell me you're surprised!

Closing remarks

I hope I have conveyed some of our views on how millions of retail investors misallocate capital and on our philosophy & methodology of investing. Our key takeaway is best articulated by my father's much-recited quote, which rings as true in life as it does in investing, "I love to be right, I don't mind being wrong, but I refuse to be confused." I sincerely hope that some of the broader ideas will be useful in managing your growing corpus of investible assets or in finding an individual who is capable, by both philosophical aptitude and skill, of doing the same. Although I have amalgamated the ideas mentioned here, I cannot claim to have originated them myself. I have been heavily influenced by my father's views on investing (and life) as well as a handful of books I have been fortunate to have come across, including *Buffettology*, *Fooled by Randomness*, *Common Stocks and Uncommon Profits*, *Predictably Irrational*, and *India Unbound*, among others.

I invite your comments (soumil@dmzpartners.in)

Source: DMZ Partners.