Concentrated Value Investing

Mohnish Pabrai, the Managing Partner of the Pabrai Investment Funds, has outperformed market indices over the last nine years by consistently believing in concentrated value investing. Pabrai likes to hold fewer stocks positioned in industries that he understands well, paying attention to two key variables: the intrinsic value of a business and its current price.

What is your investment philosophy?

Our investment philosophy is derived from the value investment philosophy first developed by Benjamin Graham and later successfully applied by Warren Buffett, Charlie Munger and others. Simply said, I believe in concentrated value investing, which basically translates into buying assets for less than what they are worth and selling them at or close to what they are worth.

Following this philosophy, one does not buy hundreds of stocks, but only a few of them, maybe 10 to 15 to construct the entire portfolio. You feel comfortable holding these positions for multi-year periods, which is what the timeframe might be for the market to recognize the value gap.

Is the philosophy that measures market value at discount or premium to the intrinsic value really a matter of subjective opinion?

It gets into issues about a circle of competence. First, you want to buy businesses that you understand well. If you are successful in doing so, then it is a somewhat predictable business, and, as a result, you do not only have a high degree of certainty but you are also able to forecast what the business might be worth a few years from now based on cash flow or hard assets or liquidation values. It always depends on the specific situation. At that stage you have a basis to place a bet if there is a wide gap between the intrinsic value and market value.

What is your research process?

There are thousands of publicly traded companies in the U.S. and around the world to choose from. If I look at a given public company, in the first three or four minutes of preliminary analysis, I would put it in one of three buckets. Either I would say that, "Yes, this is worth drilling down because it is a business that I either understand very well, or it is something that I can get my hands around fairly quickly." Alternatively, it is 'no', because it is something that is just outside the circle of competence. Or, in some cases, it is too difficult. I would say that probably 99% or more of businesses I look at go into the "No" or "Too Difficult" pile and very few businesses make it through, so to speak, the first three-minute filter into saying that, "Yes, there are attractive fundamentals here. Let us drill further down." So the first cut is basically one where you just ask yourself a few honest questions about how well you understand the business, or whether there is a basis to get to a valuation in the future, and ultimately if it is a predictable business.

Generally, what kind of businesses are not predictable or do not make it through your first cut?

Industries of rapid change are an almost automatic pass. Technology companies and biotech companies would be an automatic pass. A company like Google would be a very quick pass. Generally, I would not be spending time on anything that is in an industry subject to quick change, or a business that is subject to quick change.

For example, we used to have an investment a few years ago in Stewart Enterprises, a company in the funeral services business. The way humans deal with the deceased is extremely slow to change. In fact, that process has changed little over several centuries and it is unlikely to change much in the next few centuries. That is a business that one can firmly predict. You would not know who is going to pass away, but you can process data and calculate how many will.

Therefore, this is a business that you can forecast because it is based on death rates, which set the parameters in the revenue model. Moreover, you can also forecast what the earnings are because the margins are stable. That is something that, on a number of fronts, makes Stewart Enterprises the actual opposite of some biotech company. Actually, in

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Originally founded in his home in 1990, TransTech was recognized as an *Inc. 500* company in 1996. Pabrai bootstrapped the company to over $20 million in revenue when it was sold in 2000.

He has been profiled by *Forbes* and *Barron's* and appeared on CNBC, Bloomberg TV and Bloomberg Radio. Pabrai has been quoted by various leading newspapers including *USA Today, The Wall Street Journal* and *The Times* of India.

Pabrai is the winner of the 1999 KPMG Illinois High Tech Entrepreneur award given by KPMG, The State of Illinois, and The City of Chicago. He is an active member of the Young President's Organization (YPO) and a charter member of The Indus Entrepreneurs (TiE). He is the founder and Chairman of the Dakshana Foundation, that just got created in 2006, and is in start-up mode.

"With most businesses, two or three variables control 80% to 90% of the outcome. I want to make sure that I understand the right variables with a good sense of how they are likely to play out."

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2002, 2001, when I made the investment, Stewart was a business that was trading at less than three times cash flow and, even if you assumed that the business was not going to grow, a business that has that much stability is worth a lot more than three times cash flow. It was a no-brainer investment to buy a stake in Stewart. We doubled our money in a few months' time and moved on.

Where is it trading now after 7 or 8 years?

It trades at approximately, 9 or 10 times earnings. It makes sense because, in general, I think that the population in the U.S. is growing at 1% every year mainly owing to immigration. This is not a growth business. There are also extensions such as life expectancy, which is increasing. I would say the growth in the U.S. death rate is increasing at an annual rate somewhere between 0% and 1%, so you can assume that the growth rate of the business is zero. Therefore, as a zero growth business, if it generates 70 cents a year in cash flow that can be pushed out to shareholders, in my book, the business is worth around $7.00 a share if it does not have excess capital. That is about where Stewart trades right now.

How do you look for new ideas and how many of them do you tend to look for every year?

Between all of these sources, I need to find one pick on average every three months. I can usually find over the course of a year or two four to eight ideas. It is quite a straightforward process. I look at the 52-week lows on the New York Stock Exchange, if not on a daily basis, at least on a weekly basis. I just scan that list to see some names that are quite familiar and then, if something looks interesting, I will only spend a couple of minutes looking at earnings multiples and other financial fundamentals. If it something that looks substantially out of the norm, I might drill down further into it.

I also subscribe to Value Line's information service that provides lists of stocks with the lowest earnings multiples. For instance, Stewart Enterprises is a company I found on Value Line's list of stocks with the lowest P/E. At that time, it was trading at 2.5 times earnings and you have to go through many years of Value Line to find a business trading at 2.5 times earnings. Simply scouring Value Line on a weekly basis gives you plenty of different lists, stocks with the lowest P/E ratio, widest discounts to book value, stocks that have lost most of their value in 13 weeks, high earnings yields, high dividend yields, and so on. I look at those lists of the top companies and see if any of those may seem interesting.

Then, there are a couple of other publications. A newsletter called Outstanding Investor Digest is published once every couple of months. They do some in-depth drill-downs, targetting businesses bought by prominent value managers. Value Investor Insight is another newsletter that I follow. By doing so, I look at the SEC filings of value investors that I respect, such as Warren Buffett, Bruce Berkowitz, Marty Whitman, Longleaf Partners, and others.

I also look at a Web site called Value Investors' Club, which has an annual flow of about 500 ideas posted along with very detailed analysis.

We have never had more than 15 names with equal allocation in the fund. My target is to have 10 positions each at 10% but we usually fall slightly off that mark. Still, we have always had 80% of assets in 10 or fewer names.

What is your research process?

I never speak to management or visit the companies. In the case of a company such as McDonald's, I may visit a McDonald's restaurant, but not necessarily the company's headquarters.

I am interested in looking at long histories of the business and collecting historical annual reports as far back as I can find. If it is the same senior management team, then I will start reading from the last few years onwards in order to see how the business has evolved over time, how it works, and how it feels. I try to form a picture in my mind of what the next few years are likely to be and what the earnings, cash flow, asset values, and market value of the business are like. I am only interested in making an investment if I can get at least a 50% discount to what the business is likely to be worth a couple of years from now. If the numbers indicate that, then I conduct a thorough analysis of the business to make sure I understand the key drivers. With most businesses, two or three variables control 80% to 90% of the outcome. I want to make sure that I understand the right variables with a good sense of how they are likely to play out.

Pabrai Funds has 400-odd families all over the world invested in the fund with the majority of these families being entrepreneurial. The companies that they run or have built and sold are in a diverse range of industries. When I look at a particular company, I look at my list of investors and try to come up with a list of those who are likely to have knowledge about the industry I am looking at. Some of them may even have deep knowledge about the business I am looking at. It is what I call "the unpaid analysts pool" at Pabrai Funds.

Can you give us one example of a company that you were helped by to invest from this 'unpaid analysts pool?'

We used to have an investment in a Brazilian aircraft manufacturer, Embraer. We actually bought Embraer just a few days after the 9/11 attack at a moment when people thought no one would ever want to get on an airplane. Embraer's stock actually had gone from $40 to $10 just in a couple of weeks. Their stock price approximately equaled the cash the company had on the balance sheet, so we were actually getting the business for free. I did a drill down on Embraer, partially through a friend of mine who is a CEO of a publicly traded airline in Latin America. I had looked at Embraer from a very different perspective in the sense that that business is really a duopoly business. Only two companies split that market, Embraer and Bombardier. Between the two companies, Embraer has what I would call an unfair cost advantage because labor rates in Brazil are much lower than those in Canada. Thus, they are actually able to produce airplanes at a much cheaper price than Canadians can.

I spoke to the CEO trying to understand the dynamics of what I was looking at and whether there was anything I had missed. He was able to give me some good data points on the future growth prospects in the 70 to 110-seater airplanes and to explain how the next generation of these new planes was more fuel-efficient, making them very attractive to the airline company.

But were you not worried about the technology risk?

The last time when jet engine technology changed significantly was more than sixty years ago. It is not an industry that changes rapidly. The Boeing 747 went into service more than 30 years ago and it is still regarded as a state-of-the-art airplane. These two manufacturers, like Boeing and Airbus, are toll bridges that the airlines have to pass through to serve their customers. The width of the toll bridge will change, the length of the toll bridge will change, but it is very unlikely that a third toll bridge will be built. If you look at the history of aviation, there have been so many attempts by a large number of countries to break

the duopoly. Unlike car companies, the intrinsic nature of larger airplanes makes it unlikely to allow for 15 companies in the market.

Another segment of the aviation market is the small, private, regional jets. Small jets are coming in for personal use. There is an incredible amount of competition now with the 4 to 8-seaters. Honda, Eclipse, Citation, and other players are all scrambling in that $2 million to $5 million price range. That becomes a much more competitive market than the ones that Boeing, Airbus, Embraer, or Bombardier are facing.

How and when do you decide to sell?

The anchor for buying and selling is intrinsic value. After I make a decision to buy a business, I write about a one-paragraph thesis. I explain why I am buying the business, what it is worth, and how that value is arrived at. If it takes more than a few sentences to explain it, it is a red flag. I go back and make some notes to that usually once every quarter to update if there is any change in intrinsic value. I like to buy assets at 50 cents or less and to sell them at 90 cents or more. If a stock gets passed 90 cents on the dollar, it is a candidate to be sold as long as the only consideration is taxes. We generally want to be tax efficient, so if that gain takes place in less than a year, unless it goes up dramatically, we are likely to hold on for at least a year.

You like to sell stocks when the market value reaches the intrinsic value of the company. Isn't this view different compared to other well-known value investors such as Warren Buffett who do not like to sell stocks?

Mr. Buffett applies the same approach that I am applying when he operated with smaller amounts of capital. If you look at Warren Buffett, the individual investor, he has a portfolio of a few hundred million dollars in his personal account. That goes through some very significant buys and sells. I am not aware of any holdings he has in that account that are permanent holdings.

Berkshire-Hathaway, run by Warren Buffett, has a different situation because they do not get the benefit of lower long-term gains taxes. Everything is taxed at the corporate rate, which is rather high. For a company that is sitting on a mountain of cash, to sell something like Coca-Cola, pay 35% or 40% tax, and then put it into cash would hardly make any sense. Berkshire's peculiar corporate structure almost forces it to take a "buy and hold" approach. Mr. Buffett, in his personal account, has traded a basket of Korean stocks in a short period of time. In 2001 and 2002, he bought a basket of REIT stocks he went in and out of in a few years. He bought several bonds in 2002 and sold them within 18 months or so. He is an active trader in his personal portfolio. The approach is actually the same; it is just the vehicles that are different.

How do you perceive risks and what do you do to manage it?

We are not concerned with the level of the market. We are not concerned with it going up or down in a week or a month, or even in a year. It only boils down to two variables. First, what is the intrinsic value of the business and what it is likely to do over the next few years? Second, what is the price it is available at to be bought today? These are probability bets in the sense that even a mutual fund management company or a rating agency like Moody's has a probability of going bankrupt. We want that probability to be extremely low. Even Embraer has a probability of going bankrupt if many of their airplanes go down. Should that happen, they will face very significant liabilities. Therefore, there are downside risks. The important factor is to have a situation where the odds of those downsides playing out are very low.

How do you regard volatility in the market?

That is an element, and it can be our friend. It gives us a chance to buy stocks at exceptional prices or sell them at great prices.

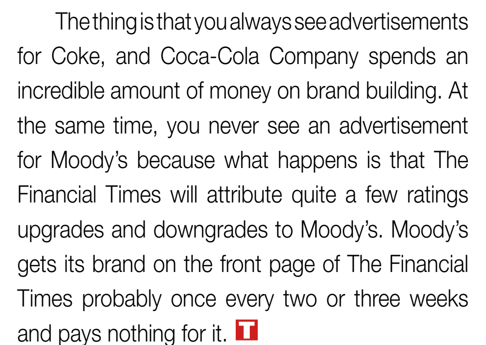
Do you look at macro trends?

I think you need to have what Munger would call "a latticework of mental models" and you also need to have wisdom in understanding the way the world works. It is a fairly simple but very critical fact. When I was looking at Stewart Enterprises, I looked at the thousand-year history of humans dealing with the deceased. With Embraer, I looked at the long history of the country.

I think of investing as being one of the broadest disciplines. Rather than visiting the business, it is probably better to spend more time understanding a variety of different subjects, though many of them may not seem to be connected with investing. Yet, the interplay is there. They work within that same macro environment or framework.

When Buffett looked at Coke, he looked at a hundred-year history of volume growth. When he looked at American Express, he looked at decades of the growth in a number of cards and charging per card and at the number of merchants. You have to have a clear view on the direction for a period of 10-20 years from now.

One of the key things to understand is that if you look at a company like Moody's versus a company like Coke, they both generate high returns on invested capital. However, Moody's generate extremely high returns because it is a knowledge intensive business, not a capital intensive business. In terms of capital expenditure, all you need is a person with a desk and a pencil to do what they do.



The thing is that you always see advertisements for Coke, and Coca-Cola Company spends an incredible amount of money on brand building. At the same time, you never see an advertisement for Moody's because what happens is that The Financial Times will attribute quite a few ratings upgrades and downgrades to Moody's. Moody's gets its brand on the front page of The Financial Times probably once every two or three weeks and pays nothing for it.

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