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Insights

3 INVESTING GUIDELINES

from Mohnish Pabrai

World renown value investor and author Mohnish Pabrai attributes his investing insights to a keen sense of cloning Warren Buffett and Charlie Munger. Here's something investors can keep in mind when dabbling in equity.

Focus on buying an existing and well-understood business with an ultra-slow rate of change.

Buy an existing business with a well-defined business model and a long history of operations that can be analyzed. This is less risky compared to going for a start-up.

Invest in simple, well-understood businesses.

Buy painfully simple businesses in industries with an ultra-slow rate of change with painfully simple theses for you'll likely earn a decent profit and are unlikely to lose much money. As Buffet said; look for mundane products that everyone needs. Following this requirement alone eliminates 99% of possible investment alternatives.

Remain squarely in your circle of competence and ignore the noise outside your circle. Within the circle, read pertinent books, publications, company reports, industry periodicals – in other words, make sure you are extremely knowledgeable on the subject.

Every once in a while, something about a business will jump out at you. If there appears to be some meat on the bone, and you sense that the business might be underpriced compared to its intrinsic value, it is time to hone in.

Most times, it will not be as cheap as you would like it to be or something will bother you, and you will take a pass. That's fine. Continue to focus on your narrow circle.

Do not make the mistake of looking at 5 businesses at once. Learn all you can about the business that jumps out for whatever reason and fixate solely on it. Once you're at the finish line with your analysis, only then look at the broader circle of competence.

Get acquainted with "low risk, high uncertainty" investing.

Pabrai claims it is something he learnt from entrepreneurs. People are under the misconception that entrepreneurs take risks and get rewarded for it. In reality, entrepreneurs do everything they can to minimize risk. They are not interested in taking risk and go after free lunches. They focus on low-risk bets which have high-return possibilities. Not high risk-high return. But low risk-high return.

He cites the example of Bill Gates in this context. The capital he put in was meagre. It was high uncertainty (Gates could have gone bankrupt) but not high risk (no capital deployed). Gates was comfortable with uncertainty but did not take any risk.

In his book The Dandho Investor, Pabrai says that low risk and high uncertainty are a wonderful combination. Risk is the potential for capital loss, while uncertainty is a wide range of possible outcomes. When the market gets confused between risk and uncertainty, it is time to profit handsomely from that confusion.

Stock markets have a perspective that businesses should have extreme predictability. Unfortunately, the real world doesn't work like that; it's messy and businesses don't go this way. They have their ups and downs. But when a company runs into rough weather, the market thinks all hell has broken loose. Where in reality, it just might be part of the natural way a business runs. The market hates uncertainty, you don't have to. When you have high uncertainty in a business coupled with low-risk, the end result is high returns.

If you have the combination in a particular business where uncertainty is high and risk is low, generally speaking, that's a situation you should be worth or willing to dig into.

Ask these 7 questions when investigating and buying any stock.

1. Is it a business that I understand very well, and does it squarely fall within my circle of competence?
2. Do I know the intrinsic value of the business today with a high degree of confidence, and how likely it is to change over the next few years?
3. Is the business priced at a large discount to its intrinsic value today and in 2 to 3 years? Over 50%?
4. Would I be willing to invest a large part of my net worth into this business?
5. Is the downside minimal?
6. Does the business have a moat?
7. Is it run by and able and honest management?

The very best time to buy a business is when its near-term future prospects are murky and the business is hated and unloved. In such circumstances, the odds are high that an investor can pick up assets at steep discounts to their underlying value.

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