In conversation with
Mr. Sanjay Bakshi
Especially for the readers of the 1st Issue

Reliance Industries Ltd.
The Heavy Weight of Indian Indices

Book Review
Ascent of Money
Financial History of the World
Dear reader,

With the monsoons hitting northern India and giving everyone a pleasant relief from the scorching heat, I am proud to present the first ever issue of Blue Chip and hope that it adds to the merriment around!

We generally associate the word ‘Blue Chip’ with the companies that make up the broad market indices such as Sensex & Nifty. To some with a flair for playing card games such as poker, it has traditionally been a token of prestige. Both the stock market and the game of poker are based on a combination of skill and luck – luck dominates in the short run and skill if you are in it for the long run!

In both these situations, possession of a Blue Chip has always been equated to having a token of safety or confidence. Our namesake magazine hopes to serve its readers with the same goal, of being a companion of MBA undergrads, like yourself, that can be banked upon for being there when in-depth understanding of recent happenings is needed or simply for the fun of reading it.

Keeping in line with the spirit of a Blue Chip, we present the cover story on a company that is a phenomenon in itself — Reliance Industries Limited, traditionally, one of India’s most trusted blue chip companies.

To make the first quarterly issue of Blue Chip special, we present a candid interview of our beloved and respected professor & revered investor Mr. Sanjay Bakshi especially for budding investors like you.

By now, in the game of life you have already been dealt the cards and now you also have the Blue Chip in your hands, then what are you waiting for? Play on and have fun!

~Anupriya
Editor for Blue Chip
web was yet to dominate the world. I received the Buffett letters within a week or so and when I opened them, I could not put them down. I was hooked to the idea of value investing.

Buffett was heavily influenced by Ben Graham's teachings at Columbia who taught him how to evaluate stocks in 1930s. In his letters, Mr. Buffett talked about Graham and his book, "The Intelligent Investor," and so I went and bought the book.

At the end of this book is a transcript of a talk that Mr. Buffett gave at the University of Columbia in 1984. The talk was titled "The Superinvestors of Graham-and-Doddsville," in which he lists the track record of a bunch of ex-students of Graham who bought different stocks at different times and ended up with astonishing performance.

One of the best ideas Mr. Buffett gives in that talk was to do with the relationship between risk and return. Contrary to what I learnt at LSE, Buffett said that to get HIGH returns, you should take LESS risk. When I read this, I immediately experienced cognitive dissonance. On one hand my profs at LSE were telling that risk and return are positively co-related and markets are efficient and humans are rational, while here was a man, who had a fabulous track record, and who said just the opposite. I promptly resolved this dissonance by dumping the idea of efficient markets and picking up the teachings of Buffett and Graham.

I also decided that I wanted to come back to India and start up an investment partnership just like the way Buffett did in his early years. So you are known as an authority on value investing in India. How did you get into value investing?

I got interested in stock markets in school. Like many others, I was attracted by hot IPOs. My friend and I used to pool our money together to increase the odds of IPO allocation. If we made any money, we did not keep it, because it went in the next hot IPO and in the end we had huge losses. Good early lesson!

I lost interest in the markets when I got into college because I met this enchanting girl, who many years later became my wife. So she kept me more interested in her than in the markets.

My interests in markets got re-ignited, when I went to the LSE. I attended a class called "Security Investment Analysis," where I was taught that markets are efficient and that there is no point doing any analysis because everything that is knowable is already in the price.

So while I being taught that markets are efficient, I came across an newspaper article which talked about a fellow called Warren Buffett. You see this was in 1990 when Mr. Buffett was not the household name that he now is. Anyway, the article said Warren Buffett has a fantastic track record in investing and he has a knack of explaining complex financial and business topics to people in a wonderful way by writing amazingly good letters to his shareholders.

I became interested in reading these letters and I wrote to Mr. Buffett. Berkshire Hathaway did not have a site then. Indeed, the world wide
that's how I got into value investing.

Why did you select value investing over other methods of analysis?

In his talk “The Superinvestors of Graham-and-Doddsville” Buffett said that if somebody explains value investing to you, two things happen - either it grabs you immediately or you don’t get it. In my case it was the former. The idea of getting something for nothing completely grabbed me. There is a joke about two professors who are walking down the corridors of their finance department and one of them spots a hundred dollar bill lying on the floor. He tries to pick it up but the other professor stops him and says well you can’t pick it up because it’s not there. If it was there, it would have already been picked up. There is a janitor who sees these two learned professors walk away leaving hundred dollar bill on the floor. He picks up the note and enjoys the money. That’s fascinating because the idea that you can get something for nothing is a very seductive idea and to most people if you put it in that way people will get it. That’s what value investing really is.

How would you define value investing? How is it different from deep value investing?

For me, all investing is value investing. Consciously paying more for anything than what it's worth is speculation. Now, this might work in a momentum-driven market where somebody else will buy overpriced merchandise from at an even higher price, which is what the Greater Fool Theory says (“I know I am a fool to buy this stock at this price, but I also know that a bigger fool will come along and buy it from me at an even higher price.”)

IPOs are a form of the greater fool theory if you think about it. Buffett once said that value is destroyed not created by any business that loses money over its lifetime no matter how high its interim valuation might get. In my class I like to cite examples of companies which never generated any cash over their life but nevertheless commanded gigantic valuations for a while.

One example is that of Samtel Color. This company had a billion dollar valuation at one point of time but it never made any money. If you look at the cash flow statement and understand the economics of the business with its need for constant investment in new plant and machinery because the old one becomes obsolete rapidly, you will find that over its life, the company never made any money for its stockholders. All of the dividends paid out were funded not from what Buffett calls "owner earnings," because there weren’t any, but out of new cash injections from owners and lenders. That’s the functional equivalent of pyramid scheme where old speculators are paid from money brought in by new ones.

This can’t last. Today, the stock is worth almost nothing. As Graham said, market is like a weighing machine in the long run but in the short run it’s like a voting machine. So all sensible investing involves seeking value in excess of price paid.

Deep value is different only by the degree of cheapness in a situation. Deep value means "cheap now", not cheap based on "future prospects." One form of "cheap now" would be a profitable company which is expected to remain profitable, having zero or very little debt, having substantial cash on the balance sheet which is surplus to the needs of the business and having an aggregate market value less than net cash alone. That’s a cash bargain as an example of "deep value".

Sounds ridiculous if you think about from the viewpoint of a businessman. Let’s say you walk into a nice restaurant and approach the owner and offered to buy his restaurant for less than the cash in the till. The owner would think you are insane and yet you get the functional equivalent of such situations in the stock market.

At the beginning of your investment career, how did you identify the first stock to be included in your portfolio?

My first stocks were IPOs as I mentioned. However they were not the beginning of my investment career but the beginning of my speculation career which ended very badly and very quickly. But when I came back to India after finishing my studies in the UK in 1994, there were a lot of listed NBFC’s. Some of these companies had very high dividend yields and many of them sold well below book value. Some
of them were very conservative in terms of lending. One of them was Cholamandalam which was selling at less than 50% of book value. It was giving you a dividend yield of more than 10%. So it was a classic Ben Graham kind of a stock.

I enjoyed investing in high yielding stocks. I also loved the idea of stripping dividends from high dividend yielding stocks which is an operation where you buy them on cum-dividend and then you sell them on ex-dividend basis at the same or even higher price, effectively stripping out the dividend. The annualized return on such operations can be very good. This happened at a time when the dividends were taxable and when dividends became tax free, such operations became even more interesting. I think in one of his talks, Charlie Munger said that when you have very little amount of money, then you can look at these obscure bargains in tiny companies. You don't find such inefficiencies in large companies because those are tracked closely by hundreds of analysts, so there is a lot of competition in that space.

Identifying stocks for value investing is a difficult process. What would be your advice to young investors looking to get into value investing?

My advice is to approach value investing with an open mind and that is an advice that I give to my students by exposing them to a variety of value investing styles.

My own investment philosophy has evolved over the years based on the different styles that I have adopted, from different role models like Ben Graham, the partners of Tweedy Brown, Philip Fisher, Warren Buffett, Seth Klarman, Martin Whitman, Richard Zeckhauser, Nassim Taleb and others.

My advice to students is to go into this (or for that matter anything) with an open mind and if the idea of value investing grabs at you then don't decide that you want to only do cash bargains early on in your career. Get exposure to different styles and see what suits you the best.

There are people who have done extremely well by adopting the Fisher/Munger/Buffett style of buying high quality companies and holding on to them for a long time, and then there are people who have done well by buying mispriced securities in bankrupt companies undergoing a debt restructuring operation, and then there are those who have bought statistical bargains like Tweedy Brown does now based on the principles taught by Graham.

I like to give exposure to all these investment styles to students and it's for student to decide what suits him or her the most. It's about trying to fit your personality to a style, and it isn't necessary that you have only follow Graham or only follow Fisher. You can take bits and pieces of things that you like the best from different role models and try to develop your own investment personality. This will happen automatically over a period of time provided you get a variety of exposure to different styles.

The other thing which I want to tell your readers is to look out for great businesses by having an “investment” frame of mind. One favorite example to explain this to think about what happens when you go out for a dinner to a popular restaurant.

Let's say you walk into joint like Haldiram's and start thinking about Return on Capital in your current location VS a situation in which you are dining, let's say, at a much more fancy place like The Oberoi. Return on Capital is the key ratio to focus on but that's just a start. So let's break it up into its two components: margin and turnover. Which one of the two situations would have a much more rapid turnover. Obviously that's Haldiram's where in a single lunch shift, a table will turn over maybe five paying customers. That's just not going to happen in The Oberoi. So, a Haldiram's restaurant may have a lower margin on sales but the very fast turnover should deliver it a much higher return on capital. This is a very useful way of thinking about a variety of businesses, so it makes sense to make a habit of it.
The ideas of return on capital and how it breaks into margin and turnover are not just abstract concepts. These are practical concepts. So my advice to students who are starting out is to think in a much more common sense way about what makes a business a great business and what makes a business a lousy business and why.

In your opinions what are the virtues/qualities that a value investor should possess?

The single most important thing in my view is to have the independence of mind. You can’t get swayed by what everybody else is doing. In fact, independence of mind is just one of the attributes of being "psychologically astute." People who are not psychologically astute consistently make errors of judgment, something I talk about in the early part of my BFBV course.

There are about 15 biases and they are in us for a reason. So one has to recognize that they were given to us by evolution for a reason. For example, "social proof" which is just a fancy phrase meaning "herd mentality" was given to us by evolution because it had survival advantage. There is "safety in numbers" when you are living in the caves and in the jungle. But when you are trying to make a living by buying securities that very tendency, which gave our ancestors survival advantage, causes us to make foolish mistakes in markets. You really have to fight these automatic tendencies which are hardwired into us, and there are specific methods of fighting them.

Another important skill to acquire is accounting and I realized this late, despite being a Chartered Accountant from a great firm, Price Waterhouse. At PW, I learnt how accounting really works but I never learnt what the numbers mean from the viewpoint of business economics. That’s the part I got by reading Graham’s "Security Analysis," Warren Buffett letters and the books by other authors like Philip Fisher. Those books really tell you how to determine if a given business is good, bad, or mediocre, and why. And its an enormously useful skill to have answers to those questions and you get better answers when you know how accounting really works.

If you combine these two skills - accounting and business economics, then you learn to visualize what the accounting numbers of a given company might look like under different scenarios 10-15 years from now. There is a famous ice hockey quote: "Go where the puck is going, not where it is." Its quite applicable to the field of security analysis and the combined skill of accounting and business analysis would enable you to go where the puck is going...

The last point I want to make is about understanding human nature. It’s important to know the power of incentives, the power of perverse incentives. Human nature has not changed much in the last 1,000 years.

The idea that bad accounting promotes bad behavior is a very powerful idea. If you have aggressive accounting - let’s say the rules allow you to recognize revenues faster than you should - and if you adopt such practices of pre-serving your revenues and postponing your expenses, you are not changing anything economically but you showing higher current earnings at the expense of lower future earnings. People would do that because of perverse incentives e.g. if their own bonus is tied to reported earnings. That’s how it starts. Then it spreads and when almost everyone is doing it, everyone else starts to do it too (social proof) and it gets rationalized. Man is not a rational animal, rather man is a rationalizing animal.

Evil in corporations almost always starts with bad accounting, and then human nature takes over and it spreads. So, understanding human nature that explains why people are going to do wrong things and how the good people end up making bad judgements, and how that inevitably results in blowups over time, is something you will learn by reading a lot of books on financial history.

What readings would you suggest to an aspiring value investor?

I mentioned some books before. Read up all the books written by Graham. He wrote two books for investors, but there are 6 editions of Security Analysis and each is a bit different
Euphoria," and "The Great Crash, 1929." A great book has come recently which is called "This Time it's Different" which by the way are the four most dangerous words in investing according to John Templeton, who is another role model.

You should also read letters written by some of the greatest value investors like the partners of Tweedy Brown and Warren Buffett, and Seth Klarman.

Warren Buffett's letters I think are the best education in finance that anybody can get, and I can't overemphasize this enough. The thing is that these letters are free and that if he had charged a thousand dollars for them, people would value them more. But he gives them away for free and people think that these are free and can't have much value, which is completely wrong. My very strong suggestion to your readers is to drop everything and just download these letters and print them out. Don't read them on the screen. Read them slowly, read a letter in four days and try to absorb what he is saying. I think there is no better place to learn about finance, about business economics, about ethics and about a whole lot of subjects related to the business world than from the letter of Warren Buffett.

Read Seth Klarman's "Margin of Safety." Martin Whitman has written a couple of books ("The Conservative Aggressive Investor" and "Distressed Investing"), and they are worth reading although his writing style is a lot harder to understand than that of Buffett.

Read up all the three books by Philip Fisher: "Common Stocks and Uncommon Profits," "Conservative Investors Sleep Well," and "Developing an Investment Philosophy." Then I want your readers to read books on history. As I said earlier that human nature hasn't changed much and people have made enormous mistakes in the past and one can learn from the mistakes made by our ancestors. There is a book called "Extraordinary Popular Delusions and the Madness of Crowds" by Charles Mackay. It is one of the greatest books on crowd psychology where you read up on Tulipomania and South Sea Bubble and once you read them you will automatically relate them to recent bubbles and manias and find that nothing has changed.

Then there are two books written by John Kenneth Galbraith: "A Short History of Financial

with different examples, so read them all. Also read all editions of The Intelligent Investor.

"Warren Buffett's letters I think are the best education in finance that anybody can get, and I can't overemphasize this enough."
You have to see how funny this is. Pick up newspapers of 5 years ago and pick up the top stories of that time and see how irrelevant they were in the whole scheme of things. People think they were terribly important but in the end they were not too important. That's recency bias where people overweight recent but unimportant or irrelevant events.

So you have to know what to read and what not to read. I like to think a lot about how to eliminate distractions. I use tools to eliminate distractions like Facebook or Twitter or e-mail or SMS. Being connected is good but so is being disconnected. Depth is also as important, perhaps more important than breadth.

You are a role model for thousands of young investors/students across India.

Who is your role model?

I get new role models every year; they typically come from books I read, or columns written by a journalist. So if I really like a column written by a journalist I would like to read his or her other columns, so you have all these people who think the way you want to think and who think better than you think and you want to emulate them.

To give you an example, there is a lady by the name of Judith Rich Harris, she writes on evolutionary psychology which is a combination of evolution and psychology. She has written two books and one is called "The Nurture Assumption" and the other "No Two Alike: Human Nature and Human Individuality".

When you read these books, you not only learn about a new fascinating subject, you also learn how this remarkable woman thinks, how she develops her thesis and you really have to read the book to understand what she is saying, but the algorithm she uses is a fabulous one, it’s the one which Charlie Munger refers to as "inversion" or "proof by contradiction."

Judith Harris has a question and she seeks various answers to that question and with extremely logical way to thinking she starts dismantling one reason after another and in the end she is left with one explanation that answers the question. That’s one hell of a way to think - like the fictional Sherlock Holmes did. I think one should read Judith Harris and Richard Feynman and other great thinkers. Even if you don’t understand their subjects, you’d understand their thinking styles.

I think it’s terribly important to have these role models from multiple disciplines.

What is your opinion on the current Indian macroeconomic environment with respect to investments in the equity markets?

None, I have no macro views. I think it is very difficult to predict these things. I have read a lot of studies by the experts who try to predict them but they don’t do better than a toss of a coin. So I don’t think it is worth it to try to predict where the interest rates, GDP growth rates or stock market levels are going to be in the next year or two.

The idea that you can buy well run companies which are selling at low valuations occasionally in the stock market is a very powerful idea. If the business is good, the management is good, the price you are paying is reasonable and you have the patience to hold on to that stock for a long time, then you will do well, particularly if you have many of them in your portfolio.

Any special words of wisdom for BlueChip readers?

First, find role models. One interesting thing about role models is that these are not necessarily the guys who did the best. The guys who did the worst, the guys who messed up, the Nick Leesons, the founders of LTCM, the Bernie Madoffs and other people who are, or until recently, were, in prison for frauds, can also be good role models. They are great role models because they are teaching you in a very vivid way "hey guys look how I screwed up my life, and I hope you don’t end up like me.”

An interview with Mr. Sanjay Bakshi

As told to Aditya Mittal & Mukul Aggarwal

Team Monetrix
Monetrix is the Finance and Economics club of Management Development Institute (MDI), Gurgaon. As one of the most active clubs in the campus, Monetrix continuously strives to contribute to the financial and economic knowledge of the MDI community by holding events and conducting knowledge sessions and other interactions.

The magazine, Blue Chip, is an effort in the same direction, of contributing not just to the MDI community, but to the fraternity of MBA undergrads throughout India.

Hope this issue of Blue Chip has served as an interesting read. Do watch out for our next quarter issue to be released in October this year!

More information on Monetrix can be found at http://mdi.ac.in/students-life/academic-clubs.html. For any other feedback or information, please mail in to us at monetrix@mandevian.com

**Note:** You may have noticed that some of the articles in this magazine have been written by team Blue Chip or team Monetrix. These articles have been kept in the issue only with the purpose of making the magazine content wholesome and are not considered for the prize money.