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Making Heads and Tails of Mohnish Pabrai

David Kessler, MBA 2008

Mohnish Pabrai launched Pabrai Funds in 1999. Less than a decade later, Mr. Pabrai's name is often mentioned in the same breath as legendary value investors who have been in the business for decades. The Pabrai Funds annual shareholder meeting has become a stop on a value investing tour that includes the annual meetings of Berkshire Hathaway, Wesco, and The Sequoia Fund. He is also a frequent guest of Bloomberg, CNBC, and The Value Investing Congress.

In 2007, Mr. Pabrai published his second book, *The Dhandho Investor*, which is quickly becoming a 'must read' for all value investors. Last year, along with Guy Spier, manager of Aquamarine Fund, Mr. Pabrai was the highest bidder in an eBay auction for lunch with Warren Buffett. With his daughters sitting on either side of Buffett, Mr. Pabrai, Mr. Spier and their families spent the afternoon of July 25 with their mentor.

In April, Mohnish made his first appearance at Columbia Business School where he appeared as the guest lecturer in Professor Bruce Greenwald's Value Investing Seminar. Mr. Pabrai's investment style has not only been influenced by Benjamin Graham, Warren Buffett, and other value investors, but also by the Indian approach called Dhandho. When asked about his investment philosophy, he often repeats the mantra "Heads I win, tails I don't lose that much." *Graham and Doddsville* was lucky enough to sit down and delve deeper into Mohnish Pabrai's investment philosophy.

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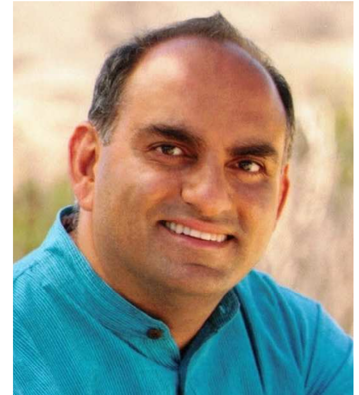
Question: How did you get started with value investing?

Until I was 30 years old, frankly, I had never heard of Mr. Buffett. I had never heard of value investing. This was 1994 and I was vacationing in London with my wife. I was looking for something to read on the flight back to Chicago, and I picked up one of Peter Lynch's books. I am an engineer by training, so this was a different field for me. I read that book on the flight and I loved it. It made all the sense in the world to me, In terms of how to and how not to invest. I thought this was an interesting area and I wanted to know more about it, so I found that Peter Lynch had another book and I read that one too. I wanted to learn even more, but I ran out of Peter Lynch books to read. I remembered that in one of the books, Peter Lynch mentioned Warren Buffett and told a story of how Buffett had called him to get his permission to use a quote. This was the first time I had ever heard of Warren Buffett. I figured since Lynch was talking to Buffett, I should learn more about who Buffett is. I looked around, and found the first two biographies that had just been published: Lowenstein's *The Making of an American Capitalist* and Hagstrom's *The Warren Buffett Way*. I read those books and I just had an epiphany. They resonated strongly with me. The thing that I found very strange was that if there is such a thing as the laws of investing, Warren Buffett has pretty much laid them out. What I couldn't understand was that when I looked at the entire mutual fund industry at the time, which were the professional managers that I had exposure to, I saw that these guys not only did not follow the fundamental laws of investing, but most of them didn't even know what they were. At the same time, their results reflected sub-par performance. So I thought there must be a correlation between these guys not following the rules and having poor performance.

The second thing I found very strange was how you can have an entire industry which does not function with a solid framework. To me, it is like people doing brain surgery by just 'winging it'. That is how I saw mutual funds work – they were just winging it, or they come up with any nuance or 'flavor of the day' they want to pursue. I had a thought that if novices like me simply adopted Buffett's approach and invested in the equity markets with a concentrated portfolio, etc. that I was likely to do better than most of the industry professionals. So I said it was worth testing this hypothesis out. I was lucky at the time in 1994; I had about $1 million in cash. I had just sold some assets of my business and I decided to go ahead and manage that in a Buffett-style concentrated portfolio, buying things I understood, etc. That is how I got into value investing.



Mohnish Pabrai
Pabrai Investment Funds

Question: You have managed Pabrai Funds since 1999. That must have been quite a time to open a value fund.

Actually, 1999 was very interesting. I think it was a great time to start as a value investor because the market in 1999 and 2000 had segregated. As a matter of fact, on the day that the NASDAQ hit its peak, Berkshire hit its 52-week low. What happened is that a lot of money had gone into these frothy dot-com type stocks, but effectively it had

come out of brick-and-mortar, normal businesses. A lot of brick-and-mortar, real-world businesses were trading really cheap. So it was actually a great time to go into the equity markets as long as you didn't drink the same Kool Aid that everyone else was drinking. In fact, after Pabrai Funds' first year, in June 2000, we were up approximately 38% after fees. Then the second year we were up by mid- 30% after fees. We did really well in the year when everything crashed and burned, for that reason.

Question: Over the past 10 years, how have you seen the value investing landscape change?

There isn't much of a change. The good news is that there is now more of a community with things like Whitney's newsletter (Value Investor Insight), conferences, and the Columbia Value Investing Program. Clearly there is now more interest. However, if you look at all of the people involved with investing in the equity markets worldwide, the percentage of them that focus on true value investing is still a very, very miniscule percentage. I think that, in general, the opportunity to do value investing is almost as good as it was 10, 20 or even 30 years ago.

Question: Where do you hunt for your ideas?

When I look for ideas, I look in places like the 52-week-low list, *Value Line*, as well as stocks with low P/E ratios, low P/B ratios, or large discount-to-book value. Now I have Joel Greenblatt's Magic Formula; I look at that on a daily basis as well. I also subscribe to *Portfolio Reports*, published by *Outstanding Investor Digest*, which gives a listing of all the buying of major value investors every few weeks. I also look at 13F filings of the usual suspects such as the Fairholme Fund, Marty Whitman, Einhorn, and all of those folks. That is basically where I go fishing.

Question: What are characteristics of the companies that attract you?

In general, I look for industries with a slow rate of change, companies with some type of moat, and companies with hard assets. I look to buy businesses where I can rest my hat on the hard assets of the business. Other times, I look at businesses that have more of a franchise value, so the intrinsic value is made up more of intangibles such as brand, etc. Basically, what I'm trying to do is find businesses that I can buy well below what they are worth. I usually try to make one bet per industry, and I typically put 10% of the fund's assets into each idea. An ideal portfolio would be comprised of 10 positions from 10 different industries all priced at a discount to what they are worth. In terms of what exactly I focus on is determined by what is on sale.

Question: Once you identify a potential investment idea, what is your process for determining whether it is in fact a good investment?

After I identify an interesting company, I begin to drill down reading the 10K's and 10Q's. When I first come across a business, I generally ask myself within the first few minutes: Is this something I understand well? Is this a relatively straight-forward business to understand? If I am not getting a clear idea in my head of how the business works and how it makes money, then I will generally stop and move on to the next business. In fact, I often move on if I can't answer that question right way. So the first question you have to ask yourself is: In general, is this a business I can understand? I made an investment in 2001 in a company called Stewart Enterprises which is in the funeral services business. I can understand that business. You bury people, cremate them, you get paid, etc. Then you can start to think about understanding the finer points, such as the brand, and what people think about the community of funeral service providers. It is not a business where a competitor can open up overnight with cheaper pricing and just take your business away. Then, there is the fact that it is rare for someone to aspire to go into the funeral business. In general, it is not an attractive business for a 25-year-old to think about entering, so it keeps the number of new entrants down. Finally, all humans eventually die. They may live longer, but eventually we die, so you also have a steady stream of customers coming in.

So these are the kinds of things to think about when you start thinking about a business. If they all make sense, then you can begin to look further into the business at things like value, why it is trading where it's trading, what it is really worth and so forth and so on.

Question: You have often said that you look for dollar bills that are selling for much less than a dollar, then you need to have the strength to be patient and wait for the rest of the world to realize it is worth a dollar. As MBA students, we are often asked for stock ideas when we interview for summer internships or full-time positions. The first question that we are often asked is "what is the catalyst for your idea to reach its intrinsic value?" How do you think about catalysts when you are making an investment?

I don't focus on catalysts. I have always felt that value is its own catalyst and that eventually the stock market becomes a weighing machine and will weigh stocks correctly. I recently bought into a European company that trades at about 1/3 of its hard asset liquidation value. I can't see any real catalyst in that business. I couldn't tell you when or what event will make that value converge, but if something is trading at 1/3 of what it's worth, I think that if you are just patient for a few years, it is highly likely that you will make money and it is highly unlikely that you will lose money.

Question: How do you think about downside risk?

At Pabrai Funds, I have made several mistakes in the past and I'm sure I'll make several more in the future. You always need to protect the downside risk. I think margin of safety is one of the most important tenets that Ben Graham talked about. You always want to ask yourself "What is my downside?" You also want to get some comfort that you have some protection. In some cases, you can get that comfort from liquidation value or hard assets minus liabilities. In other cases, you may get comfort from somewhere else. For example, if you look at a company like Moody's or American Express, you couldn't invest in these based on liquidation value. If their brands were permanently impaired, you would probably be losing money. However, as long as the brand continues to grow in value, you can end up making a lot of money. When you are looking at the margin of safety you can look at it in terms of hard assets like Ben Graham used to, or you can look at it in terms of more intangible assets which can be very valuable.

Question: As a value investor, you have mentioned

you look out over the 3- to 5-year period. Wall Street obviously has a much shorter horizon. How do you maintain the temperament to hold a security the time it takes to realize its value?

I'm very blessed with the investors I have at Pabrai Funds. I have about 400 families across the five funds I manage at Pabrai Funds with over $550 million in assets and on a typical day, I never hear from any of them. I have an annual shareholder meeting that many of my investors show up to. It is a great group of investors. Even recently, with the market turmoil, I really haven't had many e-mails or calls. I love to partner up with these types of folks. So I don't really face much pressure from the investor base.

Second, I generally don't discuss the existing portfolio positions. That keeps a lot of the noise down. Third, I think the temperament or patience comes in part from the way we are wired or the way we can learn, or not learn, from Ben Graham, Warren Buffett, etc. You know, Warren Buffett has said many times that people either get value investing in five minutes or they won't get it in five years. So, there is something in the human wiring of our brain that, for some of us, makes all the difference in the world right away and the patience that it requires is part of that wiring process. For others, they may buy into the concept completely, but they temperamentally just don't have the patience.

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Question: When do you think about selling an investment?

I typically try to buy things for fifty cents or less and I start to think about selling them when they get to be worth ninety cents or more. When things are above ninety percent of intrinsic value, they become candidates to be sold. Of course I factor into the decision things such as long-term vs. short-term gains or what other opportunities there are for the money. When things go to one hundred percent of intrinsic value, I would be looking hard for replacements or thinking about going to cash.

Question: In the past, what were some of the signs that made you realize you had made a mistake?

At all times, you have to be asking yourself the question "What is the business worth?" and "What is the intrinsic value of the business?" A couple of things can happen. First, you could have made a mistake on what you thought the business was worth and you could later have realized that it isn't worth what you thought it was. In this case, you should look at the current stock price. The algorithm I use is to ask whether the current worth of the business is less than the current stock price. If the answer is yes, there is no question that the stock ought to be sold. On the other hand, even if I made a mistake, but the current value of the business is still above the current stock price, then I will typically wait for two or three years from the time I bought before I would think about selling. I'll give the market some time to try to close that gap.

Mohnish Pabrai, Warren Buffett ('51), and Guy Spier

Question: Several value-oriented hedge fund managers that have spoken to our class this year talked about the advantage they have to go both long and short the market. I know that you have different opinions about shorting stocks.

I think that Charlie Munger expressed it really well at this year's Berkshire Hathaway Annual Meeting when he said that they made most of their money going long on a few great businesses. Buffett has ventured into all kinds of derivatives or pair trades, or shorting, etc., but clearly he has made most of his money by being long on great businesses. I think that the math on shorting is very bad.

First of all, in general, over very long periods of time, markets go up in value. So the starting point of a short bet is to have head-winds against you. That is the first problem.

The second issue is that the maximum you can make if you short a stock and it goes to zero is double your money. The maximum you can lose is infinite, because a stock can keep going up, but can only go down to zero, so you don't have a symmetrical risk-reward relationship. The maximum you can make is two times your investment; the maximum you can lose is everything. It is a poor bet to have those types of odds on any bet you are making.

Third, I think it is so much easier temperamentally to go long on a business. If you short a business, you either have to put up stop-losses, or end up on a leash glued to a monitor all hours the market is open. I don't believe that is a very productive way to live your life. I'm usually drooling on my pillow on the West Coast when the markets are opening. So it certainly wouldn't work for me since I generally don't look at the market until several hours of the trading day have passed.

Question: I know you are a big proponent of Charlie Munger's Latticework of Mental Models approach. How have you applied this thought process to investing?

Well, I think that Munger's mental models approach is a very powerful construct. First of all, he talks about the notion

of worldly wisdom. He encourages folks to read and learn about things that are outside of the theme of value investing or might not seem to have a connection to value investing, but I think it is very useful to know the way the world works. Reading books on science, economics, or other different disciplines and to have a basic understanding of all of these different disciplines is useful to the investing process. I think investing in general is one of the broadest disciplines that one can go into, because any stock you look at is affected by so many different variables. Many of these variables touch on subjects that are outside of investing and finance. So it is very useful to have a broad set of frameworks and tools to draw on. I think it is very useful to basically become a person who is strong on worldly wisdom.

Question: You are a frequent speaker at many events, such as the Value Investing Congress, where you get to hear many investors pitch their favorite ideas. What are some of the biggest mistakes you see investors, especially younger investors, making?

Many times, when I hear about a stock idea from another investor, the idea being presented does not seem to have the margin of safety tenets. I generally find margin of safety to be the weakest part of most ideas. There is a very important thing about Ben Graham's idea of margin of safety which is that the higher the margin of safety, the lower the risk, which is obvious. The second tenet is that the higher the margin of safety, the greater the return. If you are buying something that is a 70 cent dollar, not only do you not have much downside protection, but you don't have much of an upside either. Both ways you are a loser. Most of the times that I see people pitching an idea, I usually see them talking about 65 – 75 cent dollars and I think that those ideas tend to be lacking on two fronts: There isn't enough of a margin of safety and there isn't enough of an upside.

Question: We were fortunate to have heard you speak in Professor Greenwald's Value Investing Seminar, where you used an analogy about smoke-filled theaters and spectacular waterfalls. Can you discuss this concept?

I was recently discussing this concept with a bunch of value investors and they all said they never heard Buffett use this analogy, but I could swear that I heard it from Buffett. So for now, I will continue to say that I got it from Warren Buffett.

Here is the basic concept. Let's say you go to see a movie and you pay $10 to buy a ticket. Every seat in the theater is occupied – the house is full. Suddenly, the smoke alarm goes off in the middle of the movie and as smoke begins to fill the theater, people run for the exit. Now, this movie theater has special rules, and the rule is that you can only leave the theater as long as you find someone from outside the theater who will take your ticket and seat. You must enter into some type of transaction where that person pays you for your ticket. So the question that comes up is at what price will that $10 ticket sell for now that there is this alarm and smoke in the theater, and the answer is that it probably doesn't sell for very much, or you might have to give it away for free, or you may even have to pay the guy to take it off of your hands. That theater is the New York Stock Exchange, because on the stock exchange every share of any business is owned by someone at all times. If there is an event which is a distressing event for a company which leads people to say I no longer want to own the stock, that is like the smoke in the theater and people wanting to exit the theater. The person who you want to sell the stock to, which is the person who wants to enter the theater, has access to the exact same information that you do. He also knows there is smoke in the theater. Therefore, for him to still be willing to buy it, the price at which the transaction takes place, is likely to be a significant discount at what the stock was trading at before the smoke. If you enter selected smoke-filled theaters, and you later find that the smoke is really nothing to worry about, or it has been put out, then there is a chance you have gotten a great investment and you can do quite well with it.

The second part of this is when you have smoke in theaters, you are going to have these huge collapses in stock prices. If you look at the stock's chart, these will look like a waterfall. So what this means is that smoke-filled theaters are likely to lead to spectacular waterfalls. As a value investor, you don't want to enter every smoke-filled theater. What you want to do is carefully analyze these smoke-filled theaters to try to find one where the smoke is not real, or the fire alarm is not real, it went off for no reason, and then buy those tickets at hugely discounted prices, then sit back and watch the rest of the movie.

I think this is a good way to summarize the framework. One example I spoke about at Columbia was Wellcare (NYSE: WCG). I generally don't talk about stocks that I own, but I felt that Wellcare was such a pure textbook example. I couldn't come up with a better example, even looking at the history of stocks. I also think people learn a lot more with Ben Graham's technique of talking about current stocks since they can relate better. Here is an event that is still playing out; there is still some smoke in the theater.

Wellcare is a situation where you have a company that is trading at over $120 a share when 200 federal agents show up at their doorstep, unannounced, holding search warrants. The stock is halted and when it resumes trading, there is no data other than news of the 200 agents. That is clearly a theater with an alarm going off, with all kinds of smoke in it. The people sitting watching the movie had signed up for this high-growth, high-momentum stock, and they had signed up to see a certain kind of movie. When the federal agents showed up, they could clearly see that this is not the kind of movie they want to see. They don't want to be hanging around with all the smoke and they want to leave. When they try to leave the theater, they needed to sell those tickets to someone else and the clearing price that they exchanged their Wellcare tickets for was $20 a share. This was 50% of just the cash on their balance sheet. Forget about the business, the earnings engine, and everything else; people were not even willing to pay for the hard assets of the business at that point – not even the liquid assets of the business at that point. So you got a very spectacular, real-world case of logic going out the window, just because of the stampede out of the theater.

Question: What importance do you place on assessing management when you make an investment?

The jockeys are very impor-

tant. It depends on the situation. I think that the ideal situation is to have a business that is a great business, which is going to grow a lot in the future and not require much capital. The best example of something like that is Moody's – a great business, growing a lot, that you can buy at a very cheap price – well below its worth and run by a spectacular manager. That is utopia, and that is what you always want to try and look for.

The real world usually is not that accommodating. You may have to look at situations, like Ben Graham did, where he focused more on the hard assets, and not much on management, etc. So, I have had some very successful investments in businesses where the bet was based on hard liquidation value, and I did not spend a lot of time assessing the quality of management, other than that they were competent.

There are other businesses where the quality of management is more critical, because of the nature of the business. I was recently looking at the stocks I've held the longest at Pabrai Funds. There are some stocks that I have held now for 5 or 6 years. I looked at these stocks and I asked what about these companies has kept me in these businesses for so long. In many cases they are up two, three, or even four times where I bought them and I still believe they are undervalued, and still hold onto them. The reason is, universally, because of the quality of management.

What I have learned to appreciate, when I looked back at that nuance - historically, I have not paid that much attention to the jockey. But I have learned, sometimes very painfully, that jockeys are much more important than I had given them credit for in the past. So going forward I care a lot more about jockeys. I'm not always able to find great jockeys along with great businesses that are also undervalued, but I have learned to appreciate the importance of jockeys.

One thing I would say is that if you take a look at three classic value managers: Longleaf Partners, Third Avenue, and Fairholme - all three are value managers, but all three have very different styles. Marty Whitman of Third Avenue cares very much about hard assets and he doesn't care as much about things like franchise value, or moats or even management. He cares the most about hard assets. If you look at someone like Longleaf, they care a lot about the franchise. They focus on the enduring moat, franchise, etc. One time they mentioned that they thought that Coke bottlers were a great business, and they went looking around the world making a list of every Coke bottler on the planet, trying to see which ones they could invest in at decent prices. In general, they focus on the business and the valuation, but not as much on the management. Their focus is more on moats and franchise value, which is what you will see if you look at Longleaf's portfolio. Then, if you look at someone like Fairholme, they are all about jockey bets. Most of their portfolio is invested in people who are great jockeys. They have large positions in Leucadia, Berkshire Hathaway, and Canadian Natural Resources. If you start to look at why they bought these businesses, it is all about the jockey.

When I look at Pabrai Funds, I think of it as a blend of the three, because I have made many investments which are very much Third Avenue-type bets – pure hard-asset plays. I have also made investments where it is about the franchise value, moats, brands and so on – a Longleaf play. I have also made several jockey bets, like Fairholme. I would say that over the past 12 months, I have learned to appreciate and spend more time analyzing the jockeys and put more weight on it.

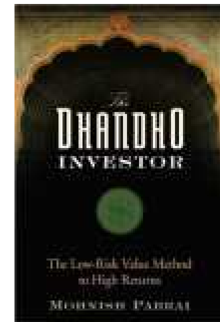
Question: What advice would you give to MBA students who aspire to a career in investing?

I think that the best thing to do is to actually set up a small portfolio of your own and start making real investment bets. Don't run these virtual portfolios – take real money that you actually have, and invest it like you would invest a $5 million portfolio. Be rigorous about it because I think you learn when you make mistakes that actually cost you money. From my point of view, that is the best way to learn.

Going to Columbia is a great idea! If you are already at Columbia, follow Buffett's advice and try to find a shop that is run by people you admire and have principles you believe in, and try to convince them to bring you on board without focusing on compensation.

Thank you, Mr. Pabrai.

-G&Dsville



In 2007, Mohnish Pabrai published his second book, The Dhandho Investor

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