



What Happens When You Don't Buy Quality?

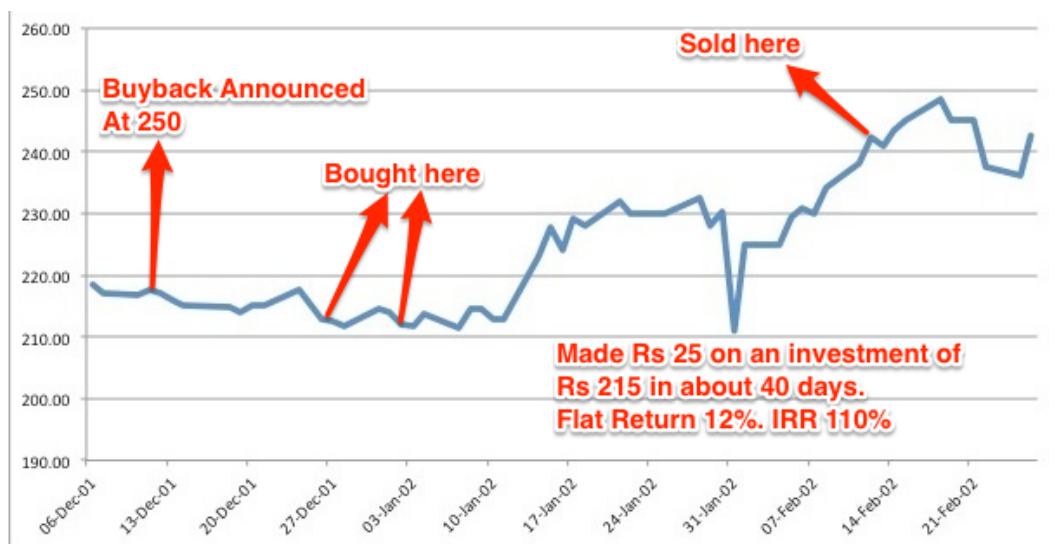
And What Happens
When You Do?

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October 11, 2013, Mumbai

How I Made a Killing in the Stock Market

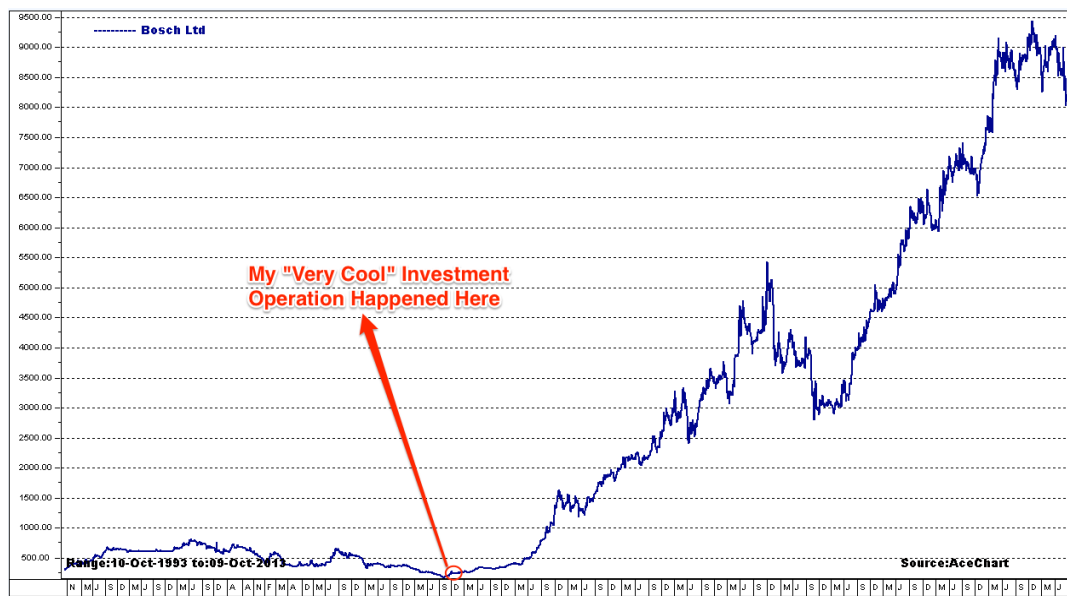
I'd like to start by telling you a story about a killing I made in the stock market many years ago involving a very cool risk arbitrage operation. By 2001, I had accumulated six years of experience in risk arbitrage with very satisfactory overall results because the arb spreads were very good as the competition was low.



So, in December 2001 this company announced a buyback at Rs 250 per share. I bought the stock at Rs 215, held it for about 40 days and then just prior to the tender offer, I sold it for Rs 240, netting a gain of Rs 25 on an investment of Rs 215. That's a flat return of

about 12% and an IRR of about 110%. Not bad at all!

What was the name of the company? Gee, I wish I could get away without telling you my trade secrets but I confessed today morning that I will tell you everything. The name of that company was MICO. Now, it's called Bosch.



Some of the dumbest things I have done have produced very high IRRs.

Let me now tell you about another fascinating experience with Graham's low-priced common stocks theme.

Low-Priced Common Stocks

This is another one very cool Graham and Dodd strategy that works during severe bear markets. It really does.

Graham called it the "low-priced-common stock" strategy which involved selectively buying shares of companies selling at absolute low price (so called penny stocks) during severe bear markets and holding them for a few years. He cautioned investors against the typical penny stocks of dubious companies which were "pushed" by intermediaries who were incentivised by fat commissions. He wrote such penny stocks were not genuine at all and their pseudo-low prices were

"accomplished by the simple artifice of creating so large a number of shares that even at a few dollars per share the total value of the common issue is excessive."¹

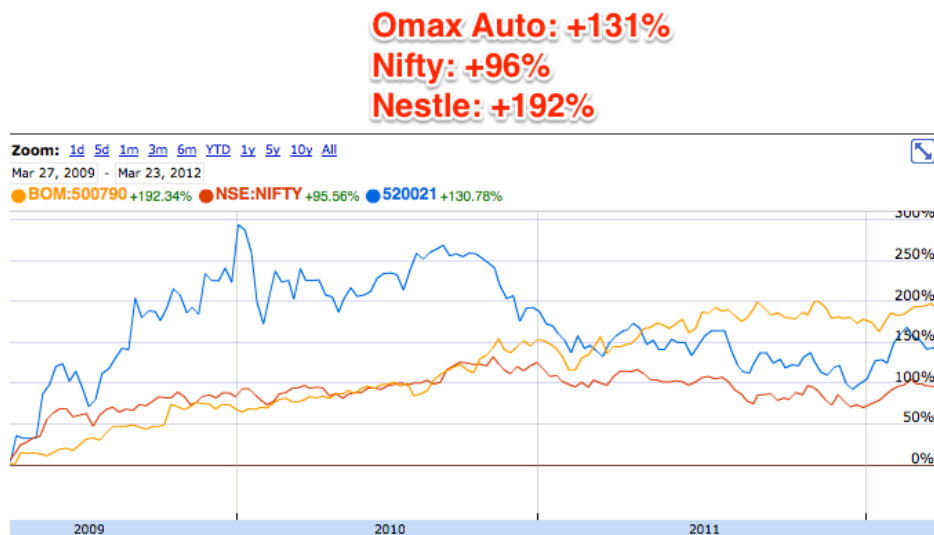
He recommended that investors should buy low-priced common stocks of the genuine variety which

"will show an aggregate value for the issue which is small in relation to the company's assets, sales, and past and prospective profits under favorable business conditions."²

Using his approach of finding such companies, back in the scary days of March 2009, I came up with a few names which displayed the characteristics of the genuine variety of low-priced common stocks:

1. Low absolute price;
2. A huge drop in stock price from its previous high;
3. A very low equity market in relation to size of company's revenues (i.e. A PSR < 20%); and
4. A high cash flow yield (operating cash flow/EV > 20%).

Here's what happened to two of those names over the next three years:



Finolex Cables: +68%
Nifty: +96%
Nestle: +192%

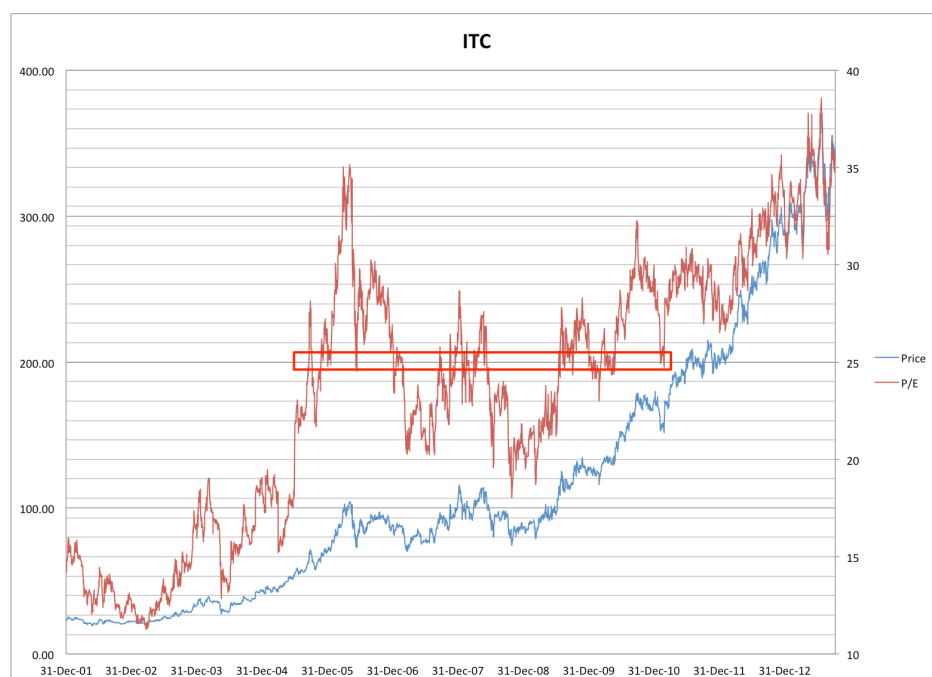


As the charts show, I would have been better off buying a Nestle (a far better quality business) instead of buying Finolex or Omax. Indeed, you can virtually take any number of much higher quality businesses than Finolex and Omax and you'd find that while Graham's low-priced common stock strategy works quite well, buying better quality businesses would have worked even better.

Let's now turn to looking at three of India's well-recognised high-quality businesses.

ITC

Take a look at ITC, one of India's high-quality businesses. The chart below plots its stock price and P/E multiple since Jan 2002. The stock price (blue) is on the left vertical axis and the P/E (red) is in the right vertical axis.




As you can see the stock has done very well over the long term. Now take a look at the P/E part of the chart. The P/E of ITC has ranged from a low of 11 in March 2003 to a high

of 39 in July 2013. Let's ignore these two extremes and focus on the P/E band of 25 which I have highlighted in the red rectangle.

Now, think about this for a moment. Paying 25 times earnings is considered as very risky and speculative by classic Graham & Dodd investors, right? I mean, most deep value investors, who consider themselves to be disciples of Ben Graham won't touch a stock with a P/E multiple of 25.

So, let's see what happened to people who bought the stock at a P/E multiple of 25 in the past and held the stock till date. The table below highlights several such occasions.

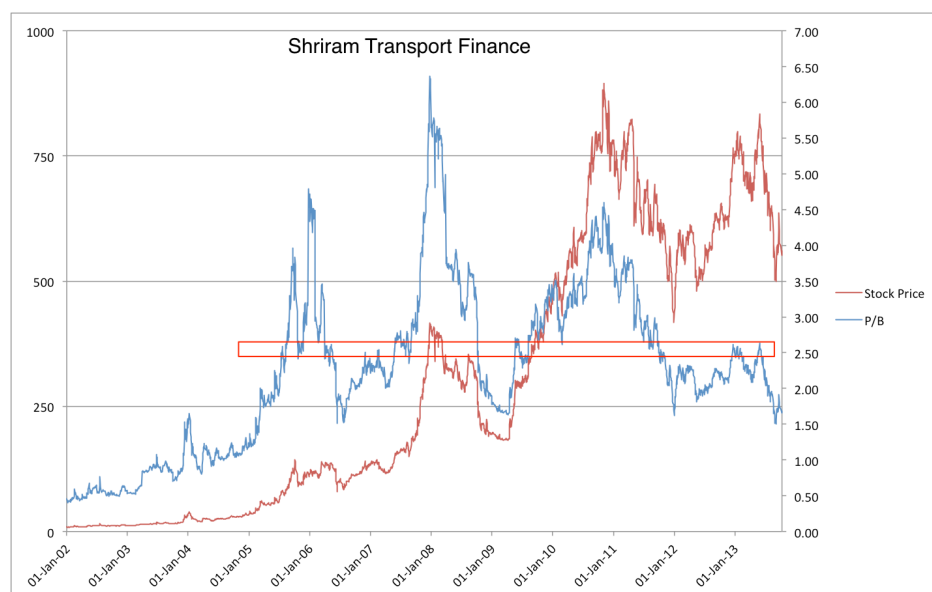
ITC					
		Stock Return	Sensex Return	Stock	Sensex
Date	P/E	Till Date	Till Date	CAGR	CAGR
19-Sep-05	25.37	438%	137%	23%	11%
03-Jan-07	25.20	296%	43%	23%	5%
21-Jan-08	25.20	244%	14%	24%	2%
20-Jul-09	25.07	208%	32%	31%	7%
07-Feb-11	25.58	121%	11%	35%	4%

 Stock Outperforms Market and AAA Bonds

Isn't it astonishing that a 25 P/E stock delivered such exceptional absolute and relative returns? Now, one good critique on what I just did would be to say that I am measuring returns till date and it so happens that ITC is selling near its highest P/E multiple since 2002. Fair enough. Let's look at the next example.

Shriram Transport Finance

The critique applied to ITC will not work here because Shriram Transport Finance has corrected a lot recently as the chart below shows.



This stock too belongs to one of India's high quality business as all of you know and has done very well for long-term investors. Since this is a financial company, this time I picked P/B ratio instead of P/E. This company's P/B has ranged from a low of 0.5 times in January 2002 to 6.4 in December 2007. Just like in the case of ITC, let's ignore these extreme

values and pick a P/B of 2.5.

Most deep value investors shun the idea of paying 2.5 times book value for a financial company stock. So, let's see what happened to those ignored this advice.

Since 2002, there have been many occasions where the stock has sold at a P/B of 2.5.

The table below highlights several such occasions.

Shriram Transport Finance					
Date	P/B	Stock Return Till Date	Sensex Return Till Date	Stock CAGR	Sensex CAGR
13-Jul-05	2.50	588%	176%	26%	13%
21-Apr-06	2.52	311%	66%	21%	7%
14-Feb-07	2.53	295%	43%	23%	6%
07-Oct-08	2.52	112%	71%	16%	11%
26-Jun-09	2.51	84%	35%	15%	7%
30-Sep-11	2.50	-10%	21%	-5%	10%

Stock Outperforms
Market and AAA bonds
Except During One
Short Period

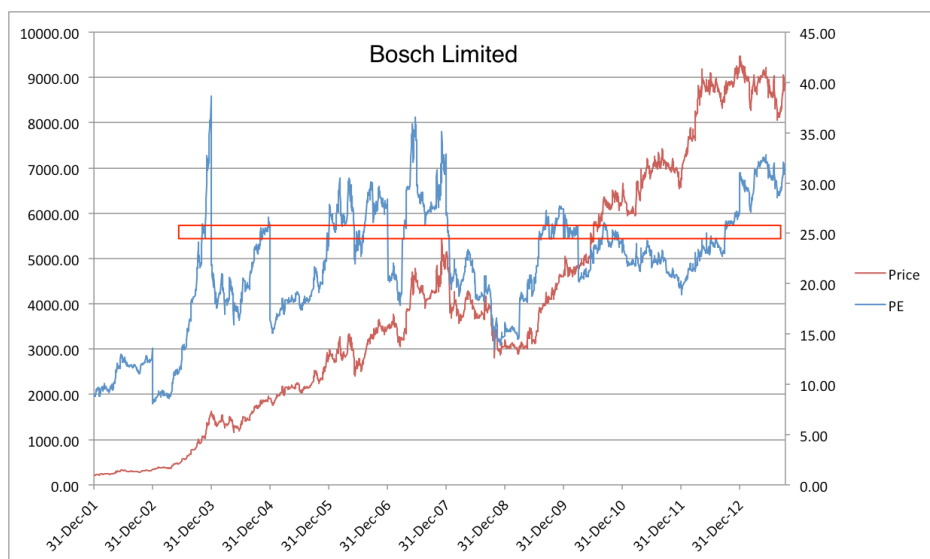
Except for one short period, paying 2.5 times book value for Shriram Transport Finance has turned out to be very profitable indeed as the stock delivered exceptionally good absolute and relative returns.

Now let's look at one more example.

Bosch

This, you will recall, is the same company in which I made a "killing" back in 2002.

All of you recognise this as one of India's high quality businesses and the stock has done very well for long-term investors.



Since 2002, the P/E multiple of Bosch has ranged from a low of 9 in Jan 2002 to a high of 38 in December 2003. Just like in the case of ITC, I have highlighted a 25 P/E band. Since 2002, there have been many occasions when the Bosch sold for a P/E of 25 and the table below shows what happened to the returns of people who bought at that valuation and

held the stock till date.

Bosch					
		Stock Return	Sensex Return	Stock	Sensex
Date	P/E	Till Date	Till Date	CAGR	CAGR
03-Nov-03	25.02	744%	295%	24%	15%
12-Nov-04	25.05	383%	235%	19%	15%
19-Dec-05	25.00	204%	113%	15%	10%
06-Jul-06	25.24	217%	86%	17%	9%
13-Apr-07	25.70	163%	49%	16%	6%
10-Jan-08	25.10	86%	-3%	11%	-1%
31-Jul-09	25.04	127%	28%	22%	6%
03-Sep-10	25.86	41%	10%	12%	3%
23-Nov-12	25.97	0%	8%	0%	9%

Stock Outperforms Market and AAA bonds except during one short period

As can be seen from the table, the results were outstanding except for one short period.

I could go on and give you example after example of long-term wealth creating companies in India which have done very well for long-term owners even though they bought them at a P/E multiple of 25 or a P/B of 2.5 in the case of financial stocks, but I think you're getting the point.

At this point, if you are deeply skeptical of my providing you with anecdotal evidence-- and you should be-- then I request you to temporarily park the scepticism for a while, as I will provide empirical evidence in a while.

For the moment, let's summarise three things we have discovered about these businesses:

1. These businesses were great to begin with a decade ago (and even earlier than that);
2. They have remained to be great businesses; and
3. Despite their greatness being recognised, their stocks have outperformed the market over long time periods and have also delivered solid absolute returns over those periods.





Now, this last point could mean that these businesses were either too cheap earlier or they are too expensive now because if they were fairly valued then and now, then their long-term returns should not have been much better than AAA bond returns.

During the course of this talk, I will try to persuade you that these businesses were cheap then despite their selling at multiples what appear "expensive" to most value investors.

But before I do that, I want to provide some more anecdotal evidence.

Columbia Business School

Earlier this year in May, my partner and I were invited to give a talk on value investing in India at Columbia Business School during which we presented the audience with a slide which has since been updated and reflects the subsequent depreciation of INR against USD.

Company	Global Company's \$ 10 Years' Return	Indian Subsidiary's \$ 10 Years' Return	P/E Multiples 10 Years Ago	
			Global P/E	Local P/E
 Nestle	241%	567%	19.2x	25.3x
 Unilever	157%	197%	17.4x	26.7x
 Colgate	137%	646%	20.3x	25.4x
 P&G	102%	405%	24.5x	22.4x

This impressive table shows that stocks of Indian subsidiaries of these Global consumer franchise giants handsomely outperformed the stocks of their parents. Moreover, they accomplished this despite the INR depreciation (all returns are in USD) and despite the fact that the Indian subsidiaries' stocks sold at higher P/E multiples (except in the case of P&G) than those of their parents at the beginning of the measurement period.

And on top of all that, we spot the same pattern we found out earlier:

1. These were great businesses to begin with a decade ago (and even earlier than that);
2. They have remained to be great businesses; and
3. Despite their greatness being recognised, their stocks have outperformed the market over long time periods and have also delivered solid absolute returns over those periods.

Now, as I mentioned earlier, this last point could mean that these businesses were either too cheap earlier or they are too expensive now because if they were fairly valued then and now, then their long-term returns should not have been much better than AAA bond returns.

Now, there is one way I can try to persuade you that quality is underpriced by markets over long time period but it will involve a bit of time travel.

Time Travel

In his 1989 letter, Warren Buffett wrote:

"What counts, however, is intrinsic value - the figure indicating what all of our constituent businesses are rationally worth. **With perfect foresight, this number can be calculated by taking all future cash flows of a business - in and out - and discounting them at prevailing interest rates.** So valued, all businesses, from manufacturers of buggy whips to operators of cellular phones, become economic equals." (Emphasis mine)

While the future is largely unpredictable, that's not the case, if we go back in time without forgetting what happened between then and now. So let's do just that with another one of India's great wealth creators.



Let's pick the date on which this stock sold at a P/E multiple of 25. That was on 12 September, 2005. Now, we already know the financial performance of the company from then till now. We have, what Buffett called "perfect foresight." Can we value the stock as of September 2005, based on what we know about the company till now? Let's try. Here is a table which provides fundamental performance data about the company:

Asian Paints Ltd. Financial Highlights [INR-Crore]											
	Mar-13	Mar-12	Mar-11	Mar-10	Mar-09	Mar-08	Mar-07	Mar-06	Mar-05	Mar-04	Mar-03
Total Income	11,085	9,740	7,790	6,821	5,515	4,467	3,710	3,053	2,606	2,400	1,828
PBIDT	1,849	1,619	1,399	1,376	725	724	523	423	367	324	288
PBT	1,655	1,454	1,260	1,257	617	631	430	343	287	238	226
PAT	1,160	1,021	881	884	419	428	283	211	181	144	140
RONW(%)	37.81	41.35	45.23	60.68	38.39	48.64	39.81	34.74	33.03	28.66	31.95
Close Price (Unit Curr.)	491.44	323.78	252.70	204.26	78.60	120.00	76.48	64.41	39.11	30.38	22.01
Market Capitalization	47,139	31,056	24,239	19,593	7,539	11,510	7,336	6,178	3,751	2,914	2,111
Adjusted EPS	11.61	10.31	8.79	8.71	4.15	4.27	2.93	2.21	1.81	1.51	1.45
PE (x)	42.32	31.41	28.74	23.45	18.95	28.13	26.10	29.12	21.55	20.11	15.18

A Huge Value Creator

With the help of this information, and a few conservative assumptions, we can per-share value of Asian Paints as of Sept 2005 (using an over-simplified model just to make a point). See table below.

Time Machine Valuation of Asian Paints as on 30 Sept 2005			
Assumptions			
Discount rate	12%		
Terminal growth rate	2%		
Description	PBT	PV factor	PV (Rs. Cr.)
Earnings for FY06 (remaining 6 months)	172	0.9449	162
Earnings for FY07	430	0.8437	363
Earnings for FY08	631	0.7533	476
Earnings for FY09	617	0.6726	415
Earnings for FY10	1,257	0.6005	755
Earnings for FY11	1,260	0.5362	675
Earnings for FY12	1,454	0.4787	696
Earnings for FY13	1,655	0.4274	707
Value of Explicit Forecast Period			4,249
Terminal Value	16,552	0.4274	7,075
Fair value			11,324
Market Cap as on 12 Sept 2005			4,738
Fully diluted shares outstanding (cr.)			95.92
Fair value/share			118.06
Stock Price as on 12 Sept 2005			49.40
Market P/E Multiple			25.10
Fair P/E Multiple			59.99

Huge Undervaluation Even at P/E of 25

As the table shows, even at a P/E of 25, the stock was hugely undervalued. Indeed, the table below shows the result of reverse engineering into the assumptions to make the market value equal to intrinsic business value. Indeed, even with the assumption that forward earnings growth rate would be only 2% a year, the correct P/E for Asian Paints in September 2005 was 60 not 25.

Time Machine Valuation of Asian Paints as on 30 Sept 2005			
Assumptions			
Discount rate	21.42%		
Terminal growth rate	0%		
Description	PBT	PV factor	PV (Rs. Cr.)
Earnings for FY06 (remaining 6 months)	172	0.9075	156
Earnings for FY07	430	0.7475	322
Earnings for FY08	631	0.6156	389
Earnings for FY09	617	0.5070	313
Earnings for FY10	1,257	0.4176	525
Earnings for FY11	1,260	0.3440	433
Earnings for FY12	1,454	0.2833	412
Earnings for FY13	1,655	0.2333	386
Value of Explicit Forecast Period			2,935
Terminal Value	7,729	0.2333	1,803
Fair value			4,738
Market Cap as on 12 Sept 2005			4,738
Fully diluted shares outstanding (cr.)			95.92
Fair value/share			49.40
Stock Price as on 12 Sept 2005			49.40
Market P/E Multiple			25.10
Fair P/E Multiple			25.10

No terminal growth and 21.42% discount rate would be needed To Equate Fair Value with Market Price!

For the market price and per share value of Asian Paints to be equated, given the performance from then till now, one would have to assume that going forward there will be

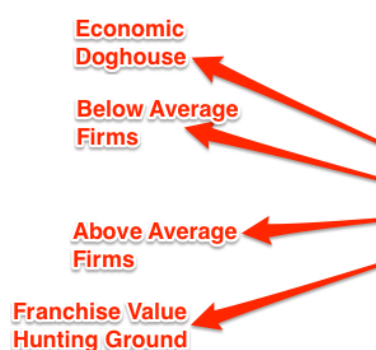
no more earnings growth. Moreover the discount rate to be used for making value to equate with price would have to be 21.42%!

So, we have another evidence now supporting my point that quality tends to get underpriced by markets. Most Graham & Dodd investors would not have touched Asian Paints at P/E multiple of 25 back in 2005. History shows they would have been wrong.

Seems like we are on to something here. Now, let me give you some empirical evidence.

Credit Suisse Paper

Take a look at the following matrix. I am going to spend some time on it.



		Transition Probability, %			
		----- end -----			
	start	Q1:--	Q2: -	Q3: +	Q4:++
Q1:--		56	27	11	6
Q2: -		28	40	23	8
Q3: +		13	28	39	20
Q4:++		9	12	28	51

Source: Credit Suisse, HOLT

This matrix is from a research paper³ by Credit Suisse. In that paper, the authors provide strong evidence supporting Buffett's philosophy of investing in successful companies with an established track record of delivering high owner earnings in relation to capital invested in the firm (the authors use a proxy called CFROI). They looked at hundreds of firms around the globe from 1993 to 2013 and at the beginning of each quarter starting from 1993, divided the universe into four quartiles. "Q1 --" were firms in the poorest performance quartile (What I have labeled as "Economic Doghouse") and "Q4++" were the best ones --

firms having the highest CFROI's and where high-quality businesses are likely to reside.

"Q2-" were below average and "Q3+" were above average.

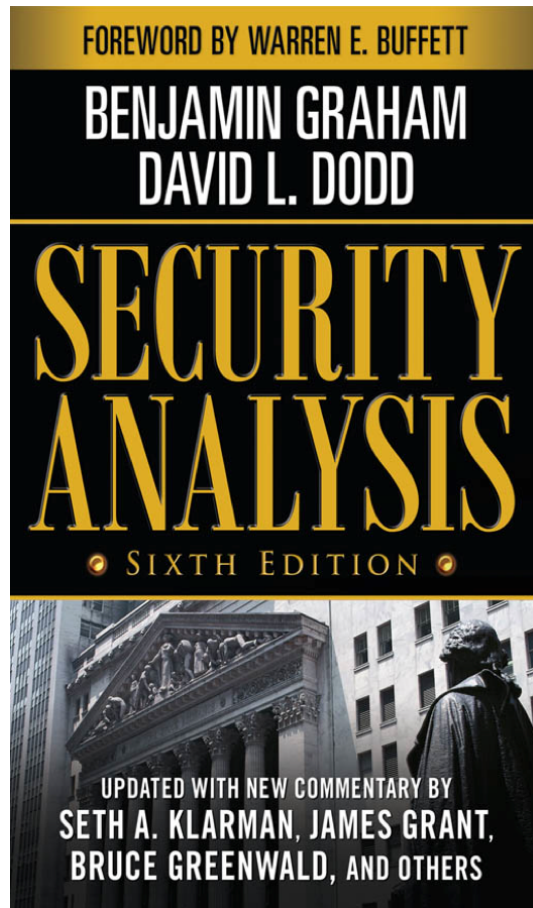
The researchers then determined the status of each firm five years later. What they found was something that Buffett had figured out long ago which had led him to abandon classic Graham & Dodd cigar-butt investing style.

Here are some of the key findings:

1. Operating performance is not random. Had it been random, all probabilities would have been closer to 25%. There is little evidence of mean reversion.
2. The best performing firms had a 51% probability of remaining among the best performing firms and the worst performing ones had a 56% probability of remaining the poorest performers;
3. Great businesses tend to remain great or they become good businesses (combined probability of 79%). There was only a 9% chance that a great business would end up in the economic doghouse; and
4. Poor businesses tend to remain poor or they become slightly better but still remain below average (combined probability of 83%). There was only a 6% chance that business in the economic doghouse would end up in the best category.

Before I list other key findings of this research, I think it would be appropriate to talk a bit about the clash of two ideologies in value investing-- mean reversion and momentum.

Most Graham & Dodd investing strategies are based on the belief in mean reversion-- that under-performing businesses would improve and outstanding businesses would deteriorate and that there is money to be made in such situations. Indeed, Graham's "Security Analysis" starts with a famous quote from Horace.



*"Many shall be restored that now are fallen,
and many shall fall that now are in honor."*

HORACE—ARS POETICA.

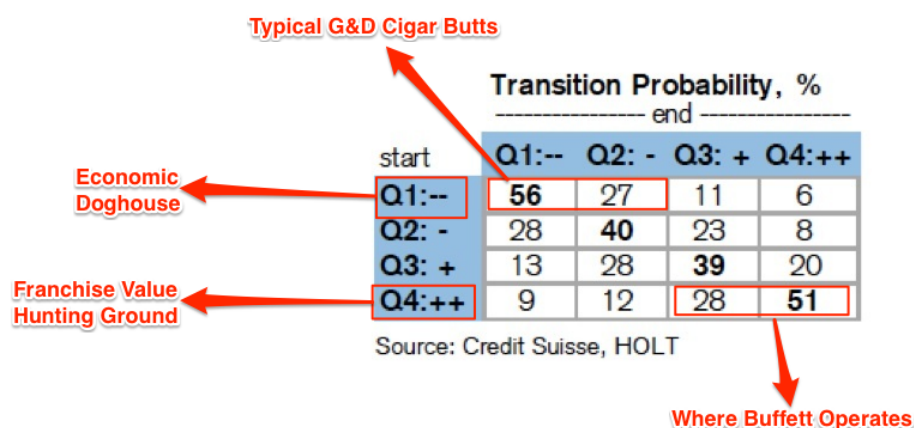
While there is some truth in Graham's ideology of mean reversion, Buffett discarded it in favour of momentum-- the belief that by and large, good businesses will remain good (and therefore he should only focus on those) and despite some improvement on some

occasions, bad businesses would remain bad (and therefore he should avoid those).

Perhaps, Graham should have rewritten Horace as "Some shall be restored that are now fallen, and some shall fall that now are in honor."

Incidentally, if you dig deeper in Buffett's philosophy, you'll find that he loves taking on projects that are overwhelmingly likely to succeed. He's isn't the venture capital type of a guy where the probability of success is low, but the consequences of success are outstanding. Buffett is a "high-probability-of-success type" of investor and this philosophy is consistent with his belief in momentum in the fundamental performance of good businesses. That belief has made him and his partners billions and billions of dollars.

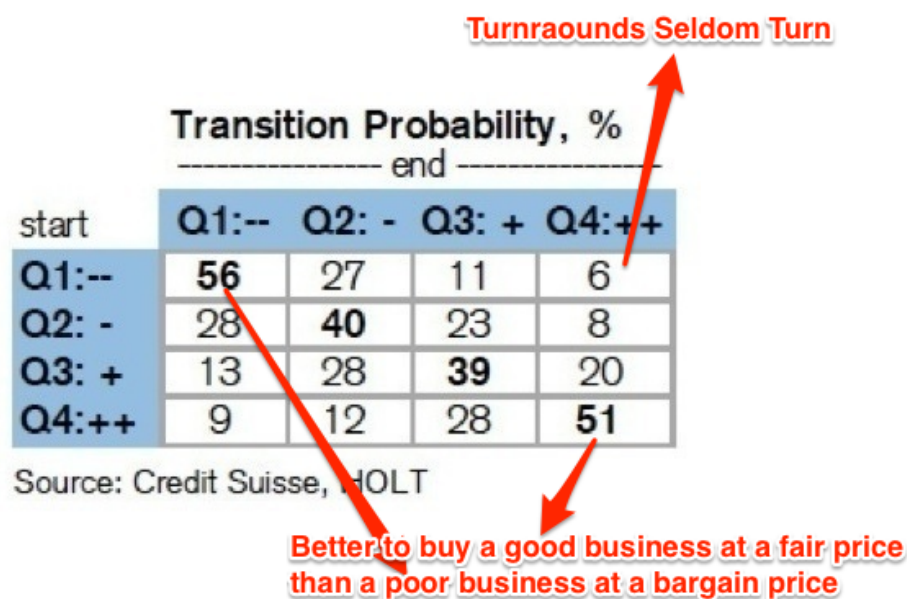
Let's revisit his transition from classic Graham & Dodd (mean reversion) to Philip Fisher (momentum) by studying some of his writings on the subject which reflect his evolution as an investor.



"We can speak from experience, having tried the other route. Your Chairman made the decision a few years ago to purchase Waumbec Mills in Manchester, New

Hampshire, thereby expanding our textile commitment. By any statistical test, the purchase price was an extraordinary bargain; we bought well below the working capital of the business and, in effect, got very substantial amounts of machinery and real estate for less than nothing. But the purchase was a mistake. While we labored mightily, new problems arose as fast as old problems were tamed.

Both our operating and investment experience cause us to conclude that **"turnarounds" seldom turn**, and that the same **energies and talent are much better employed in a good business purchased at a fair price than in a poor business purchased at a bargain price.**"⁴ (Emphasis mine)



"We have written in past reports about the disappointments that usually result from purchase and operation of "turnaround" businesses. Literally hundreds of turnaround possibilities in dozens of industries have been described to us over the years and, either as participants or as observers, we have tracked performance against expectations. Our conclusion is that, with few exceptions, **when a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact.**"⁵ (Emphasis Mine)

The Reputation of a Business with Poor Fundamental Economics Remains Intact

Transition Probability, %

----- end -----

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Source: Credit Suisse, HOLT

"If you buy a stock at a sufficiently low price, there will usually be some hiccup in the fortunes of the business that gives you a chance to unload at a decent profit, even though the long-term performance of the business may be terrible. I call this the "cigar butt" approach to investing. A cigar butt found on the street that has only one puff left in it may not offer much of a smoke, but the "bargain purchase" will make that puff all profit. . .

Unless you are a liquidator, that kind of approach to buying businesses is foolish. First, the original "bargain" price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces - never is there just one cockroach in the kitchen. Second, any initial advantage you secure will be quickly eroded by the low return that the business earns. For example, if you buy a business for \$8 million that can be sold or liquidated for \$10 million and promptly take either course, you can realize a high return. But the investment will disappoint if the business is sold for \$10 million in ten years and in the interim has annually earned and distributed only a few percent on cost. Time is the friend of the wonderful business, the enemy of the mediocre.

I could give you other personal examples of "bargain-purchase" folly but I'm sure you get the picture: It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."⁶

**There is Never Just One
Cockroach in the Kitchen**

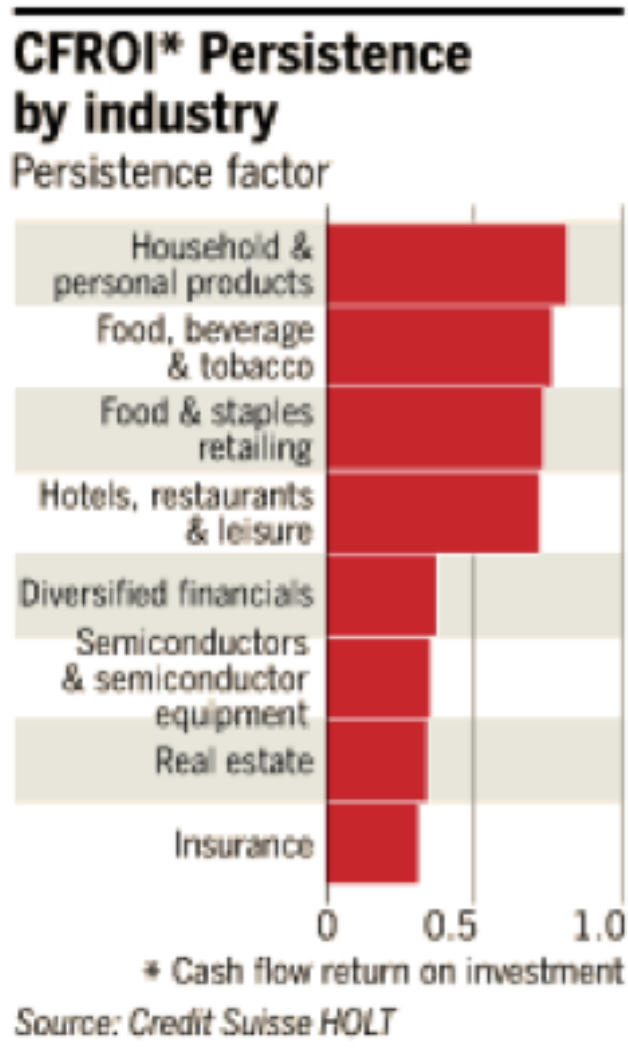
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Source: Credit Suisse, HOLT

**Time is a friend of the wonderful business
but an enemy of the mediocre**

Now, let's come to the next key finding of this research. Apart from discovering that over long time periods, wonderful businesses tend to stay wonderful and crappy ones tend to stay crappy, the research study also found that the highest persistence of excellent performance was concentrated in sectors like household and personal products, food, beverage and tobacco, food and staples retailing, hotels, restaurants and leisure.



It's not surprising that Buffett has focused his stock market investments in these very sectors (except hotels). Why? Because they are relatively recession proof. In contrast, he avoided making stock market investments in the highly cyclical real estate and semiconductor businesses.

It's the Graham and Dodd style of investors looking for mean reversion who end up investing in highly cyclical sectors which are likely to have lots of cigar butts and potential turnaround candidates. Warren Buffett, on the other hand, looks for businesses having enduring competitive advantages backed by demonstrated consistent earning power, and it so happens that those types of businesses happen to be concentrated in sectors having persistent

CFROI's.

The final key finding of this study was that despite being recognised as successful businesses, the Q4++ category (think Nestle India, Hindustan Unilever, Colgate, P&G, ITC, Bosch, Shriram Transport Finance, and Asian Paints discussed earlier) continue to deliver outstanding investment results over the long term. But if the market was efficient, this should not have happened! The prices of such stocks should have been bid to the point where buyers would not end up earning exceptional returns. But they did! Quality is systematically underpriced by markets over long time periods.

We know this empirically not just from this one study but from many others. For example, financial economist Robert Novy-Marx looked at NYSE firms between 1963 and 2010 and international firms between 1990 and 2009. He found the same persistence of high performance, not just in fundamentals but also in the stock market.

"More profitable companies today tend to be more profitable companies tomorrow. Although it gets reflected in their future stock prices, the market systematically underestimates this today, making their shares a relative bargain – diamonds in the rough."⁷

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Source: Credit Suisse, HOLT

Why Does Buffett lurk in this corner?



So, now we now know why Buffett lurks there.

1. Great businesses in predictable industries meeting basic human needs and wants are likely to remain great; and
2. Despite being recognised as great, their stocks are likely to be under-priced. Why does that happen?

I have a theory behind that and its got something to do with marshmallows.

The Marshmallow Experiment and Valuation of Stocks



Watch this [video](#)

The marshmallow experiment describes the tradeoff between instant and delayed gratification. Indeed, valuation is nothing but dealing with that tradeoff.

"Investing is often described as the process of laying out money now in the expectation of receiving more money in the future. At Berkshire we take a more demanding approach, defining investing as the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power – after taxes have been paid on nominal gains – in the future. **More succinctly, investing is forgoing consumption now in order to have the ability to consume more at a later date.**"⁸ (Emphasis Mine)

How do most people deal with delayed gratification? They discount it heavily. They may not know this explicitly but when people prefer instant gratification over delayed one, implicitly they are using a high discount rate to bring back to present value that delayed gratification and the consequences of using a high discount rate is that the present value comes out to be less than that of instant gratification.

Now, think how this works in the transition probability matrix for most investors (who set prices in markets) and for Buffett.

A while back I had posed this question:

		Transition Probability, %			
		----- end -----			
start		Q1:--	Q2: -	Q3: +	Q4:++
Q1:--		56	27	11	6
Q2: -		28	40	23	8
Q3: +		13	28	39	20
Q4:++		9	12	28	51

Source: Credit Suisse, HOLT

Why Does Buffett lurk in this corner?



And I had provided two answers:

1. Great businesses in predictable industries meeting basic human needs and wants are likely to remain great; and
2. Despite being recognised as great, their stocks are likely to be under-priced.

By now we know both anecdotally and empirically that quality tends to get underpriced by the market. Now let's dig deeper to see how that happens.

By definition, a great business, with enduring competitive advantage will be compounding capital employed in the business at high rate for decades and decades. That's what Q4++'s are. Now, if the distant cash flows are discounted back to present value using a high discount rate, their present value will be much lower than if a lower discount rate was used.

Most investors, explicitly or implicitly, use high discount rates for distant cash flows

(delayed gratification) and they justify it by saying "well its risky, so I will add a few hundred basis points to the discount rate." Buffett does not do that. He does not believe in the idea of equity risk premiums at all.

"When we look at the future of businesses we look at riskiness as being sort of a go/no-go valve. In other words, if we think that we simply don't know what's going to happen in the future, that doesn't mean it's risky for everyone. It means we don't know – that it's risky for us. It may not be risky for someone else who understands the business."

However, in that case, we just give up. We don't try to predict those things. We don't say, "Well, we don't know what's going to happen." Therefore, we'll discount some cash flows that we don't even know at 9% instead of 7%. That is not our way to approach it.

Once it passes a threshold test of being something about which we feel quite certain we tend to apply the same discount factor to everything. And we try to only buy businesses about which we're quite certain.

As for the capital asset pricing model type reasoning with its different rates of risk adjusted returns and the like, we tend to think of it – well, we don't tend to think of it. We consider, it nonsense.

But we think it's also nonsense to get into situations – or to try and evaluate situations – where we don't have any conviction to speak of as to what the future is going to look-like. **I don't think that you can compensate for that by having a higher discount rate and saying, "Well, it's riskier. And I don't really know what's going to happen. Therefore, I'll apply a higher discount rate."**⁹ - Warren Buffett (Emphasis Mine)

"Buffett does not add a risk premium. Instead, he relies on his single-minded focus on companies with consistent and predictable earnings and on the margin of safety that comes from buying at a substantial discount in the first place. **"I put a heavy weight on certainty," Buffett says. "If you do that, the whole idea of a risk factor doesn't make any sense to me."**¹⁰ (Emphasis Mine)

When Buffett "puts a heavy weight on certainty," he is, in effect, telling us that he uses a lower discount rate to evaluate what he considers as certainty. He is saying: "I know these businesses will be compounding capital at a rapid pace for a long long time generating distant but huge cashflows, and I put a lot of value to that ."

On the other hand, the stock market is dominated by people who resemble those four-year old kids in the marshmallow experiment. They simply do not want to wait for much larger rewards several years and decades from now. They prefer instant gratification to delayed gratification. When they apply large equity risk premiums to distant cash flows, they end up with much lower estimates of intrinsic business values. As a consequence, quality gets underpriced and investors like Buffett snap up the chance to buy these businesses at bargain prices.

What people perceive as risky Buffett perceives as low risk. He handles risk by avoiding Q1-- and Q2. No turnarounds, no semiconductors for him. By limiting himself to investing in businesses that will meeting basic human needs and wants, he limits the risk of permanent loss of capital. He does that by using a discount rate of the long term US treasury bond rate (except when he believes it's artificially low, when he adds a few percentage points to that rate) for valuing stocks.

We should learn from Warren Buffett. When we're dealing with Q4++, we shouldn't use equity risk premiums to estimate value.

If you apply low discount rates to long-duration moats (or what Michael Mauboussin calls "Competitive Advantage Periods"¹¹) running into centuries, you'd get a different kind of valuation than you'd get if you discounted delayed gratification heavily.

"Whether the currency a century from now is based on gold, seashells, shark teeth, or a piece of paper (as today), people will be willing to exchange a couple of minutes of their daily labor for a Coca-Cola or some See's peanut brittle. In the future the U.S. population will move more goods, consume more food, and require more living space than it does now. People will forever exchange what they produce for what others produce."

Our country's businesses will continue to efficiently deliver goods and services wanted by our citizens. Metaphorically, **these commercial "cows" will live for centuries and give ever greater quantities of "milk"** to boot. Their value will be determined not by the medium of exchange but rather by their capacity to deliver milk."¹² (Emphasis Mine)

This is especially true for businesses in India because India offers scalability, like almost no other country out there. We should follow Buffett's advice and not discount very long duration moats heavily, like most investors and markets do. When it comes to investing in enduring moats, we should abandon dumb anchors like P/E multiples, and all-time high stock prices.

"The term "value investing" is widely used to imply the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics...are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics - a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield - are in no way inconsistent with a "value" purchase."¹³ - Warren Buffett

"If a business earns 18% on capital over twenty or thirty years, even if you pay an expensive looking price, you'll end up with one hell of a result." - Charlie Munger¹⁴

"Time is the friend of the wonderful business, the enemy of the mediocre." ¹⁵ - Warren Buffett

Key Takeaways

1. Buffett shifted from mean reversion to momentum for very good reasons.
 2. Research bears out Buffett's reasons for the shift.
 - Wonderful businesses are likely to remain wonderful for decades.
 - Bad businesses remain bad for a long time.
 3. Although great businesses do sell at relatively higher P/E and P/B multiples, the stock market systematically underprices quality in the long term.
 - This happens because most investors tend to discount delayed gratification too heavily.
 - You shouldn't do that.
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Chapter 41.
 3. <http://www.project-firefly.com/node/18029>
 4. Warren Buffett in his 1979 Letter to BRK shareholders.
 5. Warren Buffett in his 1980 Letter to BRK shareholders.
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8. Warren Buffett in his 2012 Letter to BRK shareholders.
9. Warren Buffett speaking at 1998 AGM of Berkshire Hathaway
10. From "The Warren Buffett Way" by Robert Hagstorm, second edition
11. <http://www.capatcolumbia.com/Articles/FoFinance/Fof1.pdf>
12. Warren Buffett in his 2012 Letter to BRK shareholders.
13. Warren Buffett in his 1992 Letter to BRK shareholders.
14. Charlie Munger's Talk titled, "A Lesson on Elementary, Worldly Wisdom as it Relates to Investment Management and Business," delivered to The University of Southern California Marshall School of Business, April 14, 1994.
15. Warren Buffett in his 1989 Letter to BRK shareholders.