

Tuesday 14 September 2010



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CEO

Textile Company

Commodity Yarn

Global Commodity
Business

Extremely
Competitive

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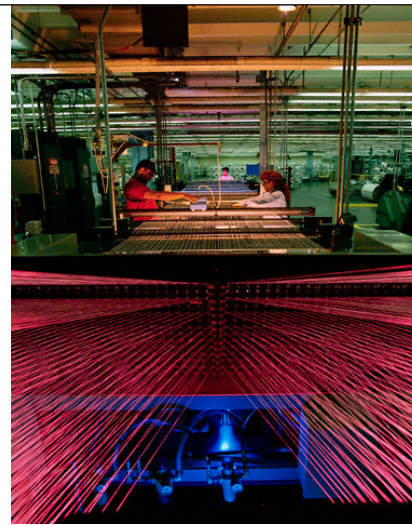
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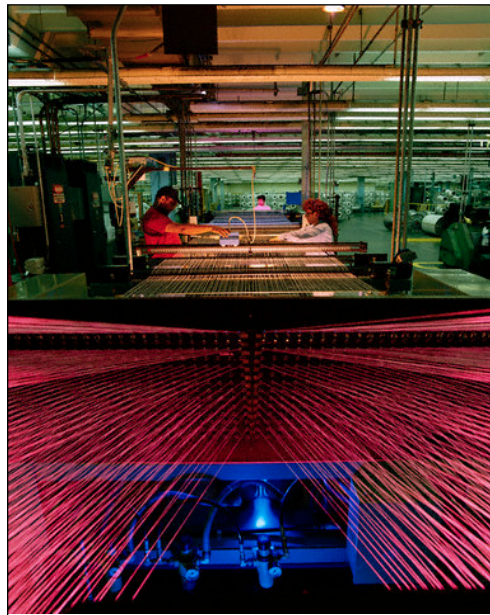
A textile machinery manufacturer approaches you with a proposal to sell you a new type of textile machine, which is more efficient than any machine invented till date.

Cost of machinery:
Rs 10 cr.

Expected life of
machine: 10 years

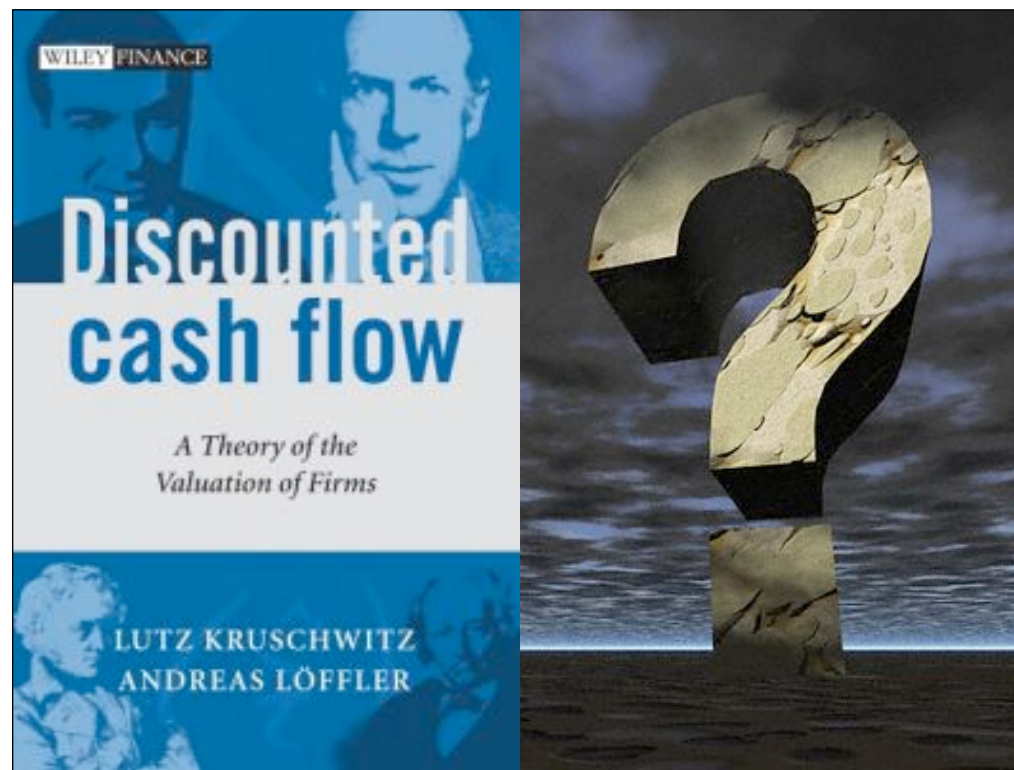
Annual savings: Rs
2.50 cr. p.a.





Expected
residual value of
the machine: Rs
1 cr.

Cost of capital:
15% p.a.



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Time	Cash Flow	Pv of cash flow	
0	-100,000,000	-100,000,000	
1	25,000,000	21,739,130	
2	25,000,000	18,903,592	
3	25,000,000	16,437,906	
4	25,000,000	14,293,831	
5	25,000,000	12,429,418	
6	25,000,000	10,808,190	
7	25,000,000	9,398,426	
8	25,000,000	8,172,544	
9	25,000,000	7,106,560	
10	35,000,000	8,651,465	
	NPV	27,941,063	
	Cost of capital	15.00%	p.a.
	Residual value	10,000,000	
	Taxes ignored		

Accept or reject?



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Let's see a show of hands here. How many of you would accept this project?



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The CEO, not only refused to invest in the project, he decided to shut down his textile business!



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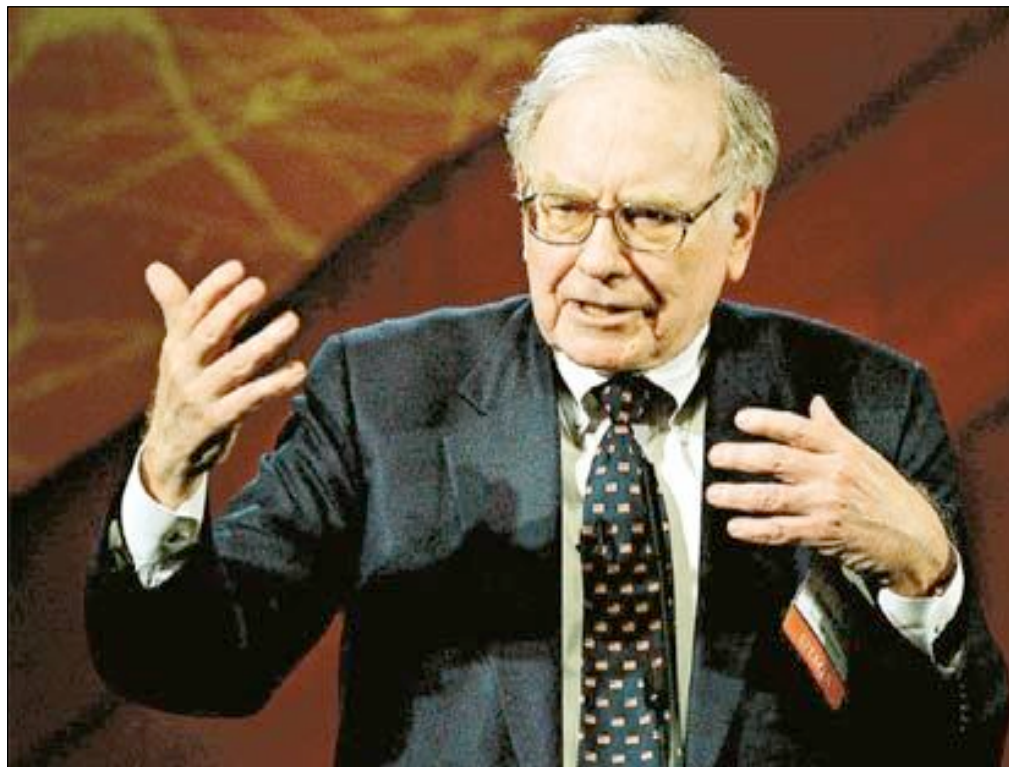
How did Buffett **solve** this problem?



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By jumping over jurisdictional boundaries of multiple disciplines



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The domestic textile industry operates in a commodity business, competing in a world market in which substantial excess capacity exists. Much of the trouble we experienced was attributable, both directly and indirectly, to competition from foreign countries whose workers are paid a small fraction of the U.S. minimum wage. But that in no way means that our labor force deserves any blame for our closing. In fact, in comparison with employees of American industry generally, our workers were poorly paid, as has been the case throughout the textile business. In contract negotiations, union leaders and members were sensitive to our disadvantageous cost position and did not push for unrealistic wage increases or unproductive work practices. To the contrary, they tried just as hard as we did to keep us competitive. Even during our liquidation period they performed superbly. (Ironically, we would have been better off financially if our union had behaved unreasonably some years ago; we then would have recognized the impossible future that we faced, promptly closed down, and avoided significant future losses.)

Over the years, we had the option of making large capital expenditures in the textile operation that would have allowed us to somewhat reduce variable costs. Each proposal to do so looked like an immediate winner. Measured by standard return-on-investment tests, in fact, these proposals usually promised greater economic benefits than would have resulted from comparable expenditures in our highly-profitable candy and newspaper businesses.

But the promised benefits from these textile investments were illusory. Many of our competitors, both domestic and foreign, were stepping up to the same kind of expenditures and, once enough companies did so, their reduced costs became the baseline for reduced prices industrywide. Viewed individually, each company's capital investment decision appeared cost-effective and rational; viewed collectively, the decisions neutralized each other and were irrational (just as happens when each person watching a parade decides he can see a little better if he stands on tiptoes). After each round of investment, all the players had more money in the game and returns remained anemic.

Thus, we faced a miserable choice: huge capital investment would have helped to keep our textile business alive, but would have left us with terrible returns on ever-growing amounts of capital. After the investment, moreover, the foreign competition would still have retained a major, continuing advantage in labor costs. A refusal to invest, however, would make us increasingly non-competitive, even measured against domestic textile manufacturers.



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The great lesson in microeconomics is to discriminate between when technology is going to help you and when it's going to kill you. And most people do not get this straight in their heads. But a fellow like Buffett does.

For example, when we were in the textile business, which is a terrible commodity business, we were making low-end textiles – which are a real commodity product. And one day, the people came to Warren and said, “They’ve invented a new loom that we think will do twice as much work as our old ones.” And Warren said, “Gee, I hope this doesn’t work – because if it does, I’m going to lose the mill.” And he meant it.

What was he thinking? He was thinking, “It’s a lousy business. We’re earning substandard returns and keeping it open just to be nice to the elderly workers. But we’re not going to put huge amounts of new capital into a lousy business.”

And he knew that the huge productivity increases that would come from a better machine introduced into the production of a commodity product would all go to the benefit of the buyers of the textiles. Nothing was going to stick to our ribs as owners.

That’s such an obvious concept – that there are all kinds of wonderful new inventions that give you nothing as owners except the opportunity to spend a lot more money in a business that’s still going to be lousy. The money still won’t come to you. All of the advantages from great improvements are going to flow through to the customers.

Conversely, if you own the only newspaper in Oshkosh and they were to invent more efficient ways of composing the whole newspaper, then when you got rid of the old technology and got new, fancy computers and so forth, all of the savings would come right through to the bottom line.

In all cases, the people who sell the machinery – and, by and large, even the internal bureaucrats urging you to buy the equipment – show you projections with the amount you’ll save at current prices with the new technology. However, they don’t do the second step of the analysis – which is to determine how much is going to stay home and how much is just going to flow through to the customer. I’ve never seen a single projection incorporating that second step in my life. And I see them all the time. Rather, they always read: “This capital outlay will save you so much money that it will pay for itself in three years.”

So you keep buying things that will pay for themselves in three years. And after twenty years of doing it, somehow you’ve earned a return of only about four percent per annum. That’s the textile business.

Which jurisdictional boundaries did Buffett jump over?



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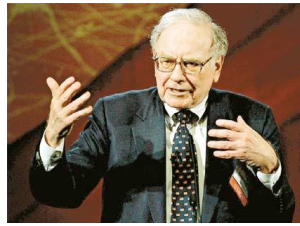
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Which mental models did he employ from which disciplines?

Competition [Microeconomics]

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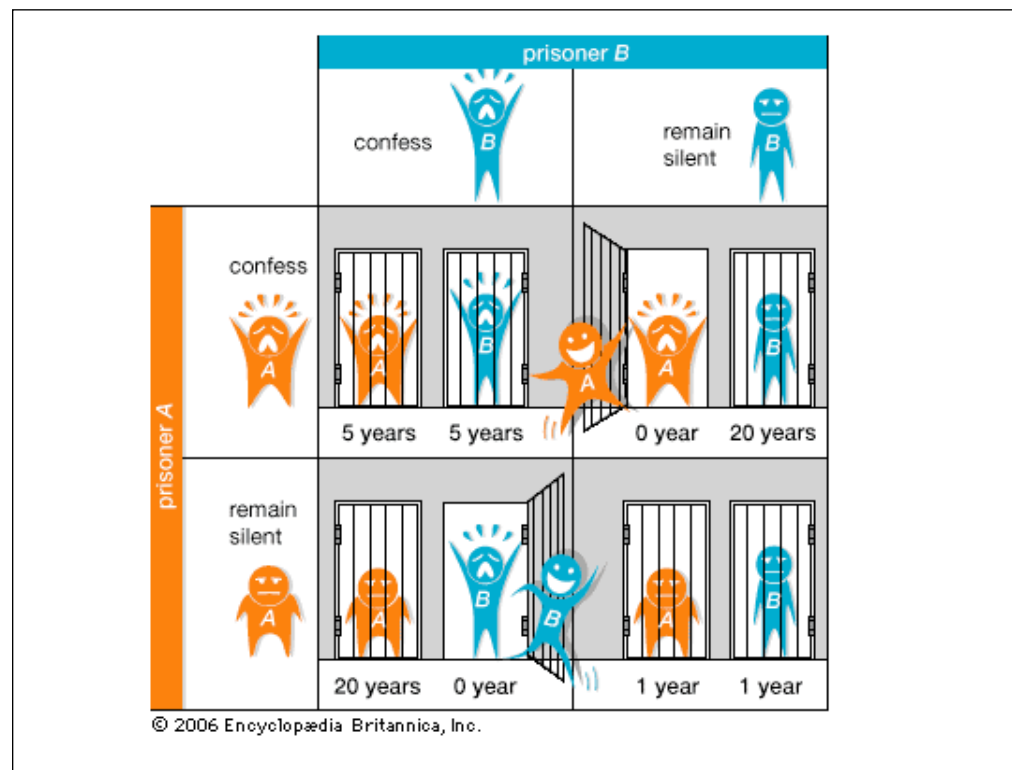
“Viewed **collectively**, the decisions **neutralized** each other and were irrational (just as happens when each person watching a **parade** decides he can see a little better if he stands on tiptoes)...

Buffett’s metaphor of the parade is
the **functional equivalent** of which
model?

Prisoner's Dilemma [Game Theory]

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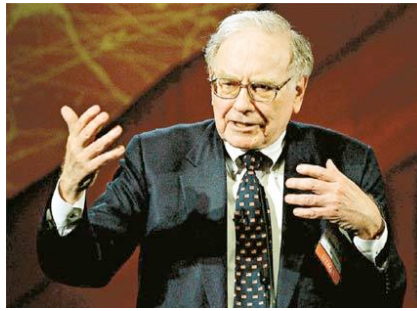
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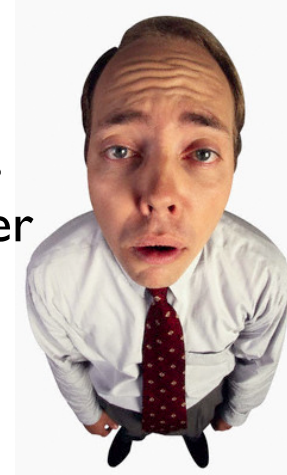
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Actions that are rational at the individual level, if copied, become irrational at the group level.



“In a business selling a
commodity-type product, it's
impossible to be a lot smarter
than your **dumbest**
competitor.”



Return on Capital [Accounting]

Opportunity Cost [Microeconomics]

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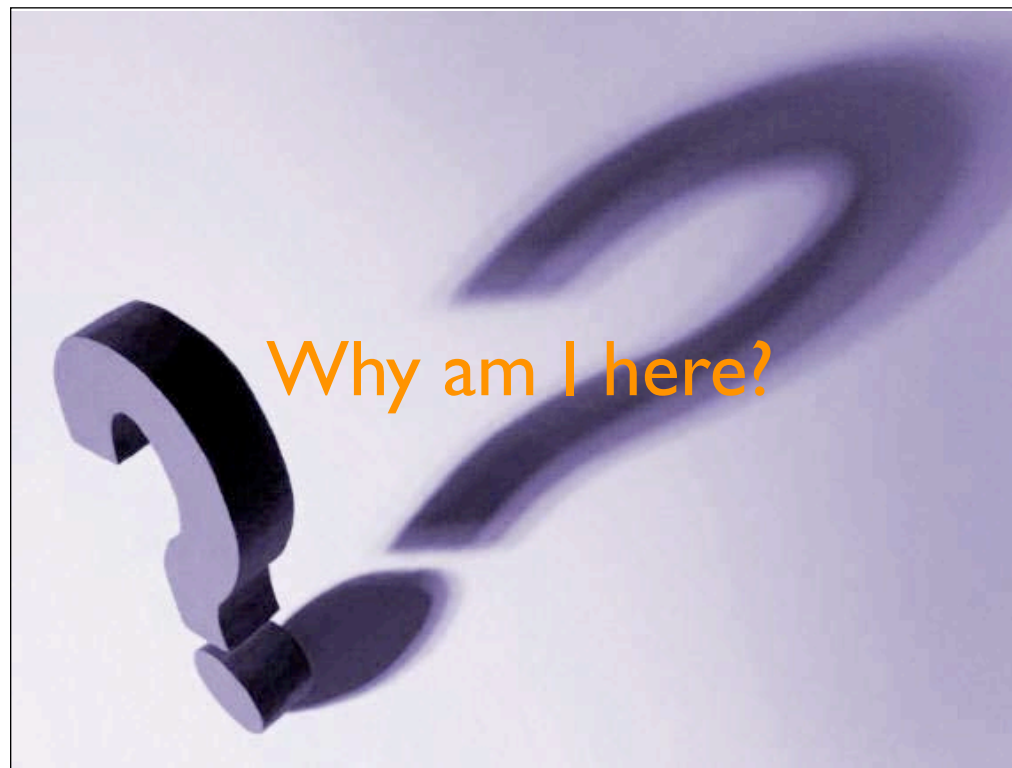
Slow Contrast Effect [Psychology]

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Throwing good money after bad

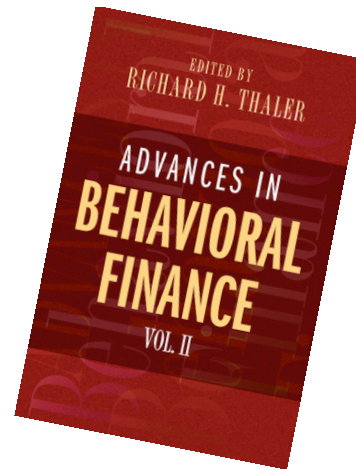
Commitment & Consistency [Psychology]



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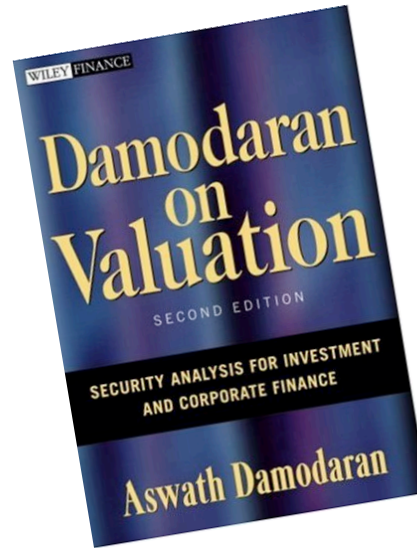
To teach you
behavioral finance?



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If that was all I taught you, it would be a wasted trip!



To teach you
business valuation?



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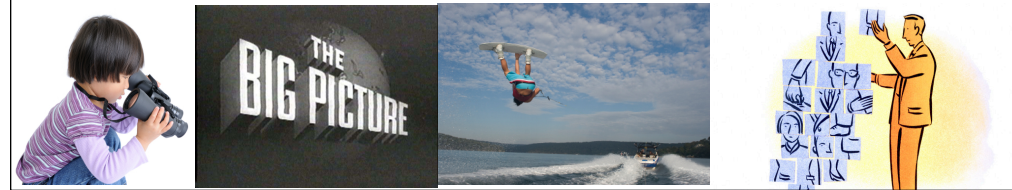
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But what is the end?





A different way to
view the world

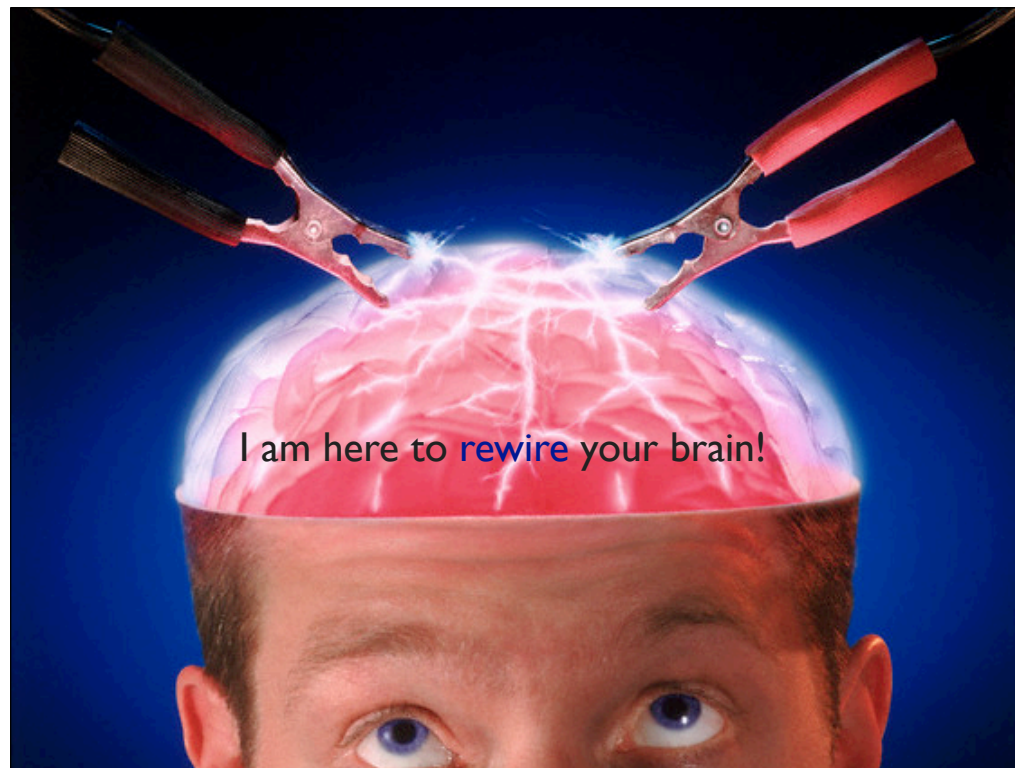


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A **rational** way to
think about things





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How will I do that?

I will start with
mental models



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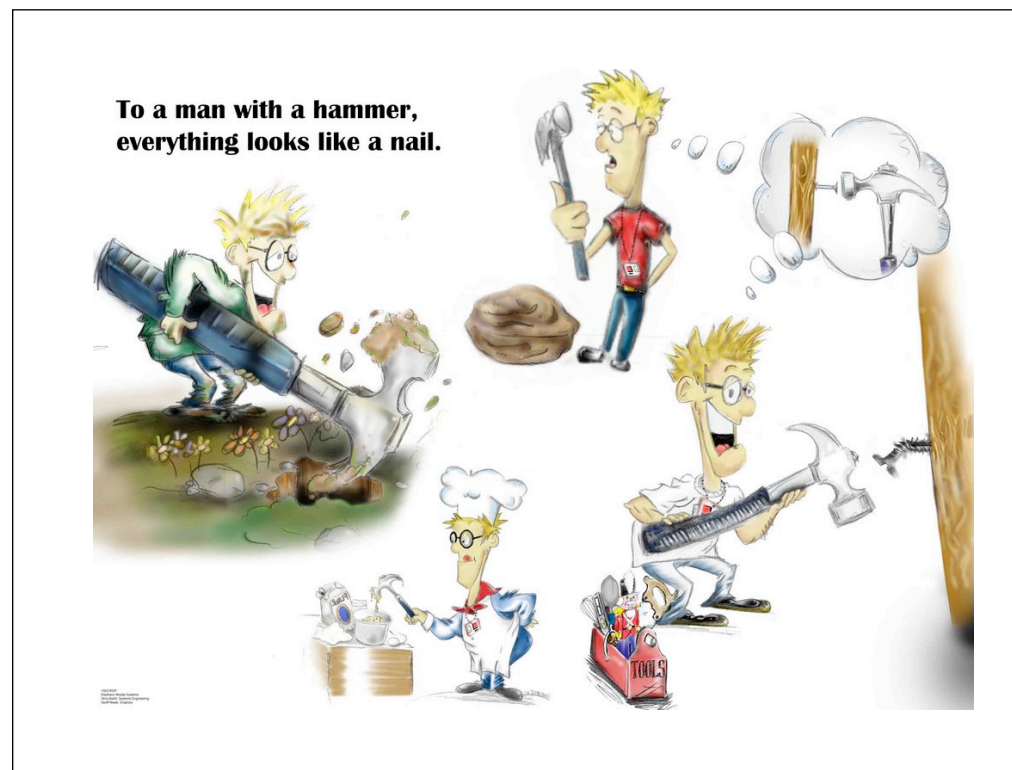
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“Mental
models” are his
idea





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All the wisdom in the world is not to be found in one little academic department. A disastrous way to think and operate. If all you have is one tool, you will tend to overuse it.



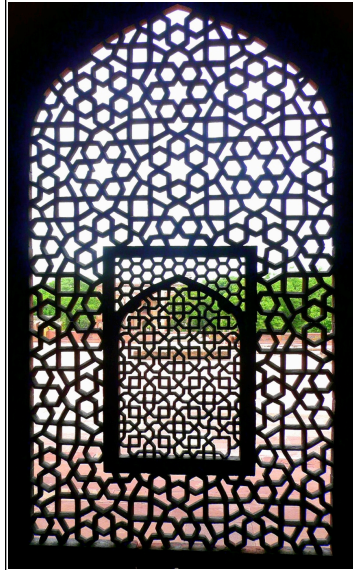
“You’ve got to have
models in your
head...





“And you’ve got to
array your
experience – both
vicarious and direct
– on this **latticework**
of models...





“Students who just try to remember and **pound** back what is remembered, well, they **fail** in **school** and **fail** in **life**. You’ve got to hang **experience** on a **latticework** of **models** in your head.”

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Boiler Room Operation

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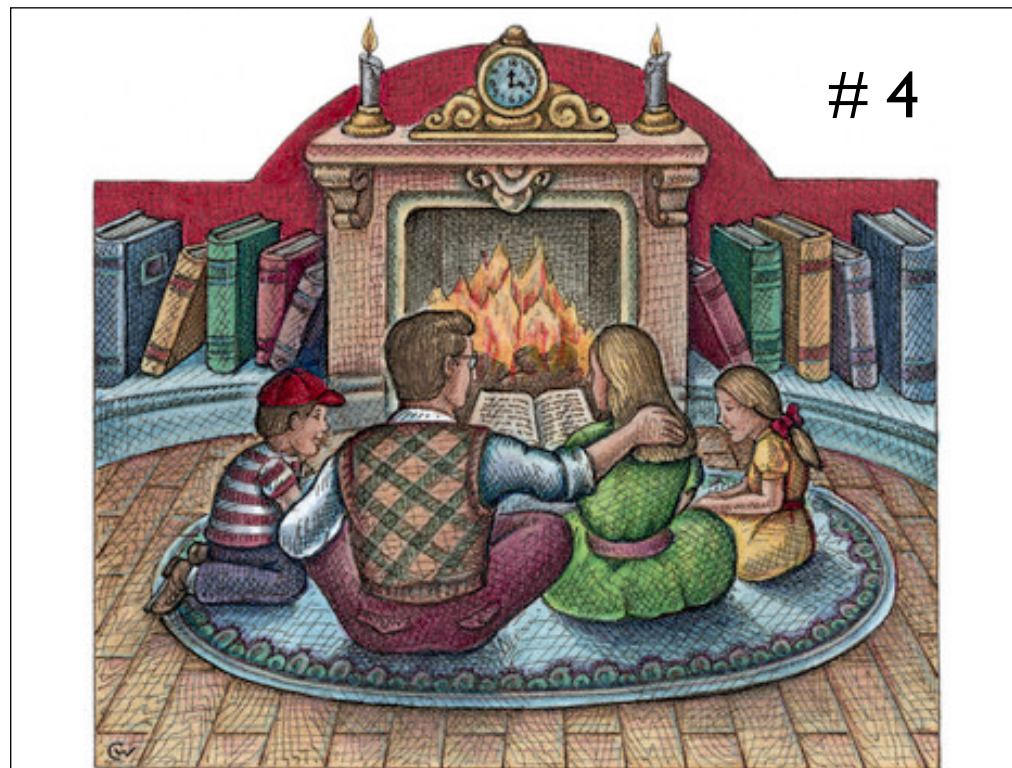
Overpriced



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Is not an offer for sale in an overpriced IPO the “functional equivalent” of a zero-sum game?



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A stock **buyback** at a **bargain** price

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Is not a stock buyback at a bargain price the “functional equivalent” of a zero-sum game?

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lets all play carefully guys so that we can all win a little!



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Overpriced



“FUNCTIONAL EQUIVALENTS” of Zero Sum Game

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Herb Simon
Nobel Laureate

Simon **influenced**
Charlie Munger about
mental models

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“One can train a man so that he has at his disposal a list or repertoire of the possible actions that could be taken under the circumstances; . . . a person who is new at the game does not have immediately at his disposal a set of possible actions to consider, but has to construct them on the spot, . . . a time-consuming and difficult mental task. . . . The decision maker of experience has at his disposal a checklist of things to watch out for before finally accepting a decision.”

“A large part of the difference between the experienced decision maker and the novice in these situations is not any particular intangible like “judgment” or “intuition”. If one could open the lid, so to speak, and see what was in the head of the experienced decision-maker, one would find that he had. . . at his disposal repertoires of possible actions; that he had. . . checklists of things to think about before he acted; and that he had mechanisms in his mind to evoke these, and bring these to his conscious attention when the situations for decisions arose. Most of what we do is to get people ready to act in situations of encounter consists of drilling in these lists into them sufficiently deeply so that they will be evoked quickly at the time of the decision.”

To think much better,
you'll need a **checklist** of
mental models



These **mental models** will come
from **multiple** disciplines

Economics
Psychology
Accounting
Neurology
Physics

Mathematics
Probability
Engineering
Evolutionary Biology

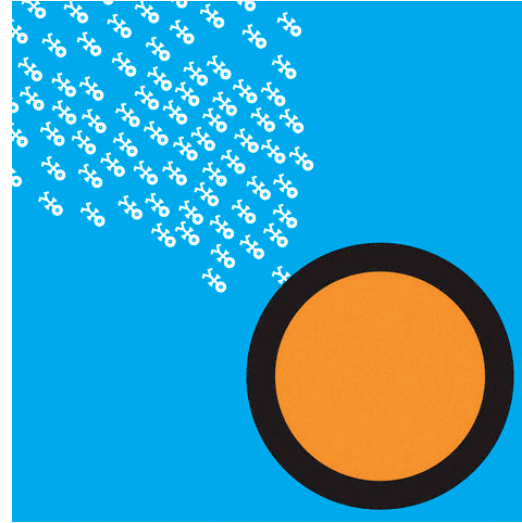
About 20 models
from **psychology**
will become
behavioral finance



Why do you need a
checklist?



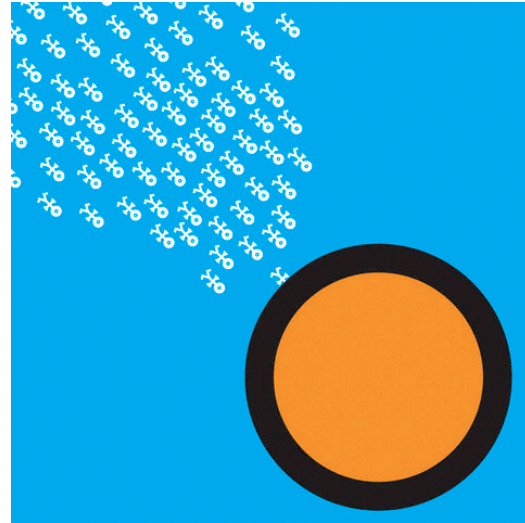
Because the human
mind is like the
human egg



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As soon as a sperm enters the egg, there's an automatic shut-off device that bars other sperms from getting in.



Mind jumps to
conclusions: **First**
conclusion bias

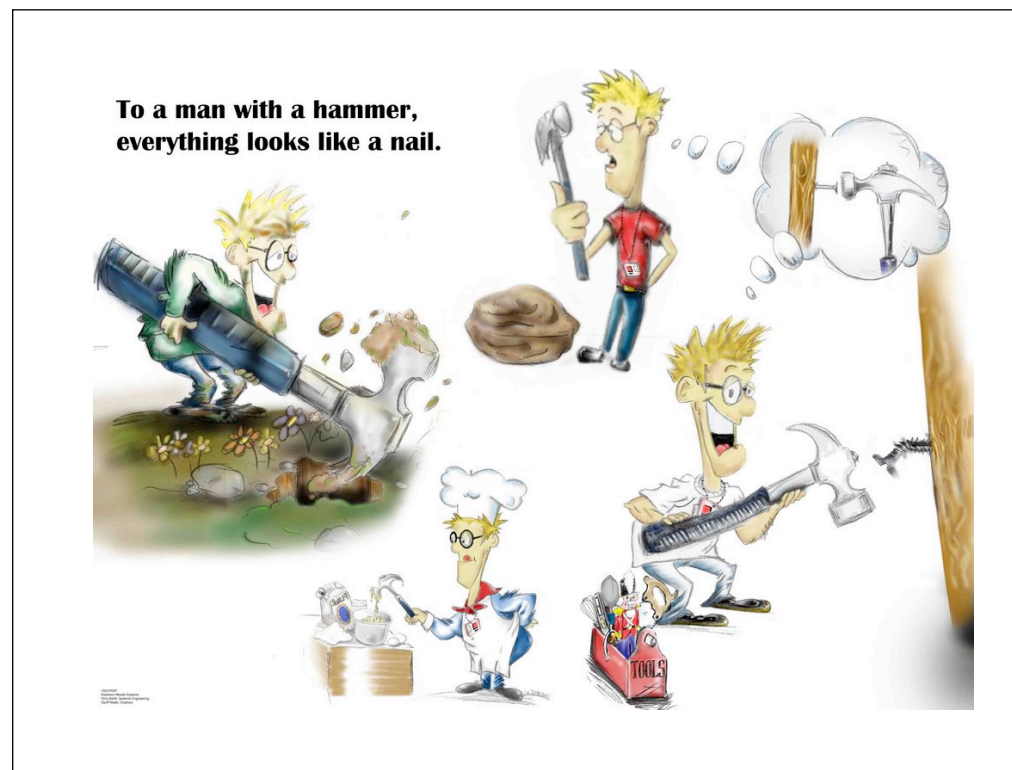
Is commodity price
rise bad for
commodity users?



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Example: steel price hike and its effect on auto
FMCG companies which pass it on and then do not reduce prices when
inflation falls
Maruti Suzuki – Royalty case



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All the wisdom in the world is not to be found in one little academic department. A disastrous way to think and operate.

If all you have is one tool, you will tend to overuse it.

6



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Assume today is 27 March 2009 i.e. there are only five days left in the financial year ending on 31 March 2009. One of your friends has approached you to advice him on his investments. He presents you with the following data about his current portfolio:

Company	Cost	Current Mkt Value	Unrealised Gains/(Loss)	Type of gain/loss, if realised
Toblerone Inc.	Rs 50 lacs	Rs 100 lacs	Rs 50 lacs	Long-term
M&M Inc.	Rs 40 lacs	Rs 75 lacs	Rs 35 lacs	Short-term
See's Candy Inc.	Rs 35 lacs	Rs 35 lacs	Nil	Long-term
Hersheys Inc.	Rs 60 lacs	Rs 40 lacs	(Rs 20 lacs)	Short-term
Godiva Inc.	Rs 40 lacs	Rs 33 lacs	(Rs 7 lacs)	Short-term

In addition, your friend also tells you that during 2008-09, he has already realized short-term capital gains of Rs 27 lacs. He now needs Rs 73 lacs by selling part of his portfolio. Which stocks should he sell?

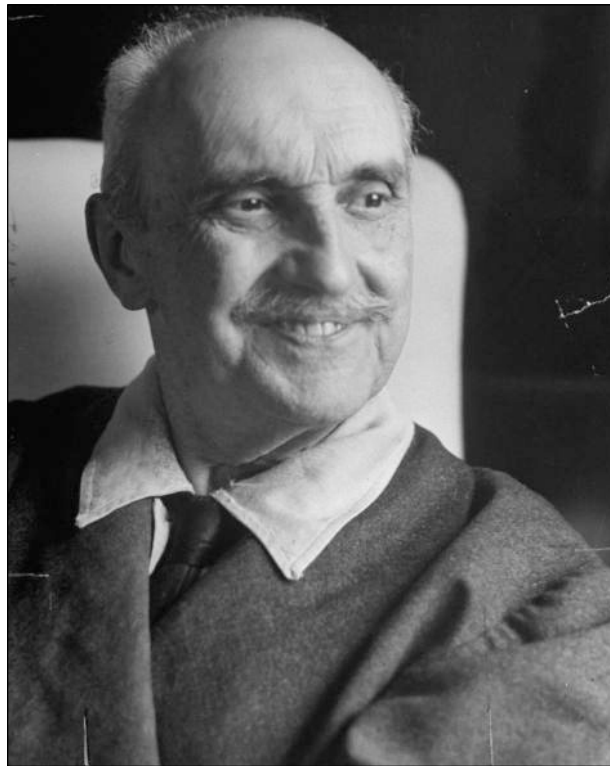


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Selling **Hersheys** and **Godiva** could
be very silly **mistakes!**

Why?



“Fanaticism
consists in
redoubling
your effort
when you have
forgotten your
aim.” - George
Santayana

Are there “functional equivalents” of
this type of error?



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Stock Market Prediction Newsletter Scam

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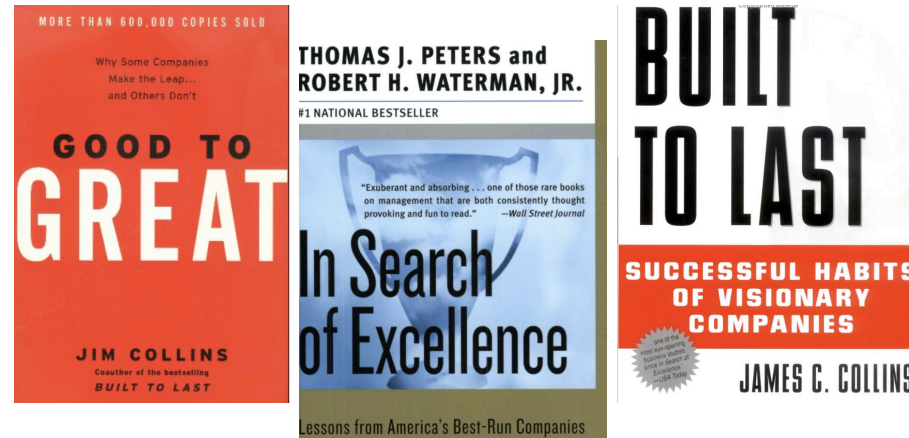
One day you receive a newsletter in which you're offered a free prediction. Reliance Industries would rise by more than 10% during the course of the next month. Coincidentally it does rise by 10%. Next newsletter predicts that Reliance will fall by more than 10% in the next month. A month passes and you notice that the second prediction has also come true.

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You don't learn much about success from these books because they ignore other companies which had similar attributes as the ones covered by these books but somehow did not become good and went on becoming great, did not become excellent, and moreover did not actually even last...

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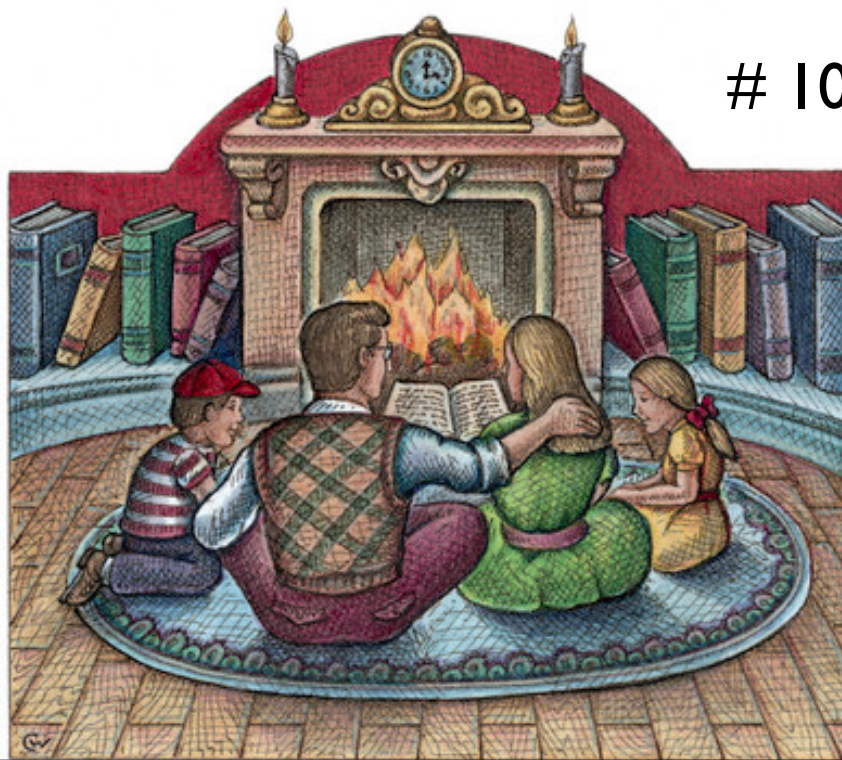
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A college drop-out as a role model

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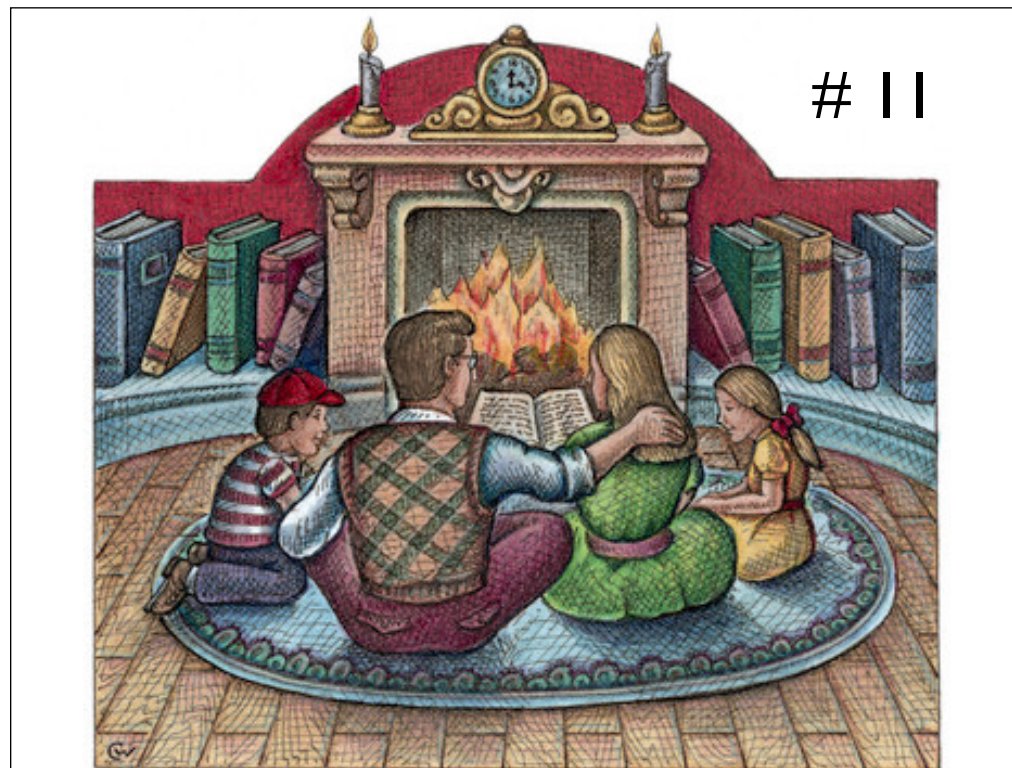


Ask a wish

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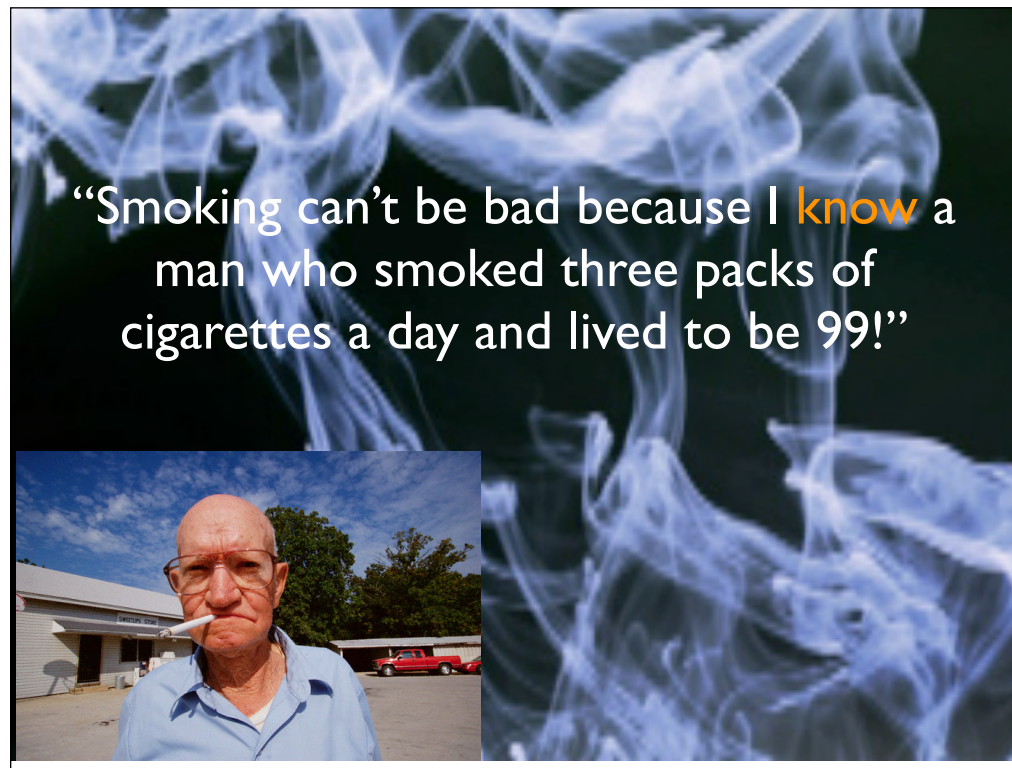
Some wishes will come true by sheer random luck, and you will hear about the grateful ones. You never see the ones whose wishes did not come true. How, then, can you ascertain the correlation, if any, prayer, and fulfillment of one's wishes?



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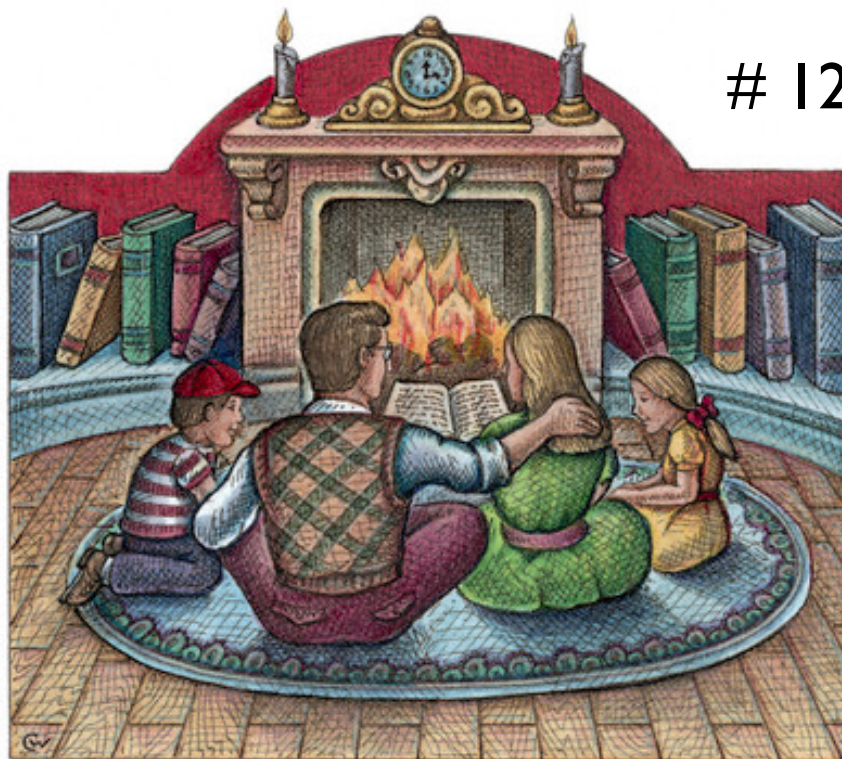
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take a sample of 1,000 smokers and a sample of 1,000 non-smokers. Then monitor the average life of each group and count how many of each group live to be 99.

QED

12



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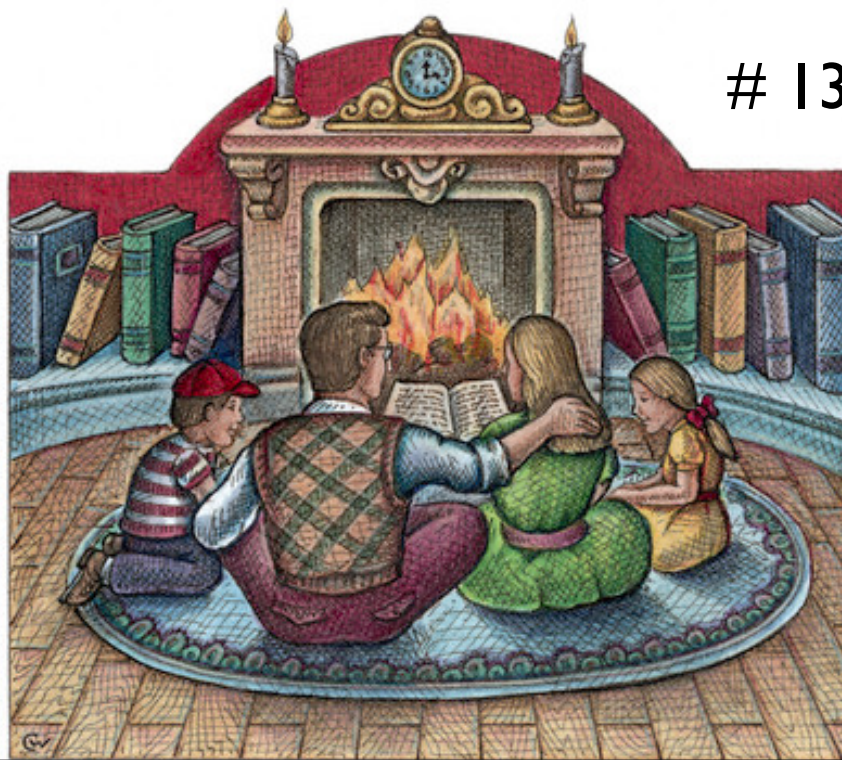


A **focused** investor as a **role model**

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Hot Shot Fund Manager

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rising NAV on a small base, new capital raised from gullible public chasing near term performance, followed by a decline in NAV with the net result that net net this guy lost money from inception of his career till date!

R J Bhatt Awards 1999

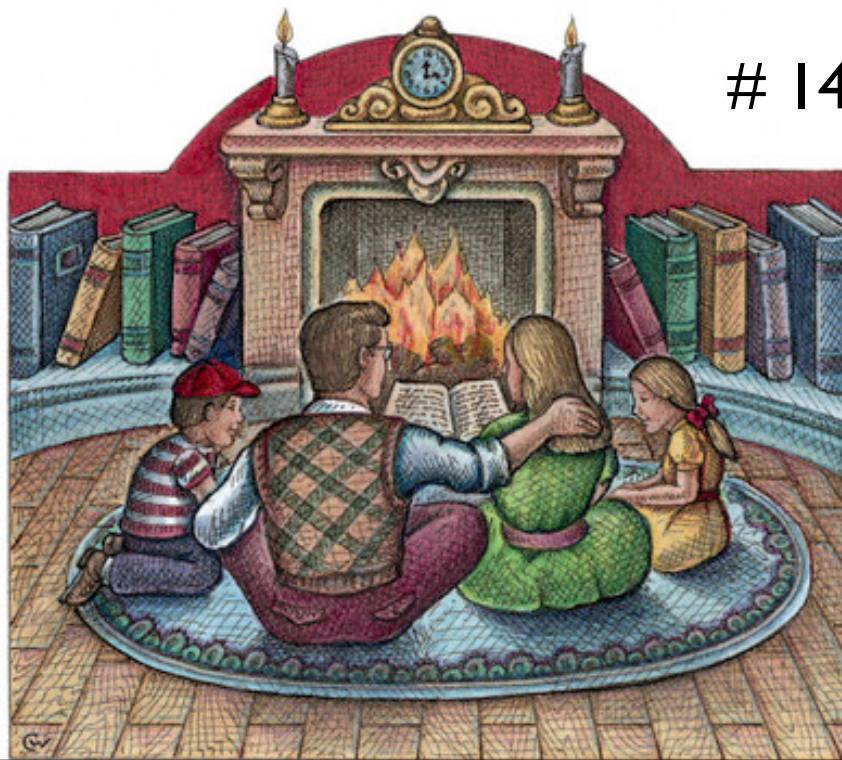


R J Bhatt Awards 1999
Presented to
**BIRLA ADVANTAGE
FUND**
The Best Performing
Scheme In the category of
Growth Funds the IRIS
Mutual Fund Award in
memory of R J Bhatt.



Fund Advertising

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“Investing” in penny stocks

Company	Cost	Current Mkt Value	Unrealised Gains/ (Loss)	Type of gain/loss, if realised
Toblerone Inc.	Rs 50 lacs	Rs 100 lacs	Rs 50 lacs	Long-term
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Godiva Inc.	Rs 40 lacs	Rs 33 lacs	(Rs 7 lacs)	Short-term

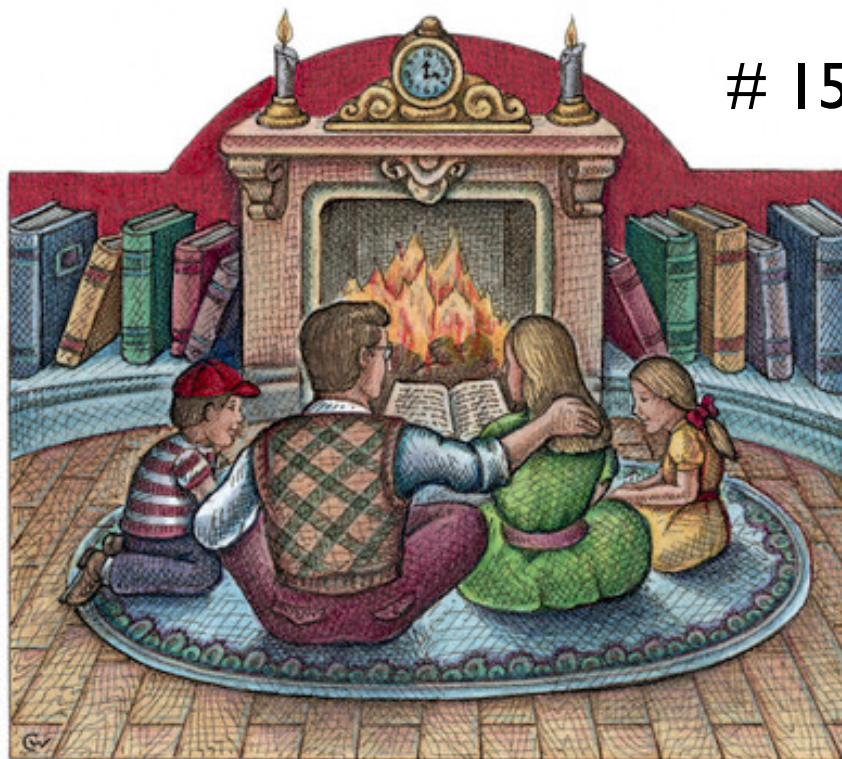




“FUNCTIONAL EQUIVALENTS”

of Availability Bias
and Base Rate
Fallacy

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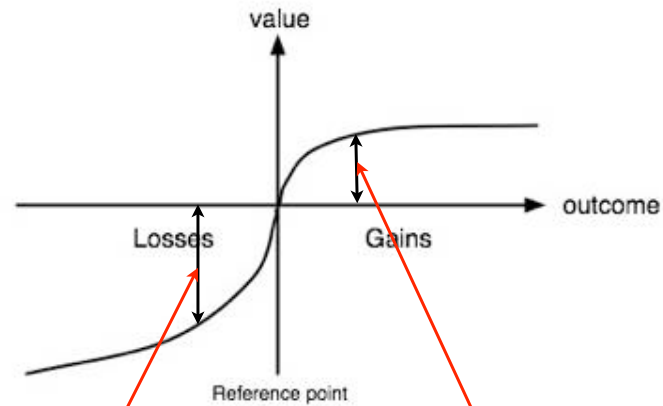
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Video Clip on Loss Aversion



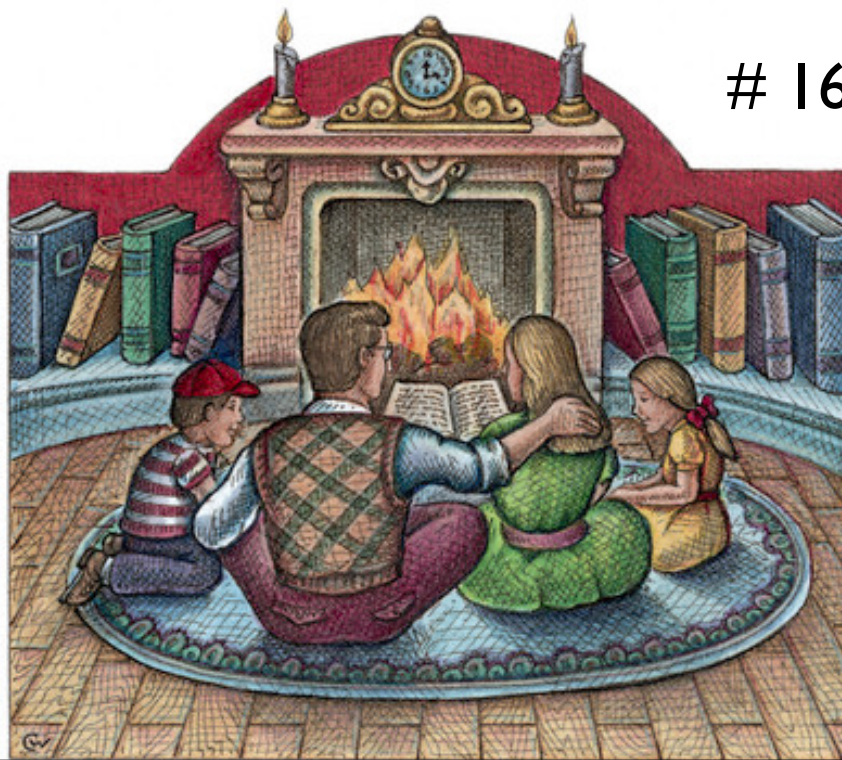
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*“The quantity of a man’s **pleasure** from a ten-dollar gain does not exactly match the quantity of his **displeasure** from a ten-dollar loss.”*

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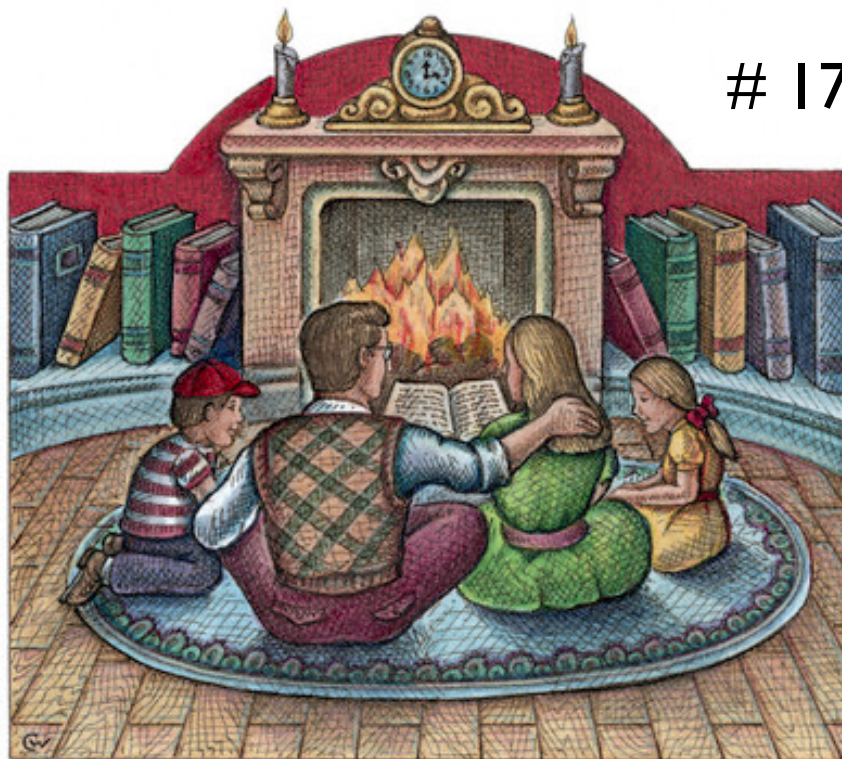
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Buying a Lamp

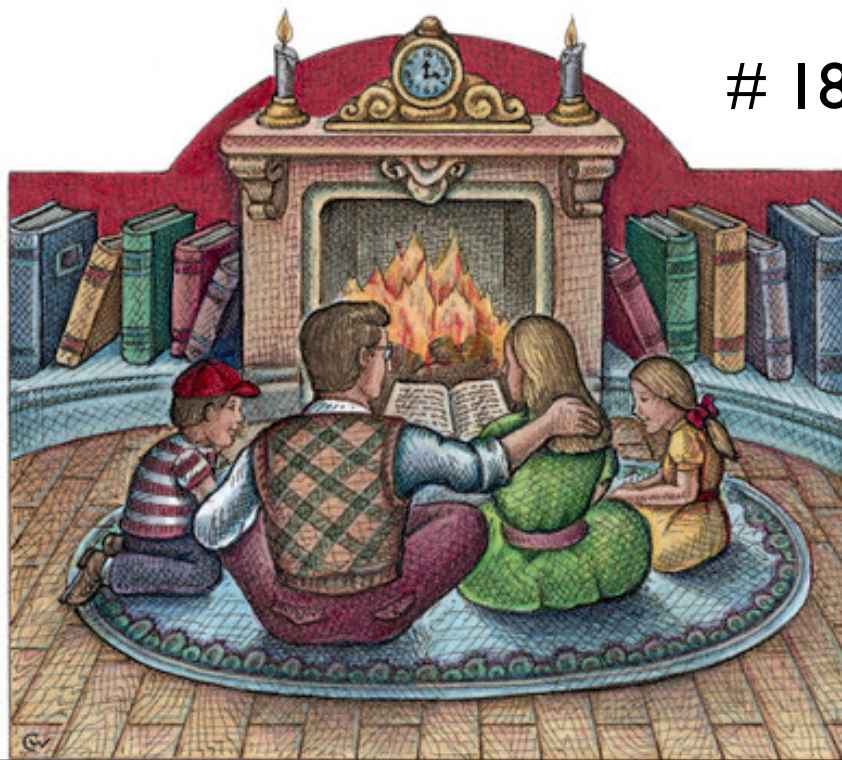


Buying a Car

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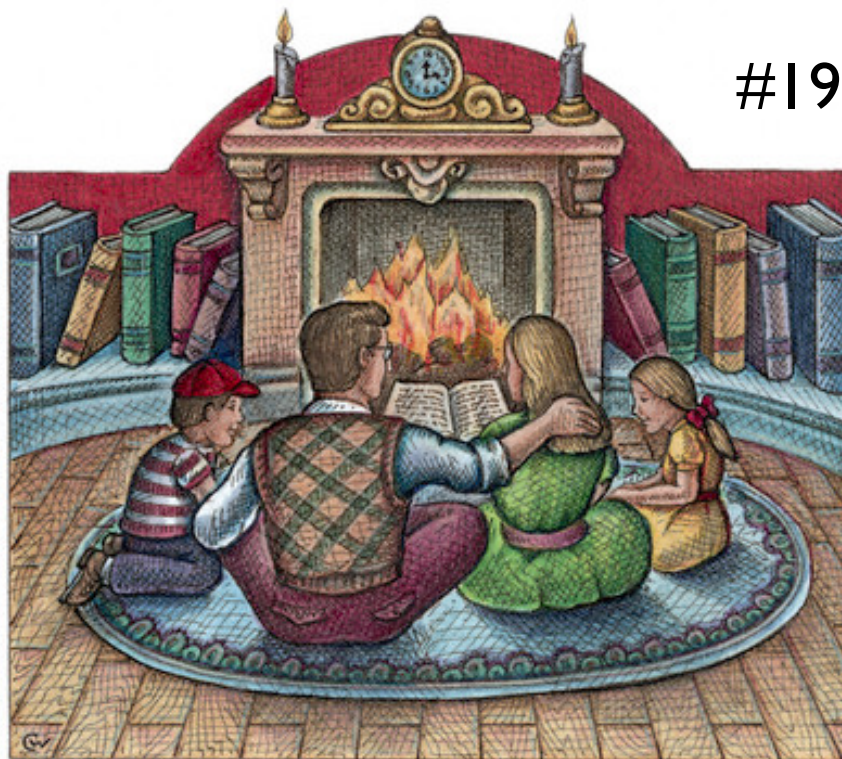
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Scene from Tin Men

#19



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	One-year subscription to the print edition of <i>The Economist</i> and online access to all articles from <i>The Economist</i> since 1997.

When I gave these options to 100 students at MIT's Sloan School of Management, they opted as follows:

1. Internet-only subscription for \$59—16 students
2. Print-only subscription for \$125—zero students
3. Print-and-Internet subscription for \$125—84 students



Dan Airely

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Au contraire! This time, 68 of the students chose the Internet-only option for \$59, up from 16 before. And only 32 chose the combination subscription for \$125, down from 84 before.*



Dan Airely

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Decoy

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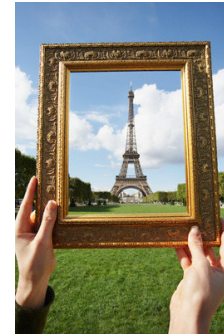
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“FUNCTIONAL EQUIVALENTS” of Framing

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Framing
matters a lot

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People can be fooled with techniques like framing because they invoke certain mental shortcuts which sometimes fool them.



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Thank you