The Walton Edge

Presented by the Oxford Alpha Fund

Volume 1, No.3 Michaelmas Term 2023

Guest Speakers for MT'23

Interview with Mohnish Pabrai, Founder, Pabrai Investment Funds

On the 21st of November 2023, the Oxford Alpha Fund was proud to host acclaimed investor Mohnish Pabrai for an exclusive interview. Mohnish is the founder and managing partner of Pabrai Investment Funds, founder and chairman of the Dakshana Foundation, and the author of The Dhandho Investor and Mosaic: The Art of Investing. He started out as an information technology consultant before making the successful switch to fund management while endorsing the same principles of value investing we embrace at the Oxford Alpha Fund.

This being the 2nd time we had spoken to Mohnish, we segmented the interview into 3 parts: first, broader questions around investing, next, building upon our past interview, and finally, learning more about Mohnish's philanthropic foundation, the Dakshana Foundation. Below, we present an abridged version of the interview we conducted with Mohnish. We are very grateful to Mohnish for taking the time to speak to us.

Q: What got you into investing; when and how did you get started?

A: My entry into the world of investment was accidental. I was an engineer by training and ran an IT services firm. I encountered Warren Buffett first through a book by Peter Lynch and some biographies, and later the Berkshire and partnership letters which opened up a new world for me. As an outsider looking into the industry, I found it peculiar that professional mutual funds were investing in a different way from Buffett's value investing philosophy, with hundreds of positions and 80% turnover, defying the principles of Buffett that one is buying a share in a business and not just a stock, and to avoid over-diversification. I thus had a theory that a village idiot following the basic laws of investing could outperform these professionals who did not adhere to principles of value investing. I was fortunate enough to have some cash which I could invest and decided to follow-through with execution.

Q: I had a similar entry into investing with discovering Buffett and the idea of thinking about stocks as an investment in a business, and we try to keep that in mind in the OAF too. One of the key concepts of Buffett and Munger is the concept of a circle of competence. How have you worked to expand that over your years of investing and how would you recommend other investors go about that?

A: We all start with a small circle of companies that are easiest to understand, usually with products and services that we consume. The circle will naturally widen as you diversify your interests and adopt the mindset of seeking worldly wisdom. Size is not correlated with investment success – successful entrepreneurs have a very good understanding of their business but might not know about anything else, yet this knowledge is usually enough for them to succeed. Munger talks about John Arrillaga who only invested in properties within a mile of the Stanford University campus and did very well. It's better to be an inch wide and a mile deep than vice versa but there's a risk that you go down a rabbit hole which does not yield many riches. There's an art to knowing which rabbit holes to pursue and if you find those with rich veins of opportunity, you don't need too many.

Q: To return to the idea of the rabbit hole and digging deeper, this leads to the idea of portfolio concentration which runs the risk of getting it wrong. From your experience, how would you know when you're digging the wrong hole and it's time to get out?

A: John Templeton said the very best investment analysts will be wrong one out of three times; most of us will be wrong half the time. The investing business is very forgiving; if you ran a 10-stock portfolio and were wrong about half the stocks – imagine the stock goes to zero – the asymmetry of risk and reward means an investor can still be extremely successful 1 out of 10 times. I have had stocks go to zero in my career; they're going to happen even if we try to reduce them.

Guest Speakers for MT'23

Interview with Mohnish Pabrai, Founder, Pabrai Investment Funds

Buffett said that 12 decisions over 58 years were what shaped Berkshire into what it is today and so we should focus on our circle of competence, stay as close to the center as possible, don't wander to the edges and definitely not beyond them, but also don't over-concentrate.

Q: How do you incorporate an assessment of management into your investing process: do you have things you look out for, and red flags?

A: The simplest way is to focus on the track record – don't listen to what they're telling you, look at what they've done, and what they said they would do and then what transpired. If we have the luxury of looking at long history of management decisions, it becomes relatively obvious how they think. We should also be cognisant of the business quality – there can be situations where management is exceptional, but the moat is mediocre. Ideally, you want business with great management overlaid on an incredible moat. But as long as you go a mile deep, you should be able to separate the wheat from the chaff.

Q: Following up on your previous conversation with the OAF, you spoke about looking for markets where people are rushing to exit; on the flip side, how would you approach markets where everyone is rushing in – for instance, Japan this year?

A: Japan may not be overvalued because it has been flatlining for so long and Japanese companies still screen cheap but there are a few challenges that come up there. The first is demographics; a declining population is a significant headwind. I would thus want to look at businesses whose fortunes are tied to exports. When Buffett bought the Japanese trading houses, their footprint was mainly outside Japan, and they were less affected by the demographic factor. The second issue is the belief Japanese companies have that the resources at the company's disposal should be for employees e.g. lifelong employment which negatively affects shareholder returns because it becomes bloated. There are many Japanese management teams that see their primary responsibility as towards employees rather than shareholders, and that's fine but you must handicap for that.

My take is that one doesn't need to follow the flavour-of-the-day; just because Japan has gone up this year doesn't tell me much, it ultimately boils down to individual businesses and their future. On the other hand, there are markets like Turkey where it's like shooting fish in a barrel after all the water has come out. I like to walk over six-inch bars rather than jump over seven-inch high bars.

Q: In our last conversation you talked about cloning great ideas from other colleagues. How do you square seeking inspiration from others versus the risk of momentum trading and crowded, undifferentiated ideas?

A: We will make mistakes and it's part of the landscape. In general, it's perfectly fine to source ideas from anywhere; smart investors are also going to be wrong half the time. When I look at a business like Reysas I have no idea when the market will recognise the real value of the business and ascribe that value to it. The market has increased the value of that business a lot since we bought it, but it still trades at a big discount, and we don't know when that gap will close.

Q: Touching on the idea of uncertainty and how to deal with it, many companies have investment committees that approve investments and you previously spoke about the importance of having one person make that final decision. To apply Munger's principle of inversion, what are some of the worst mistakes an IC can make?

A: If you look at Berkshire Hathaway, where Buffett brought in Todd and Ted under him, he made it clear they have full independence to invest in their ideas with such an extreme degree of autonomy that Buffett said he did not care if they put their entire individual portfolios into one idea. I think that's the correct approach: anything else which takes away from the independence of the manager will do more harm than good. When I was investing in Turkey, if there was any type of investment committee, they would never reach consensus. You used to never get fired for buying IBM and an investment committee would always chase comfort for that reason.

Guest Speakers for MT'23

Interview with Mohnish Pabrai, Founder, Pabrai Investment Funds

Buffett and Munger have had a difficult time finding good managers – it is easier to find good investments than good investment managers and it is very challenging to identify someone who is likely to be a great investment manager in future.

Q: At the OAF, we are also very impressed by your philanthropic foundation. What were the reasons for setting up the Dakshana Foundation?

A: The investing business is set up such that if you're even slightly above average you'll end up quite wealthy, beyond what brings you happiness through consumption. I realised close to 20 years ago that we would end up with excess wealth and you can either give it to your gene pool or recycle it back to society. After setting aside some for my daughters, I wanted the social return on my capital to be high. Unfortunately, most NGOs and charities don't really think that way; sometimes they spend 80% of the funds raised through the act of fundraising. I ran into someone in Bihar who ran an organisation called Super30 that trained underprivileged students and helped them get into IIT. The return was off-the-charts and I wanted to help him scale it. He said no, and I asked if he had any objections if I cloned the model instead, and he said sure. Different leaders at Dakshana have come up with different tangents and initiatives, and my job is to judge them against our core model and say no when needed. The focus is very important. I expected that we would fail for many years but we found our traction very quickly and the best days of my year now are when I visit the homes of Dakshana scholars. I'm blown away by the impact and the team is so passionate.

Q: Could you give us some examples of extensions or other projects that you declined because they did not meet that hurdle?

A: We will need to find other initiatives in the next few years. This particular model will run out of IIT seats and medical seats eventually: the IITs take in 16,000 students a year and it's competitive enough that I don't think Dakshana can ever take up more than 10-20% of their seats. We've looked at some things that haven't worked out.

The one model that looks appealing is Akshaya Patra which provides hot mid-day meals for schoolchildren in India. The government decided that if parents understood that schools could provide one good meal, it would be a carrot for parents to send their children to school to combat illiteracy in India. They thus give schools 50 to 75 cents per student and middlemen take 20 to 30 cents per student to provide a meal. Instead, Akshaya Patra says give us the 50 cents and we will provide a 1-dollar meal, and the quality is good enough that it would likely be 2- or 3-dollars if provided by the private sector. Their kitchens are just incredibly efficient and so we've cloned some ideas from them too. They think the same way as Dakshana about social return on capital and efficiency too. From the Akshaya Patra model it's very clear to us that students are getting very nutritious meals, and that literacy in rural areas where children used to mainly serve as labourers has climbed significantly.

Q: One last thing: from all your experiences in life, what is one thing you could leave to your 22-year-old self?

A: Something with students when they think about careers and companies is they focus on big brands and what makes people envious and this is the wrong model. The Buffett model of focusing on going to work for people you like and admire and trust is more important. Secondly, try early in life to find what you are passionate about. I found investing at the ripe old age of 30; if you are lucky enough to know what you are passionate about before you graduate, that's a huge advantage. Go all-in once you have figured that out – an inch wide and a mile deep – and you will blow the doors off.