Mohnish Pabrai's Q&A Session with Students at Indiana Univ. Kelley School of Business on April 1, 2021

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Eric: I am excited about today's speaker as he is one of the lists of folks that we've been having in on these Zoom chats and just the opportunity to get some time and pick the brain of some of these wonderful investors and authors has just really been exciting to me and I hope to you as well. Our guest today is Monish Pabrai, and the Pabrai Investment funds were inspired by the original 1950s Buffett partnerships and our close replica of that original partnership with its rules. The Pabrai Investment Funds managing partner is our speaker today. He is a hardened disciple of Warren Buffett, and he closely follows his principles on value investing and capital allocation. From its inception in 1999 through December of 2020, a hundred-thousand-dollar investment in the Pabrai Investment funds has grown to over 1.4 million dollars after fees and expenses. The funds have beaten the DOW, NASDAQ, S&P 500, and the vast majority of mutual fund managers over the long term. Mr. Pabrai, before being an investor, was the founder and CEO of TransTech which was an IT consultant system integration company. He founded that in his home in 1990. He bootstrapped the company to over 20 million in revenues before it was sold in 2000. TransTech was recognized as the Inc 500 company in 1996. Mr. Pabrai been profiled in Forbes and Barron's. He appears frequently in CNN, EBS, CNBC, Bluebird Television and Bluebird radio. He's been quoted by various leading newspapers, including USA Today, Wall Street Journal, Financial Times, Economic Times of India. He's an author of two books on value investing: "Mosaic, The Perspectives on Investing", and "The Dhandho Investor", which many of you have read. That's been translated to many different languages, including German, Mandarin, Japanese, Thai, Korean, Vietnamese, Spanish. Mr. Pabrai is the winner of the 1999 KPMG Illinois High Tech Entrepreneur Award given by KPMG State of Illinois in the city of Chicago. He's a member of the Young Presidents Organization. He's the founder and chairman of the Dakshana Foundation, which is a public 501(c)(3) corps that focuses on poverty alleviation through education. They alleviate poverty by identifying brilliant, but impoverished teenagers and providing intensive coaching for the IIT and medical entrance exams in India. He loves playing Duplicate Bridge, and he also has recently received a lifetime ban for playing Blackjack at one of the Las Vegas casinos because he was winning too much with his system. We might have to have him back and talk to us about that system sometime. But he is a gentleman who's an accomplished author, investor, entrepreneur, and philanthropist, and I'm excited to introduce Monish Pabrai to the class. With

that, I'll open it up for some opening comments from Mohnish, and then we can go into some Q and A whenever you like.

Mohnish: All right. That's wonderful Eric, thanks for that generous introduction. I used to run an IT services firm in Chicago in the 1990s, and maybe around 96, 97 we had hired the first couple of IU grads kind of young kids who were out of school maybe a year or two, and I was really impressed with them. They were really good. I asked them, "how can I get more of you?" They said, "we should go on campus and recruit". TransTech was growing fast at the time. We were hiring almost like one person a day. We set up a campus recruiting program at IU and for a few years, I accompanied them to Bloomington. Those were some fun trips. We did get some more IU talent, which was wonderful. I had a little bit of an intersection at IU, maybe close to a quarter century ago. Please whatever was on your mind. Let's go through it.

Eric: All right. Because it can be kind of tough on these Zoom sessions up, I've got some questions that you guys submitted. If you'd like to ask a question, just throw something on the chat and I can call on you. Don't be shy about that. But I'll start us off with a couple of our students that asked questions. I kind of aggregated some of the questions if they were similar. Sean Mahan and Kelly Direct Jay Gordon in the MBA program wanted you to talk a little bit about, just given all the investment opportunities out there, how you identify which ones you want to dig in on further before deciding what to buy. What types of screens might you run? Are there multiples or ratios that you really favor or avoid? How do you go from this huge universe of stocks to the one you're actually going to spend your time on?

Mohnish: Yeah, that's a good question. Well, there are a number of different ways one can go about it, and there're a number of different ways I go about it. One needs a system where one can eliminate large slots of companies where each company doesn't take more than a few seconds or maybe a minute. When I look at a business, the first question that's going through my head is, is it within my circle of competence? A lot of companies would disappear based on that question. There are also entire industries I don't have much interest in. US healthcare is very corrupt and does not operate with market forces. Pretty much anything in US healthcare, I either consider outside my circle of competence or no interest. If there's a biotech company, if there's a hospital, if there's a pharma company, if there's some CVS, Walgreens, that sort of thing, generally speaking I'm not interested in those kinds of businesses. It's a very quick pass. Similarly for defense contractors, I'm a little skeptical about the kind of long-term nuances and whether things are as clean as it should be and so on. Not much interest. Also, a lot of tech names tend to be highflyers and they tend to lose me on valuation and such. Even there we have done pretty quickly. I mean, if I look at Snowflake, it will take me like about 15 seconds to move on. A lot of things get eliminated relatively quickly. There has to be something that's drawing me in. One of the things I do is I look at Value Investors Club. They have thousands of companies posted on the club, and people are

continuously adding ideas. Generally, that is a somewhat filtered list because there's a lot of restrictions on who can post ideas and the rules, they're off. It's a good place to go hunting, it's also a very good place to learn because many of the write-ups and the comments are very insightful. Value Investors Club is one possible source. Value line is another source. I have a subscription to Sum Zero, which is another source. Then I typically get several investment ideas emailed to me pretty much every day by folks across the world. I look at those as well. Again, many of those may not fit for a variety of reasons, but when you go through all of this, some ideas and some companies stick out and then I'll spend more time on them. The objective when I'm looking at a business is to as quickly as possible, say no and move on. If I can say no in 15 seconds, that's great. In some cases, it might take a minute. In some cases, it might go to 15 minutes, and then I might say no. In some cases, it might go to a few days. But the idea is to be really good at saying no. The business should be able to convince a very deep skeptic that it deserves more time and a spot in the portfolio. That's generally how I go about it.

Eric: As a follow-up, one of our students Justice Boys asked, "you mentioned your circle of competence. How do you kind of balance the idea of a circle of competence and diversification within your portfolio?"

Mohnish: Yeah, I don't think one needs to compromise on the circle of competence for diversification. Diversification actually is overrated. If you look at most entrepreneurs, Sam Walton and others through their entire lives, they have no diversification, and they didn't have any sleepless nights because of that. There are also examples, I always give the example of Charlie Munger's friend: John Arrillaga, who only invests in real estate within two miles of the Stanford campus and he's a billionaire. His circle of competence is extremely narrow. It's not even real estate, it's real estate in a very specific geography. If you looked at his portfolio, you would say, well, this looks very concentrated, but that has not stopped him from doing extremely well. Even if you understand just a couple of things, or a couple of industries, or even a single industry and your portfolio was focused on that industry, or even focused on just two or three stocks, as long as the competence is solid, one should not be compromising to get more diversified.

Eric: As you're trying to look through your circle of competence, what kind of level of knowledge do you have in order to feel comfortable that that's included in your circle of competence?

Mohnish: Yeah. To ask the question is to answer it. If you find yourself asking yourself the question, is this within my circle of competence? I can just make it very quick for you, it is not. If you find yourself asking a question, what is this business worth? Again, it's not within your circle of competence. If something is in your circle of competence, you would know it really well. You would know the two or three variables that would drive most of the outcome in the long term, the valuation of the business would be quite apparent. It is very important to stay

dead center in your circle of competence. Usually there is not a fine clear boundary between competence and incompetence. As you move away from the center, the degree of competence goes down and the risk factors on investing in those businesses goes up. As close as you can stay to the center of your circle of competence is the critical part. Don't be concerned that you don't understand many things. I'd say I probably don't understand 99% of stocks and I'm not particularly breaking out hives about it. You don't need to understand a lot of things. You just need to understand a few things well and stick to those few things.

Eric: Great. Kris Morton asked the question in chat. Are you able to ask it or do you need me to ask it, Kris?

Kris: Yeah, I can ask it if you want.

Eric: Yeah

Kris: In Dhandho Investor, you had an example of a business you had to research to become competent, I think it was shipping mergers. My question basically is in the context of that example in the book, when you're first starting out in the investment world, when do you recommend digging in to become competent in a business versus taking a pass? Does that make sense?

Mohnish: Absolutely. I think the shipping company at the highest-level shipping isn't that complicated. I was intrigued by a few things I had read, so I said, "Let me dig in some more here to understand". I believe the business was in these ships that were VLCCs, very large crude carriers, and at the time there were like 400 of those ships in the world. These VLCCs are specialized ships that transport crude. I didn't think the shipping was too difficult business for me to get my arms around. I wasn't very familiar, or I wasn't familiar at all with crude shipping, but I was curious about it. I said, "okay, let me see if I can read up on this and understand how the business and the industry works. And it didn't seem that complicated to figure out". I was able to use a heuristic that one of my friends in commercial real estate had told me, and I realized that that same heuristic and that same mental model would work in shipping. There was an insight which I had gleaned, and I thought that that insight would work in this area as well. In commercial real estate, especially if you're talking about tall office towers, 30, 50 storey type office tower in large metro areas, generally speaking, those office towers may take four to six years to get bill to come to fruition from the time that someone has the land and creates a plan and tries to get the permits, it might be easily five years before the building is ready. Generally speaking, what happens in real estate is that when the market is really tight and when rents are rising a lot, a lot of these projects get started because the economics look so favorable. Generally, what happens is, because there's lemming behavior, all these towers get started at about the same time, and they get delivered about at around the same time. You go from a very tight market to a depressed market because there's too much supply. This five to

six-year gestation period in office towers leads to booms and busts in commercial real estate, we don't see that same nuance in, for example, industrial space or commercial warehouses and those sorts of structures, because there, you could be done with construction in 12 to 18 months. Because the timeframes are so short, you are typically able to turn on and turn off the spigot relatively soon versus while looking at what the situation is. But you're putting up a 50-storey tower, you're already up to the 25th storey. It doesn't matter what the market is doing, that baby's going to get delivered and it's coming out regardless of whether people want that child or not, that baby's coming out. I noticed that when I was looking at the VLCC market, it had a similar attribute. There are only three or four places where these ships get built, mainly the Korean shipyards. If you wanted to get a new VLCC, you'd go to one of the Korean ship shipyards, and put down a deposit in about three years or so, they would deliver you a ship. If the queue was long, it might take longer. These shipping rates in VLCCs, I noticed, had very extreme fluctuations.

They could go as low as $5,000 a day to as much as 200 or $250,000 a day. There was a very wide range way more than commercial rents. Commercial rents in office towers do not have a 50 to one variance in rents over even decades. But in the shipping business, you can see pretty large variances. Whatever I had learned about the office tower business, I realized that it was on steroids in the VLCC business, and the booms and busts would get even more exaggerated because of that huge variance. These were some of the factors that made it interesting to look at that business. It was really understanding the dynamics of how daily rates are determined for shipping crude oil and how you couldn't instantaneously increase the fleet, even if demand went up, because it would just take time to build those ships, et cetera. I think what you can do is if you are curious, I think that learning about different businesses and learning about different industries and nuances is always been of interest to me. I love to kind of know how the world works, whether we get to the point, whether we can make an investment or not is a second question. Sometimes we can read or learn enough that we feel we've really got it nailed. We understand the dynamics that would drive that result. Just to go a little further because there's so much great learning in that shipping. An example is the company I was looking at, at the time is called Frontline, and they were the largest operator of VLCCs in the world at the time. I think the global fleet was around 350 to 400 ships, and they had about 80 ships.

The unusual thing about Frontline was that a hundred percent of their fleet was on the spot market. There are two ways, if you are a ship owner, that you can run your fleet. One way is you can sign long-term lease agreements with, let's say for example, Aramco or Exxon or whoever, some refiner, so that they would say, yeah, I will lease your ship at $20,000 a day for the next two years, for example. In that case, whether they're using the ship or not, or whatever's happening, you're getting paid. Your cash flows are really stable. Or you could be at the other end of the spectrum where you're saying, I'm only willing to rent

per voyage. When you have a ship that needs to go from Saudi Arabia to Louisiana, and that journey may take maybe 25 days or something, you can rent the ship for 25 days on the spot market at that time. Frontline had their entire fleet on the spot market, they also had debt on their ships, but the debt was tied to individual ships. It was like a mortgage on each ship, and it was non-recourse to the parent. At the time I was looking at Frontline, shipping rates had collapsed mainly because demand for oil had gone down and shipping rates had collapsed to less than $10,000 a day, eight or 10,000 dollars. At those prices, they're losing money. They cannot make ends meet at that price. When shipping rates collapse like that, there's a second nuance that kicks in. I'm sorry, I'm taking a little bit of time, but just to explain kind of how things work, because these are all things I learned when I was looking at it is after the Exxon Valdez went to ground in Alaska there were a set of new regulations that came out around oil carrying ships.

They mandated that all the new ships that get built needed to be double hulled. All the ships that were built after the Exxon Valdez crash were required to be double hulled. The ships before that Exxon Valdez incident were single hulled. In the shipping business, when you rented these ships, single hulled ships, which still existed, they were older, rented for lower rates per day than double hulled ships. But when rates collapsed like below 10,000, what that meant was they were too many ships. Nobody was renting single hulled ships because the delta between single and double hull disappeared. Typically, there were these Maverick Greek owners of these single hall rust buckets, and they're sitting on this fleet and no one's renting it. Scrapping of, those ships skyrockets during those types. The ship owners look at it. One thing that real estate guys do is they project present circumstances to infinity. If current rents are high, they believe rents will always be high, and the ship owners are even more extreme than the real estate guys. If the shipping rates are quarter million a day, they believe they will always be quarter million a day, and they all go to the Korean shipyards and place a gazillion orders for ships all at the same time. When these ship rates are low, like eight or 10,000, all these Greek ship owners rush to all the scrapping yards and say, take my ship and give me the price of the metal because they just assume they'll never be rented or whatever else, and so on. They know that there are these maritime regulations that make it harder and so on. What ends up happening when rates are low is, the fleet decline from 400 ships to 370 ships or 350 ships because of all the scraping, then when oil demand comes back up, now you don't have those 50 ships.

Typically, what you would see is that it would go even more asymptotic than Bitcoin. The shipping rates would go from 10,000 a day to 200,000 a day in the space of three weeks or two weeks, it would go really fast because literally, you couldn't find a ship, right? Everyone's clamoring for them. When I looked at Frontline, I did a really simple calculation. I said there was a website that would tell you what the selling price of these ships was. I just looked at their fleet and said, okay, if you shut down the business and sold all the ships, what would you

get and how much is the debt? What would you end up with and what's the stock price? The stock price was, I think, 4 or $5. The liquidation value was 8 or $9 per share. I said, there's no way to really lose money over here because if all hell breaks loose, they can keep selling ships, and as they keep selling ships, they'll make more than the stock price. I put about 10% of the fund's assets into Frontline, and in a few months, it shipping rates started to go up and it went up to like 10 or $11 a share. I had a very nice gain in a relatively short period of time, and I exited Frontline, patted myself on the back and moved on. Then when I looked at Frontline, I think a year or two later, it was over $150 a share. I missed that entire ride because like I said, it went to the other end, which was euphoria. Of course, my whole thesis was around just something where I couldn't lose money, but I could have been a little bit savvier about the fact that when you have these extreme compressions, you're probably going to see a pop on the other end. I could have, for example, kept a small position or something, but such is life. Sorry to tell you more about shipping than you ever wanted to know.

Eric: No, that's good. I would like you to circle back around a little bit in talking about diversification, obviously, in the academy, we're quite big on it. Then if you look at most of the money management industry, they've taken that to where folks hold, sometimes hundreds of names in a portfolio. What do you think about diversification? How many stocks will you hold? You mentioned frontline, you had that 10%. What do you think about kind of portfolio construction?

Mohnish: Yeah, I think at Pabrai Investment funds, we have never invested more than 10% of assets in one position. Typically, that's our preferred situation. Kind of a 10 by 10 portfolio, if you will. But what I have historically been unwilling to do is cut the position back. We have had situations in the past where two stalks make up 70%, and I don't lose any sleep over that. I'm not a big proponent of cutting the flowers and watering the weeds, just not very interested in doing that. The portfolios will tend to get more concentrated, and I would not make a change purely from the perspective of unquote risk management or anything like that. I would look at the business and look at the nuances around those businesses and see what made the most sense. In my personal portfolios, I rarely have more than three stocks. Many times, I have one stock and even in our foundation, we tend to be quite concentrated because there just aren't that many ideas that you can find that you understand well and are deeply mispriced and so on. Most people would not be able to sleep well at night doing what I did or doing what I do. You definitely have to do things that give you comfort.

Eric: One of the students, I think Mike McCarthy in our Kelly Direct program had listened to an interview that you did and talked about how you focused a lot on India and emerging nations, and it's harder to find mispriced securities in the US There were a number of questions that were put in of what is your view on efficient markets? Is the US an efficient market where we should only be

looking at other places or, are there various levels of inefficiency? Maybe you could touch on some of that.

Mohnish: Sure. I think its efficiency or inefficiency is not directly related to specific markets. There were times, and there will be times in the future when US markets would be very inefficient. I don't believe that the inefficiency that exists today in the US markets are leading to a lot of securities that are undervalued. I believe the inefficiencies currently in the US markets are in sectors, which I believe are overheated and overvalued. There are pockets where I think it's probable that things are, since I don't short, that's just academic, it's irrelevant. When I am specifically looking for undervalued names in the US presently, those are few and far between that I can find right now. Especially I'm looking for significant discounts. I'm not looking for something that's worth 10 and selling for eight or something like that. I'm looking for something worth 10 and selling for four. That doesn't exist much today, but it has existed in the past and it will exist in the future. Different markets around the world are at different points in that cycle. Some markets of the whole markets are very cheap, and in others there's just more inefficiency on both sides, undervalued and overvalued. I think that other markets being able to look into markets outside of the US could be of some advantage to an investor.

Eric: You mentioned a philosophy against shorting. I think Ade had a question from an article read on the on the website that you had written a number of years ago. Ade, are you able to come on and ask your question?

Ademola: Okay, thanks. Yeah. In one of your articles, you said, when you look carefully at the economics of study, it makes no sense to take the bet. However, some advocates say that the use of short selling as a long-term strategy in combination with long position can help balance your returns. In other words, you make profit in both rising and falling markets. My question is, has your views changed in the light of this philosophy? Thank you.

Mohnish: If you look at the top 10 wealthiest people on the planet, top 20 wealthiest people on the planet, top 50 wealthiest people on the planet, I don't see any short sellers in there. If shorting is such a great activity, why don't I see these awesome short sellers in the Forbes 400? Why don't I see them there? That list is dominated by two characteristics, people who are long only and people who are non-diversified. For example, my hero, Sam Walton and the Walton family and, so on or Bill Gates or Jeff Bezos and so on. These are all long only players. If you're mathematically inclined on paper, it looks really nice that I can go long 10 stalks that I think are undervalued and then short 10 stalks that I think are overvalued and create alpha and all of that. There are some people who are very gifted at that and who can do very well. But the issue with shorting is that it comes with a need to be really good at risk management. Let's say, you shorted Tesla at $50 a share. Typically, what a short seller would do if they knew what they were doing is, each time Tesla went up 10% of price, for example, they would cut their short position by 10%. By the time it got to a hundred or

something there off, they're out in effect, right? That's how you manage the risk, because as it's going up in price, your losses are magnified quite significantly. On the other hand, typically the way they manage it is that if Tesla goes down in price, as it goes down in price, they increase the short position.

If they're short at a thousand shares, at 50, they at 45, they might make it 1100, and at 40 they might be at 1200. You're typically playing this game where you are doing this. I think even the best short sellers, the way they measure their results, they would say, "look, if the S&P long term has done 9% a year, and I have long term lost 3% a year, it's an exceptional result because I created 6% alpha". Well, I don't see how that gets you on the 400 other than by convincing people to give you fees for losing 3% a year. I have a couple of gurus, Warren and Charlie. What they say for the most part makes a lot of sense to me. They say specifically when they had companies that they believe were great short candidates, they were almost always right about the company, but always wrong on the timing. It's really hard to get both the timing and the direction correct. It is so much easier to make money on the long side. The other thing is that if you're short, you got an umbilical cord link to a court machine, When the market's open, like, I have no idea what's happening to my portfolio right now. I mean, I have no leverage, I have no shorts, and quite frankly, it's irrelevant what happens today or tomorrow or next month and so on. Even if I never got to see any stock quotes, it's perfectly fine. That is not how a short seller lives his life.

Eric: Very true. Patrick O'Neill, one of our MBA students, wanted to know more just about how your process, you've started to identify a name and how you go through the research process, and specifically what kind of sources of information do you find are the most impactful. Is it going through the case, the earnings calls, and research reports? How do you go through your process and what are the important items that you get the most out of?

Mohnish: Yeah, I think with each situation, it is different. Sometimes there's a great write up on Value Investors Club, and that'll get you quite a way along and then you can dig through the company's filings and especially what they've been saying a few years ago about their business, maybe five years or 10 years ago, and versus what has transpired. Do they under promise and over deliver or vice versa. I think the idea is that it's kind of like a treasure hunt in the sense that, oh, it's a jigsaw puzzle more where you got some understanding of a business, have some thesis about why this could be interesting, and then you are looking for evidence that confirms and denies that and just keep absorbing. I'm always looking for a flimsy reason to stop research and be done and move on. Like recently, I was looking at a company and it looked interesting, but after about three days of digging, I was like, "yeah, this is not interesting, we're moving on". But the good news was, I learned a lot about the industry, I learned a lot about the company and the CEO. Those are all good things. It gave me a good amount of data and knowledge, and I enjoyed the process.

Eric: How long do you typically hold the stock?

Mohnish: Well, there's a quote which I ran into last year, which I wish I had run into 20 years ago which is, I think a quote by Thomas Phelps who wrote 100 to 1 in the Stock Market. It's a great book he wrote in 1972, I can't recall the exact quote, but basically, he's said to the effect that every sell decision is in fact an investing mistake, anytime you sell your, in effect, in effect, acknowledging that you made an investing mistake. Utopia would be that you made an investment that you could hold for a few decades, and that would be compounding at a solid double-digit rate over that period. You didn't have to do anything. You just sit on your ass and the company just kicks ass for you. Such businesses do exist and it's easy to identify them in hindsight. It's a lot harder to identify them before that's happened, but that's the holy grail. I went through quite a significant change in my thinking last year. For a couple of decades, my thinking was like, with Frontline you buy it kind of half off and then you double your money, and you move on and prints and repeat and that is fine. It can certainly be a good way to make a buck, but it is tax-inefficient and you're on a treadmill of activity. Even in the case of Frontline, I miss the big run. I captured my double, but I didn't capture the big run. My thinking now is much more around compounders. It's around questions like, what is the destination of this business in 10 or 20 years?

What does this business look like in 10 or 20 years? Of course, a business like Frontline just couldn't get there. I mean, the only thing you could do with business like that, from my point of view, paid the arbitrage game of liquidation value versus the stock price. It'd be very hard to hold it on earnings because it was so volatile. I think the holy grail is to find these compounders that the rest of the world has not figured out and then you just sit on your ass. That's the game plan.

Eric: That sounds a lot to me like kind of the transition that that Buffett kind of had in his career, where you started out looking at net-nets from the Ben Graham days, and then started transitioning in into more that, obviously when you're on the first side, where you're just trying to get something valued and buy it at 40, 50 cents on the dollar, that seems to be much more kind of formulaic than finding that. How has your process had to change what kind of valuation discounts because obviously those companies may not get down to 40, 50% as often as a commodity company might. How has that philosophy changed how you do things?

Mohnish: Yeah, I had dinner with Charlie this past weekend on Saturday at his place, and he looks great and doing well. Many times, when I see him, he will say XYZ company is a cinch, or ABC company is not a cinch. For example, if you asked him about American Express, Charlie would say it's not a cinch, but if you had asked Buffett and Munger about American Express, maybe 20 years ago, they would've said, it's a cinch. What it means is that the odds that you would have something destroyed that franchise was just so infinitesimal at that point,

which is not the case in their minds today. It's a very good business, it probably does really well, but in the definition that he uses of a cinch, which is a pretty high bar, he doesn't think it's a cinch. It's very funny, when I have these conversations with Charlie, I'll ask him, Is it a cinch, Charlie? No, this is not a cinch, this is a cinch, blah, blah. Once Charlie says something is a cinch, and if it's sitting at a cheap price, I know all I got to do is back up the truck, and life is good. One thing that changes when you're looking at these 50 cent dollar bills versus these long-term compounders, is you need to get as close as possible to a cinch. I haven't asked Charlie this, but if I were to ask him, "Charlie, is Costco a cinch?" He would probably say, "Yes, Costco is a cinch". Okay? Because it's very hard to imagine forces that would destroy Costco today. In fact, each time they open a store, the moat becomes that much more valuable. Each time they add a member, the Moat becomes more valuable. On both sides, you've got this deepening moat effect taking place every day. The question when you're looking at these long-term compounders is, is a fanatical focus on near cinches. If you're not going to sell the business for a rate very long time, capitalism is brutal. 99% of businesses that get started won't even last 10 years. Even Fortune 500 companies won't last more than a few decades. Eventually, almost all of them will die. Trying to find the exception to the rule is, in many ways, the fool's art, but that's also the path to getting to the promised land. Cinch is a very important mental model, which I think is really interesting and important. There's a good friend of mine, and he used to work at a multi-billion-dollar fund. Many years ago, maybe this must be more than 10-15 years ago, he was the analyst looking at American Tower. The company had organized a fuel analyst at these large firms to visit their headquarters and they were going to have some presentations for maybe an hour. Then they were going to have lunch, and then they were going to have a golf game with the CEO, CFO, and a few other people. He showed up a little early, and he was sitting with the CFO in his office, and the CFO had his feet on his desk. It didn't appear to my friend, like the CFO had anything to do, he was just sitting there relaxing. My friend asked him "don't you have deals to do? Like, you're just sitting here. Don't you have things to do?" He said because, they're a very acquisitive company. They buy lots of towers. That's how they grow. He said, "Look, anyone who owns a tower has our phone, and anytime they want to sell a tower, they can call us. We already know what we are going to pay for the towers. We just sit here, the calls come in, we give them our term sheet, and life goes on. Then we keep acquiring more and more towers". Each tower is getting more and more valuable over time because they're hanging more and more tenants off all of this stuff, right? There was another company called Bandag, which was in Iowa, they're retreading tyres. Chuck Akre had visited their headquarters a few decades ago. Again, when he went in to see the CEO, he saw the guy had his feet up on his desk. If the CEO has his feet up on the desk, generally speaking, that's a kickass business to invest in.

The first question to ask is, is it a cinch? Okay. Like Amex is not a cinch, and Costco's a cinch. That's a high bar. The second question is, is this a business that

the guy can run with his feet on his desk? Most businesses cannot be run that way. If the guy puts his feet on his desk for half a day, in three months, he'll be out of business. That's the reality with most businesses. Then there was a third one. I was thinking it'll come to me, let me think about that. But I was just thinking that, it's a very different way of thinking about it, right? One way of thinking about it is these 50 cent dollar bills, blah, blah, blah. The other way is you're going after these long runways. Basically, the way I look at my portfolio now, it's a museum. Eventually what that museum has to have is only cinches and only feet-on-desk businesses. Let me be very candid with you. I am not in the promised land right now. I only have two businesses that I can think of where they are cinches and the feet are on the desk. But two is not bad. The idea is, hopefully in the next few years, all these Mickey moat businesses go out of the portfolio and get replaced with these awesome businesses. Oh yeah, the third question to ask is, "what is the destination?" If I look at a business like Costco, they just entered China, they opened one store in China, and the store got mobbed.

They had to put restrictions on how many people could come in because they just couldn't handle it. If you fast forward 20 years, what does Costco look like? I don't know what it looks like, but it's possible China has a thousand stores, could easily be with the realm of possibility. They're probably more than 160 or 170 countries where Costco has no presence. Could they have a presence in 10 more countries in 20 years maybe? What does that business look like in 20 years? It probably looks a lot better as long as the culture stays set, and the core DNA of Costco remains intact. That's a business that, at least looking at it in 2021, looks like a cinch with a great destination. The question to ask yourself is, "what is the destination?" If you ask a question, well, what is the destination on Frontline? Your head will go into a tailspin, you got to deal with all the Greek owners and figure out what they're doing. Then you might get some ideas. That's the thing, cinches feet on the desk and awesome destinations.

Eric: Mohnish, then, if you're looking at, Costco, and that checks those boxes, then are you trying to value it on where it's at currently? How much are you giving it for its destination? What do you think about?

Mohnish: Yeah, the problem for someone like me is, I want to have my cake and eat it too. I want a cost worth three times earnings, and it's slightly about three times earnings. Let's look at what God Google says Costco's trailing multiple is right now. The trailing multiple, according to Yahoo, is 36. 36 is not bad for a kickass business like Costco. But for a cheap skate like me, at 15 times my earnings, you lost me. I would go above three for Costco. I might be interested to even look further at low double digits. But when you get past that, you lose me. Such is life.

Eric: Mohnish, Alex Scott, one of our MBA students in one of your interviews talked about kind of a pre-investment checklist you go through and he wanted to know what items or questions might be on that list. Can you expand on that?

Maybe is it the cinch for the first couple or three. Could you go through kind some of those attributes on your checklist and how those came about?

Mohnish: Yeah, the checklist is a living, breathing document. I just recently added these three questions to the moat section checklist. Is it a cinch? Are the feet on the desk? Is the destination awesome, right? You already have three out of the 170 questions already. The other 167, I'm not inclined to list here right now. But I would say that it's not that difficult to come up with a good checklist. All I did was, I looked at how great investors lost money. Like I looked at businesses that Buffett and Munger and others invested in, where the end result wasn't great. Then I looked at were there, were there things known before the investment was made that could have prevented you from making that investment. The checklist basically asked the question, for example, Buffett made an investment in Dexter shoes, and it did not work out well, and they got decimated by foreign competition and cheap Chinese labor. For example, the checklist question would be, is this a business that could be negatively impacted by cheap overseas labor? That's a checklist question that would come out from that. When you look at a business like Amex, the answer would be no. Even if you look at a business like Costco, the answer would be no. But there are definitely manufacturing businesses in the US where you would want to ask that question and figure out what the realities are.

Eric: Mohnish, in your book, you talked about kind of these infrequent big beds, and I think it's a form of the Kelly formula. Do you use the actual Kelly formula or do you just figure out 10% is kind of as much as you would put for your customers? How do you use the Kelly formula when you're trying to put together the portfolio?

Mohnish: Yeah, in my book, if I were to ever do an updated edition, I would take out the Kelly formula. Kelly Formula is actually a mistake in my book, basically, it does not apply to making stock investments because it really works if you get to make the same bet 10,000 times. If you knew that heads were 51% and tails were 49% and you were allowed to participate in 10,000 coin toes, well, you would bet on heads all the time. Then the formula would allow you to determine that if you have a thousand dollars, how much to bet each time so that your bankroll doesn't disappear, and you optimize the upside. The Kelly formula works if you have those sorts of nuances in betting, that is not the nuances we have in stock picking, because we don't get to make the same bet over and over. I would just disregard everything related to the Kelly formula as far as stock investing goals. The 10% just came about because it just felt comfortable to me. When I came up with it, I said, this sounds like a good, diversified portfolio. I think what I've come to realize is that in my personal portfolio, I'm fine with even higher concentrations, but I really have to know the businesses extremely well with other people's money. I think the 10% is fine from my point of view.

Eric: Mohnish, how do you go about setting kind of the intrinsic value that you on is the use of DCF? How do you go about that? Then I think in your book you talked about using some scenario analysis and what it would be valued under different scenarios. How many scenarios kind of make sense if the business is simple versus complicated?

Mohnish: Yeah, I think it depends on the business. I mean, if you were looking at Costco, you would need to have some range of future stores, future memberships, future kind of profitability per store, all those sorts of metrics. You'd have to have some numbers along those lines in your head. Then you could backtrack from that into what might be a reasonable price to pay, and then what return you might expect. I think with each business, it is different. I think it just depends on the business and depends on what's going on with the company. The analysis varies by the nature of the business and these numbers. I'm not a big fan of DCFs. I think anytime you reach for Excel, I gave a talk on the 10 Commandments, Moses kind of made up the 10 Commandments, the real 10 Commandments. One of them is Thou shall not use Excel, and if you find yourself reaching for Excel, it means there's a problem. Like, I know that if I can get Costco at nine times earnings, I don't need Excel to tell me I'm going to make money.

Eric: Do you use the same hurdle rate for all the investments and try to do a risk control just through your research process? Do you change it and have your hurdle rate come down kind of those interest rates have come down or do you believe more of an absolute hurdle rate for your investments?

Mohnish: Well, the hurdle rate also has changed quite a bit with this approach of buy and hold forever. Because if you take the approach of holding a business forever, I mean, let's say Costco went to nine times earnings and I bought it, et cetera, and then in a few years it's at 40 times earnings. My take on a business like that would be that "just leave it alone, don't sell it". Even though it is probably true that the returns from that 40 times earnings number aren't as spectacular as they were from the nine times earnings number and the risk is higher. But the idea is that if the family that owned Costco probably would not be looking at that multiple and selling, my nuance needs to be like the family. The key question is, is the business getting better? Is the moat getting deeper and is the company becoming more valuable? If those answers are yes, then I just leave it alone and not worry too much about what type of return it would generate in the future.

Eric: Mohnish, I have a question from Rohan Malkar, he's one of our MBA students, and he talks about some of your philanthropy work how do you apply some of the investments from, or tenants from your investment? How do those carry over into social work? How do you do a return on investment if you're looking at philanthropy?

Mohnish: Yeah, I think when I first started to look at giving back, because I was seeing that, if the compounding works, you end up with more money than you can use and giving it your gene pool isn't the smartest thing to do, you're actually hurting them more than helping them. I was very disappointed when I looked at a lot of charities because I wanted to find a charity that I could give money to. I found that either they had many different initiatives, which itself is a problem because if you have three initiatives of a charity and you measure the outcomes and one is better than the other two, then the following year you should be one initiative, put it all into the one that has the highest return in for society. But that's not how charities function. The thing is that if a business does not do well, and does not service its customers well, it'll eventually go out of business. But if you are the Rockefeller Foundation and you have a billion-dollar endowment, for example, billion dollars in assets, the law only requires you to spend 5% of that in a year. They'll spend 50 million, and it doesn't matter what happens to the 50 million, whether it helps society or not, the next year, the 950 million would've probably grown to, again, over a billion because of the investment returns. Probably 4 or 5% is not that hard to get. You again, have a billion, you again spend another 50 million, you could keep spending 50 million stupidly a year for 50 years, and the engine would keep going. A business like Costco, if it doesn't deliver value to its customers in a few years, it will disappear.

There is no feedback loop in philanthropy that autocorrects, capitalism works because of creative destruction. In philanthropy, that's not the case. On top of it, what happens is Principal Rockefeller created wealth. Now it's a bunch of agents who are running everything. What do the agents care about? Well, the number one thing they care about is getting paid. They have nice jobs, they get paid well, everything is stable. They're not going to spend the whole billion in one year. They'll just keep rolling out the 50 million. Nobody put out a glitzy annual report, show some pictures of some good things that you've done, and life goes on. Now no real measurements of impact. What I did when I started Dakshana was that I did not want to go down that path. I wanted the impact to be known and measured. So most, most endeavors in philanthropy do not lend themselves to easy measurement. I mean, if you are distributing needles in some inner city to help people not get HIV and such, it's a very good initiative. The measurements become much tougher. What was the impact? How much did this help or hurt or whatever? Those things become really hard. What I decided is that I would limit myself to programs that let themselves do easy measurement. I inverted the problem. I said, even if an initiative is really good, if it doesn't lend itself to easy measurement, we are not going to do it because then there's no feedback. Dakshana went down a path of education. Education was near and dear to me. I saw the multiplier effect it could have. Then we have a system where we get independent third parties giving us a report card every year. That report card is very valuable to us. I pay a lot of attention to it. Our management teams pay our attention. Now recently we put in incentives where a significant portion of our faculty comp and all of that is based on the

results that they don't control. I think those are important things for non-profits to look at and consider.

Eric: We had some different questions about behavioral finance and so forth. One came from Max Kim who wanted to know if you could maybe talk about maybe a large setback you've had in investments. How did that impact your confidence and how your process keeps you from overreacting to something like that and still keeping with your discipline?

Mohnish: Yeah, there's a saying, "if wealth is lost, nothing is lost, If health is lost, something is lost, and if the character is lost, everything is lost". The question relates to wealth being lost, which quite frankly, in the large scheme of things isn't that meaningful. It is in the nature of investing that if you make 10 investments, at least four of them probably won't work out the way you expected. They'll work out worse than you expected, and it could be five or six out of 10 that work out worse than you expected. Anytime we are trying to project the future of a business, it's not an easy endeavor. I mean, who could have projected we'd have a pandemic? It just came out of the blue. If you had asked me once we knew we had a pandemic, what stock prices would look like a year from now, I would say they look terrible, and I'd be completely wrong. The way the future unfolds is so different from the way we might rationally think it ought to unfold. I think that having investments not work out or having investments go south is just power for the course. Obviously, I would not like to lose money and not like to lose money on investments. But it has happened. It has happened many times in the past. In fact, at Pabrai Investment funds, I've had several zeros where the company has gone bankrupt and we collected next to nothing versus what we invested. I made an investment in a mortgage company in 2006-2007 Delta Financial, I think 50-60 million dollar investment went to zero. We used to have an investment in a zinc recycler, horse head holdings, significant investment went to zero. Then countless investments, which either went flat or declined somewhat, didn't have a zero, but they might have been down 20% or 30% when we sold. That's happened a gazillion times. This is all par for the course. I think all we can do is have discipline and process, and one of the reasons why we have 10 bets is so we can write these out. But I think, for me personally, it doesn't really rattle me or anything like that. I'm just not wired that way.

Eric: We had one more question, what do you think the best trait is for an investor to have and what is the most kind of valuable skill that they can try to develop?

Mohnish: The single most important trait for an investor to have is extreme patience. So the timeframes in which businesses go through change is very different from the timeframes with which your brain processes information. So business change, change takes years and decades and your processing time within seconds or minutes. And so if you are the kind of person who loves to watch paint dry, like especially a wall that just been painted white, and you can just sit there and watch that wall, you are ideally suited to be a great investor. If you

are the kind of person who thrives on the inactivity of doing nothing, it's great. I think you can do very well. It reminds me of a Seinfeld episode. Seinfeld might be past the genre that the viewers here have looked at.

Eric: I'll get in any way, Mohnish

Mohnish: But Eric might have seen a couple of episodes. There was one episode where Elaine is on a flight with her boyfriend, and her boyfriend is just looking at the back of the seat in front of him. He's doing nothing. His eyes are open, he's just looking at the seat back in front of him. Elaine asks him, what are you thinking? And like all of us men, he said, nothing. She said, no, what are you thinking? He said, nothing. I'm just looking ahead". Yes, but you have to be thinking about something. By the time the flight ended, they had broken up. She had broken up with him. Okay. In reality, he was so well suited to being a great value investor, because he was so happy just looking at the seat back in front of him. He was in bliss, and she couldn't handle.

Eric: What was it? Puddy, was that the character's name? I think, yeah, Puddy is a value investor, all right? Oh, obviously I think it was you and Guy who had the lunch with Warren Buffett. Couple questions on that. Do you think it was worth it, number one, and what was the main takeaway you got from having lunch with Warren Buffett?

Mohnish: Well, I think my only expectation for bidding for the lunch and meeting Warren was to just thank him. I felt like I had used his intellectual property and was earning a livelihood with his intellectual property, and it was a way to maybe kind of pay at least part of the tuition bill and to look him in the eye and just say, hey, thank you very much. It's been exceptional. I didn't really have any expectations beyond that. I went for lunch with my family. My daughters were at a great age at that time 9 and 11, which is a good age. Guy Spier came with his wife. We had a wonderful lunch. I think the first thing Buffett did when he got there, he said, look I have nothing on my calendar all afternoon. When you guys get sick and tired of me, I'm happy to leave, but I don't have to be anywhere. It can go on as long as you want. Then very quickly, he tries to put you at ease, and you think you're just having lunch with your grandfather. The lunch was, on many levels, spectacular. I think that the takeaway from the lunch, I have a decent friendship with Warren now. It's been 13 years since we met for lunch. The lunch also led to a friendship with Charlie and to many other relationships in my life. It's been really spectacular. I think even the takeaways have been spectacular. There were so many takeaways. I think after the lunch I made some notes. I think we asked him about 55 different questions that we could recall. Buffett tries really hard to make sure that you feel like you got bargain. For example, he told both my daughters, who were sitting on both sides of him that the single most important decision you will make in your lives is who you decide to marry. They are now young ladies, and they remember that message quite well. I don't think that message would've resonated as much if I told them that, or their mom told them that, and so on. They heard

that and they appreciate that, and I think they will make sensible choices on that front.

Eric: Sorry, I'm laughing. I have three daughters who are transitioning, in college, and in young adulthood. Yeah, it'd be good to have a surrogate grandfather give him good advice right.

Mohnish: Yeah

Eric: Mohnish, there's been a number of questions just on kind of career advice and so forth. There're a couple of folks who would love to kind of start a fund at some point. Could you talk a little bit about how you got your funds started, how you attracted investors, how you set it up. I know you have some thoughts on fees with how you did it similar to the Buffett partnership. Could you expand on some of those for the students?

Mohnish: Sure. Yeah. Pabrai Investment Fund started in 1999, and I really wasn't planning to start a fund or anything. I had done quite well investing my own money. I think a million had turned into 12 or 13 million in about five years, some 94 to 99. Things have gone quite well. I enjoyed that whole process and such. I used to give my friends stock tips. They approached me in 99 and basically said, look, this stock tip business is random. Sometimes we don't see you for a while, and we don't know whether to buy or sell or whatever. They wanted to give me money to manage. I wanted to make sure that if I took their money, that I wouldn't lose my friends. I wanted to set up a mechanism by which their downside was very limited. Actually, when Pabrai Investment fund started, it really started as a hobby. I had no plans to grow and scale it. I just thought it's a little million dollar pool capital of my friends, which is easy for me to invest when I'm making my own investments. I actually guaranteed their principal, and I also guaranteed them 6% a year. Above that, I would take one four, they would get three-fourth. About 15, 16 months into the funds, we had about close to 3 million in assets. I decided it would be good to actually run it as a real business. I couldn't do that with these guarantees and such, it wouldn't scale. I requested my friends that we would make an amendment and we would take out the guarantees. They said, no, no. We like the guarantees. The guarantees are great.

What I did is I set up another fund, and then I just told them this fund is going to close down, and the other fund has the same rules, except there are no guarantees, principal and 6% is not guaranteed. They all moved over there. When they had no choice, they all moved over there, and that worked out fine. I would just say this, that, "Buffett says that you could be a leper in the middle of the Atlantic in a robot, and they will swim to you in shark infested waters to invest with you if you deliver above average returns". If you have had a history where you've done well, and it's all double track record, I think that that is the key to attracting assets and getting a fund business off the ground. I think some prerequisites to get a fund business off the ground is, number one, if you're

good at it, you should already be independently wealthy. Number two, you should have had done quite well, had a good track record, et cetera. Then beyond that, I think the friends and family should be very willing to have you manage some of their assets. Then once that's going, then others should have an interest as well. It's almost automatic if the pieces are in place and it's very uphill if those pieces are missing.

Eric: Mohnish, a lot of the students obviously there early in their careers, there's a lot of noise about how one should go about the business. How should they think about developing their own investment strategy as they work through the business?

Mohnish: Well, I think the best way to learn is to actually have a brokerage account, which has a meaningful portion of your assets and you start making investments when you have high conviction. You make mistakes, and you learn from the mistakes, and you keep going. I think that's how you get going. You cannot do this on an Excel spreadsheet with some hypothetical portfolios. It has to be real, and it has to be real with a meaningful portion of your assets.

Eric: Someone wanted to ask, "What was the biggest mistake you have made in your career, and what lessons have you learned from them?"

Mohnish: Well, I think my career has had a lot of left and right turns. For the most part, I think the journey has been very good and very rewarding. I think the one mistake I made a few years back; I think in 2014, is I had the idea to set up a holding company and to acquire insurance businesses and then invest and have float and all of that. I did set up that entity. We did raise more than 150 million of capital. Then we bought an insurance company, and then I realized it was all a mistake, that there were a number of things that I was learning that I knew that would not work out as I had planned. Then I made the decision to unwind and salvage and get back the capital. Thankfully we were able to sell the insurance company for a little more than we bought it for, which was good. We've returned most of the capital back, and I think that whatever is left, I think we will return more than we took in. The end result for the investors is not going to be great, but there's no loss of capital. I think anytime I make a mistake in investing where there's no loss of capital, it's a home run. I think in recent years, in investing, that would be a mistake, but I also learned a lot from that whole experience. I learned a lot from actually owning an insurance business and actually sitting in the board meetings and looking at claims and really got a great understanding of the business. I think from a learning point of view it was exceptional.

Eric: Okay, great. I know we're coming up close to the end of our time, but I'd love for you to just any kind of broad career life advice for the students and any closing statements or thoughts you might have.

Mohnish: Yeah, well, I think IU is a great place. I think you guys do a great job of sending forth. The Kelly School does an exceptional job. When I was a student in my

early twenties, I really had no clue about many things, including what to do and so on, kind of drifting through life, if you will. I think the key is that you go to work for someone you like, admire, and trust. That's what Buffett says, focus on. The normal tendency for students finishing school is to go for name brands, the large name brands look great, and those name brands are also great to talk to with your friends, “hey, I'm going to work for Alphabet, or I'm going here and there”, which is fine. But I think a better way to approach it is to ask yourself what you really like to do. If you could find somebody you really admire that you go to work under more than the great brands, what matters is who are the people you would work for and who are the people you would work with. Those are important things and the kind of work you would be doing. The focus should be not so much on what would look good on a resume, but on what would allow you to maximize your potential and accelerate your learning. I think that's really the key.

Eric: Great advice. Thank you so much for your time today, Mohnish. I didn't realize you had been on our campus before. We'd love to get back to Bloomington, sometime back in the Midwest, but thank you so much for taking the time today to talk about your investment philosophy and process with our students. It's really appreciated.

Mohnish: Thank you, Eric. Looking forward.

Eric: All right

Mohnish: Bye.

Eric: Thank you again. All right. Bye-Bye.

Mohnish: Thank you.

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