

15TH ANNUAL WEALTH CREATION STUDY (2005-2010)



UU Investing

Creating wealth from the unknown and unknowable

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UU Investing

Creating wealth from the unknown & unknowable

What is UU Investing?

- **UU Investing is investing in the unknown & unknowable (UU i.e. the “world of ignorance”)**
- **What is UU? = Situation where future states of the world are unknown**
- **UU investing = the art of “selecting assets that will fare well when future states of the world become known.”**

“

The real world of investing often ratchets the level of non-knowledge into still another dimension, where even the identity and nature of possible future states are not known. This is the world of ignorance.

”



Understanding UU

- 3 states of the world – Known (K), Unknown (U), Unknown & Unknowable (UU)

Understanding K, U and UU

	Knowledge of outcomes	Investment environment	Stock market relevance
Known <i>(Risk)</i> <i>(K)</i>	Outcomes known; Probabilities known	Distribution of returns known	Not very relevant; very few outcomes have known probabilities
Unknown <i>(Uncertainty)</i> <i>(U)</i>	Outcomes known; Probabilities unknown	Distribution of returns conjectured	Faced by all stock market investors
Unknown & Unknowable <i>(Ignorance)</i> <i>(UU)</i>	Outcomes unknown; Probabilities unknown	<ul style="list-style-type: none"> • Distribution of returns conjectured • Complementary (i.e. special) skills rewarded 	Profitably exploited ONLY by intelligent investors

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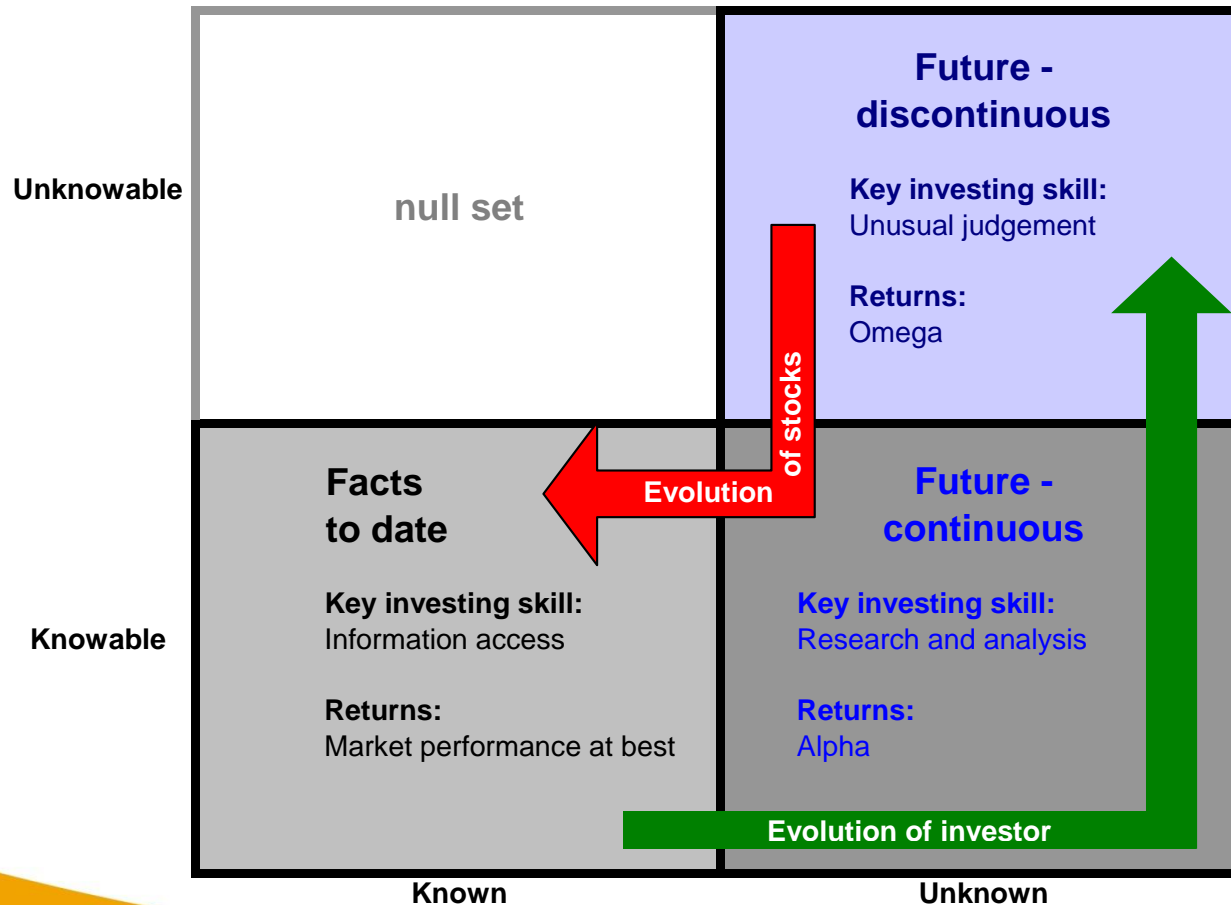
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UU Investing in stock markets

Evolution of stocks – from UU to UK to KK

Evolution of investor – from KK to UK to UU



- When the future is broadly a continuity of the past, it becomes knowable through research and analysis.
- When the future is discontinuous from the past, it enters the realm of the unknowable, and calls for unusual judgement, courage and patience.



Past examples of UU investing

Infosys: at the time of IPO in 1994, which got undersubscribed

UU situation

- New company in a new sector
- The Y2K opportunity
- India's competitive advantage in intellectual capital businesses
- Management depth of Infosys

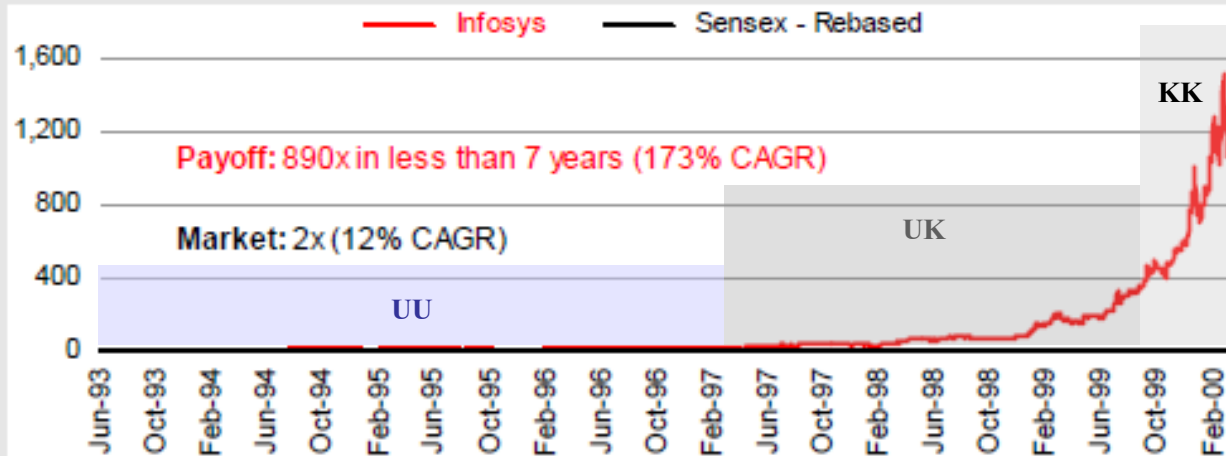
Special investing skills

- Domain knowledge of IT and its potential
- Knowledge of IT experience in other countries
- Assessment of Infosys' management competence and character
- Understanding of labor cost arbitrage

Payoff

Infosys stock appreciated 890x over 7 years post IPO listing

Infosys v/s Sensex



Past examples of UU investing

Bharti Airtel: in FY03 when it had a net loss of Rs1.8b

UU situation

- The opportunity size of wireless telephony
- High level of profitability once the break-even level of subscribers is achieved
- Management execution capability

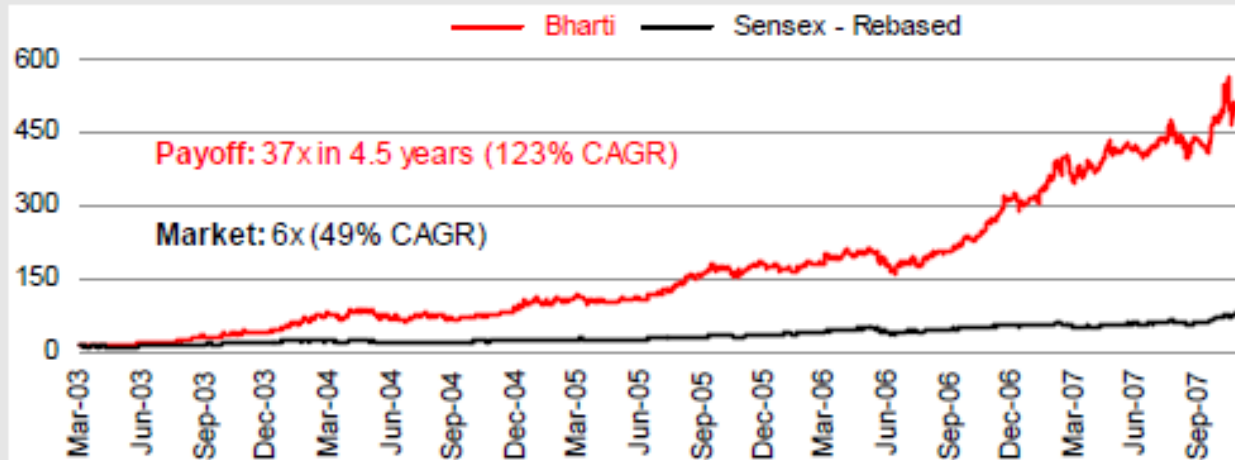
Special investing skills

- The concept of value migration - from wired telephony to wireless
- The exponentiality of network businesses, where every member added to a network expands the number of transactions manifold

Payoff

Bharti stock appreciated 37x in 4.5 years from March 2003

Bharti Airtel v/s Sensex



Past examples of UU investing

Pantaloon Retail: early stage investing

UU situation

- New company in a new sector
- The opportunity in Indian organized retail
- Management execution capability

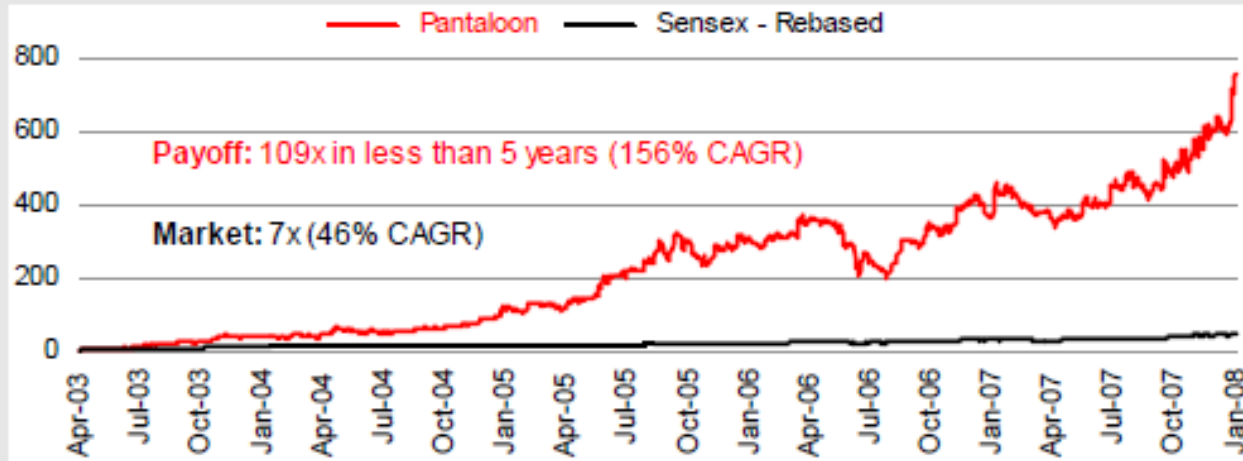
Special investing skills

- The concept of value migration - from unorganized retail to organized
- The success story of organized retail elsewhere e.g. Wal-mart

Payoff

Pantaloon stock appreciated over 109x in less than 5 years from March 2003

Pantaloon Retail v/s Sensex

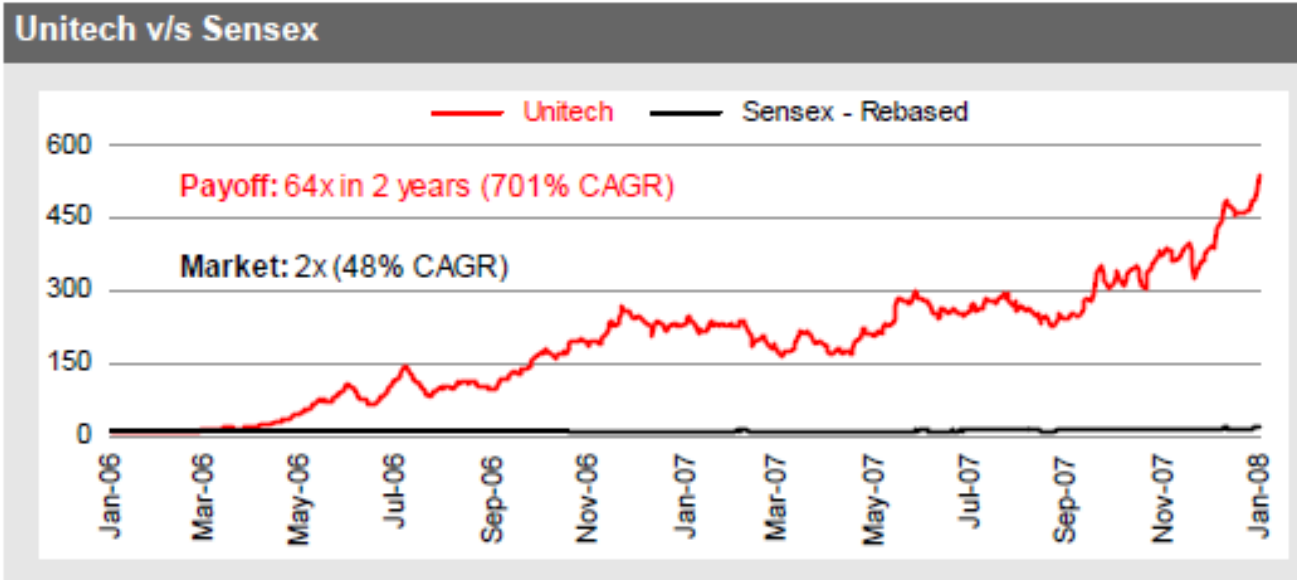


Past examples of UU investing

Unitech: pioneer of organized real estate

UU situation	Special investing skills
<ul style="list-style-type: none">Real estate boomUnitech's low-cost land bankManagement execution capability	<ul style="list-style-type: none">Experience of real estate boom in other Asian countriesIncrease in funding sources for home buyers due to focus of banks on mortgages

Payoff
Unitech stock appreciated 64x in 2 years beginning 2006



Past examples of UU investing

Titan Industries: resurgence from Rs131m PAT in FY02 to Rs2.5b in FY10

UU situation

- Explosion in jewelry sales (13x)
- Divergence of rising profits amidst falling margins (due to higher share of lower margin jewelry business)

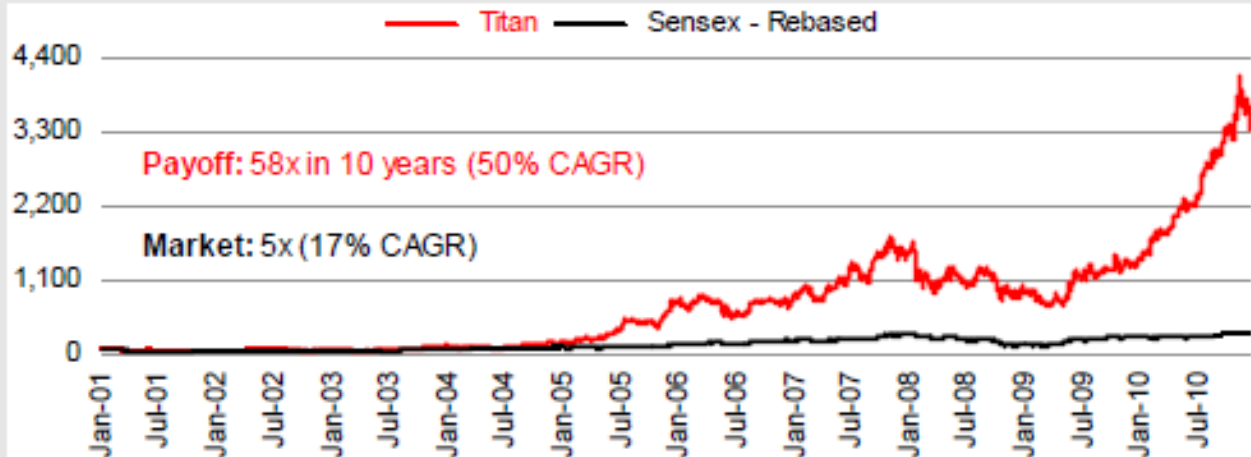
Special investing skills

- Exponentiality of discretionary spend (e.g. jewelry) on the back of economic prosperity
- Value migration from unorganized to organized jewelers, specially the re-assurance of house of Tatas
- Profitability of near monopoly business (domestic watches)

Payoff

Titan stock up above 58x in the last 10 years

Titan Industries v/s Sensex



Past examples of UU investing

Tata Motors: recent turnaround

UU situation

- The turnaround in JLR
- The revival in Indian CV sector

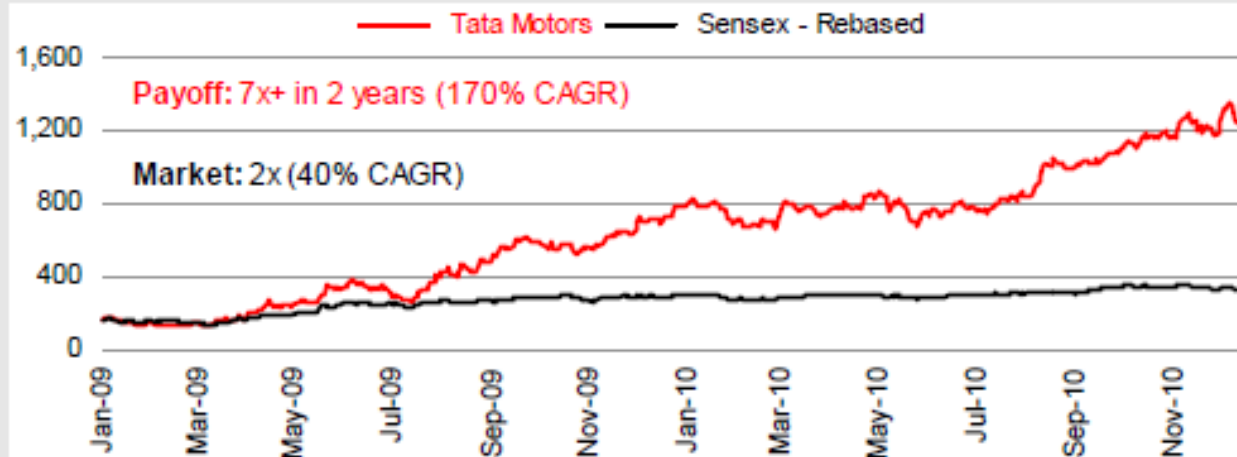
Special investing skills

- Domain knowledge of the luxury car business
- JLR's focus on emerging markets like Russia and China
- Scope for margin improvement following falling commodity prices
- Knowledge of CV business cycles

Payoff

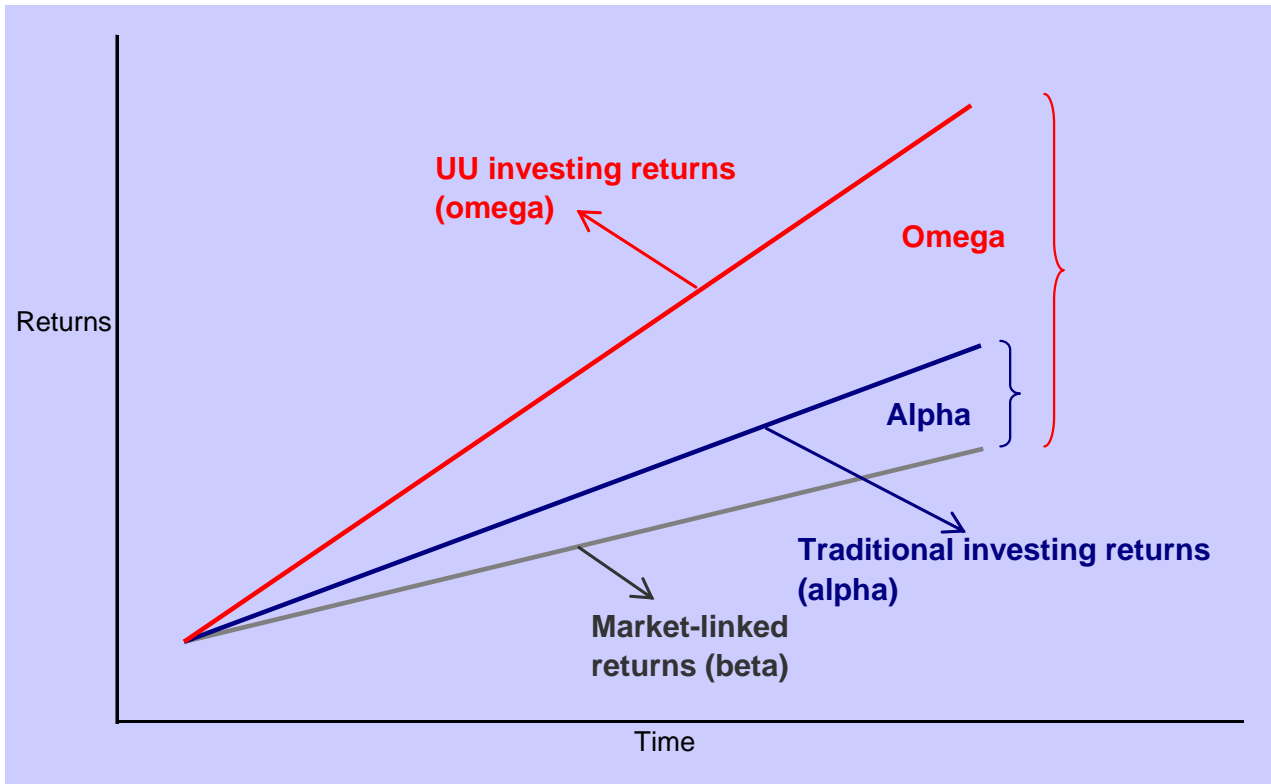
Tata Motors stock is up over 7x in 2 years beginning early 2009

Tata Motors v/s Sensex



UU investing for Omega returns

- In the traditional investing model, portfolio return in excess of benchmark is called "Alpha".
- We call the very high excess return possible from UU situations "Omega".



“

There are systematic ways to think about unknowable situations. If these ways are followed, they can provide a path to extraordinary expected investment returns.

”



How to go about UU investing

Step 1: Know UU Success Principles (SPs)

Step 2: Look out for UU situations

Step 3: Be aware of the pitfalls

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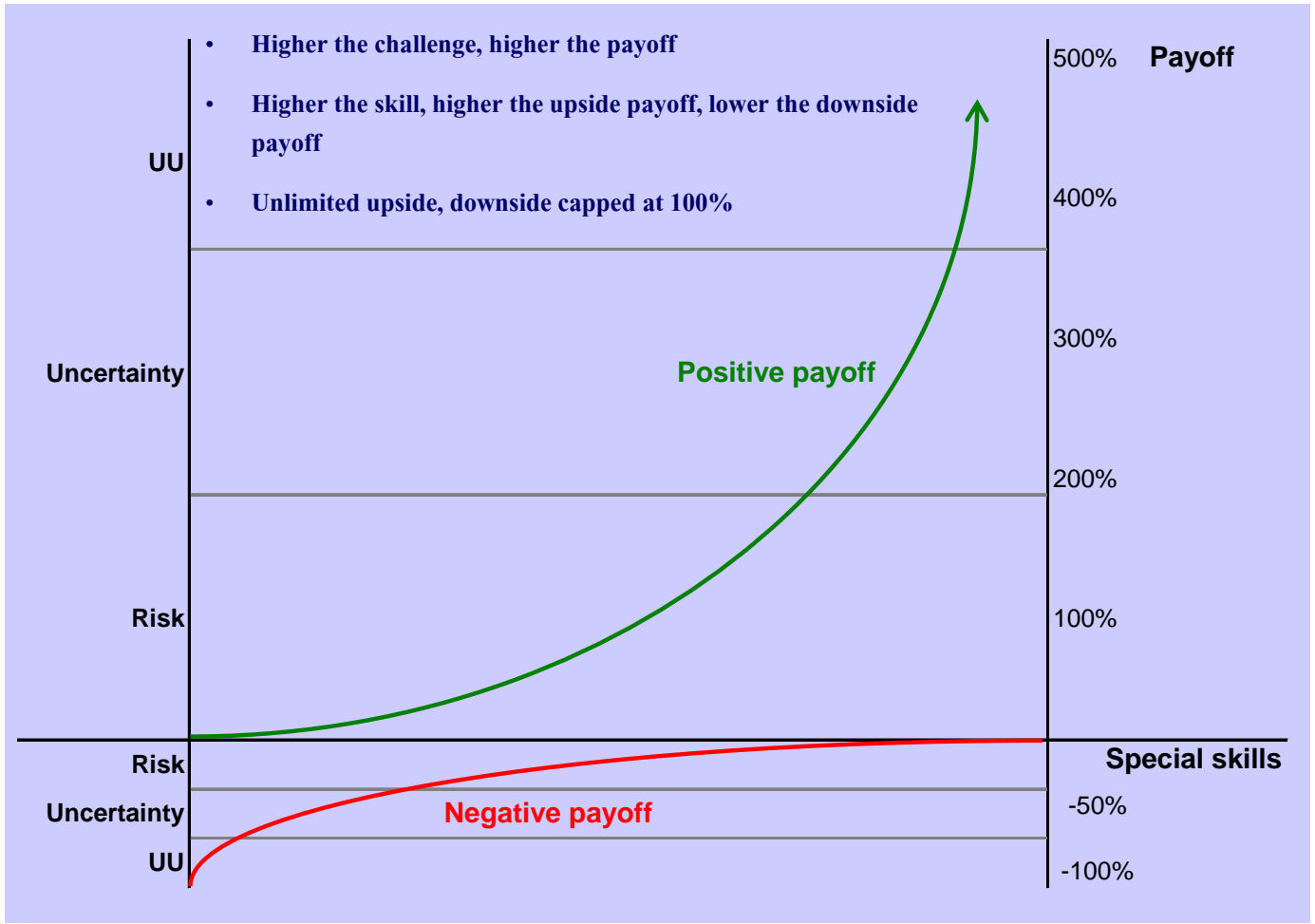
Clear thinking about UU situations, which includes prior diagnosis of their elements, and relevant practice with simulated situations, may vastly improve investment decisions where UU events are involved.

”



Step 1: Know Success Principles

SP #1: High asymmetric payoff



“

The opportunity to get a 10 or 100 multiple on your investment as often as you lose virtually all of it is tremendously attractive.

”



SP #2: High level of complementary skills

- Domain knowledge of specific businesses
- Past experience elsewhere (in other companies, in other industries, or in other geographies)
- Management assessment
- Imagination and unusual judgement
- Conviction and courage to commit the investment

“

Alas, few of us possess the skills to be a real estate developer, venture capitalist or high tech pioneer. But how about becoming a star of ordinary stock investment? For such efforts an ideal complementary skill is unusual judgment.

”



Step 1: Know Success Principles

SP #2: High level of complementary skills (continued)

With complementary skills, the investor moves from Quadrant C to Quadrant D, earning healthy returns

	Easy for Others to Estimate	Hard for Others to Estimate
Easy for you to estimate	A. Tough markets; no excess returns	D. Benefit from the UU situation using special skills
Hard for you to estimate	B. Avoid action; possibility of significant loss	C. Potential UU situation

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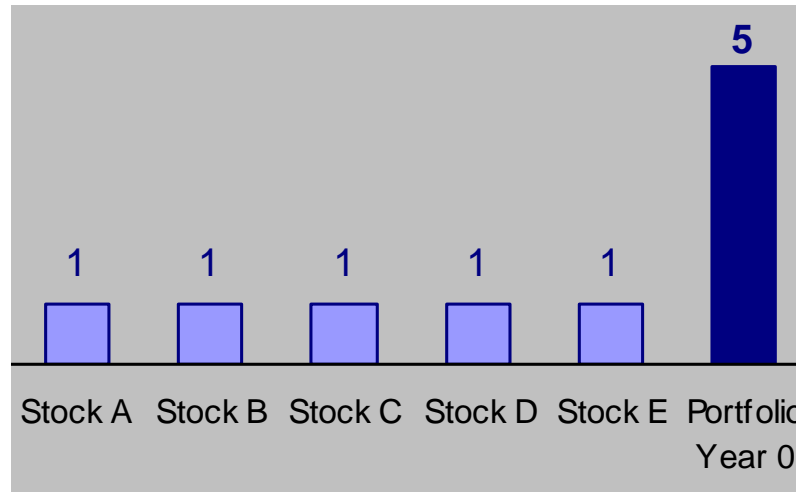
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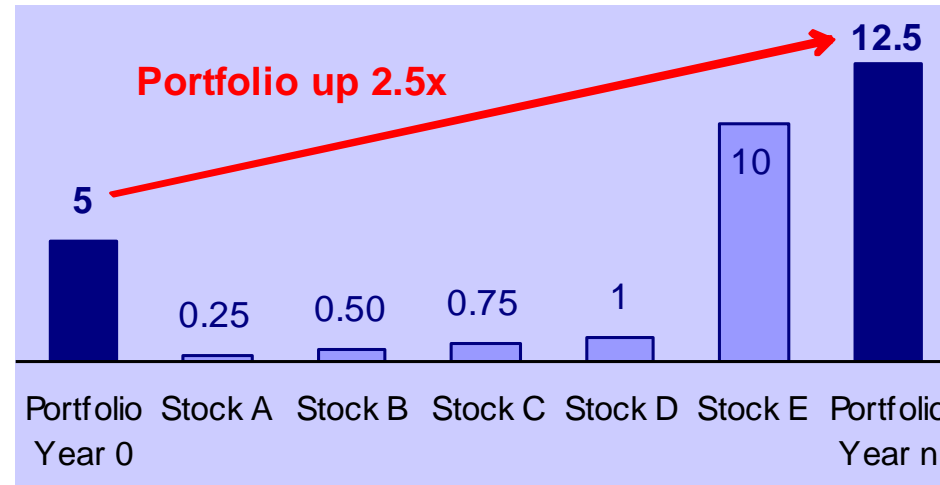


SP #3: Portfolio approach to diversify risks

Initial Portfolio



Healthy final portfolio despite low stock success ratio



SP #4: Non-aversion to hindsight criticism

- Non-aversion to hindsight criticism is the core behavioral principle.
- UU portfolio may offer healthy returns, but several individual ideas would perform very poorly.
- This creates room for hindsight criticism of these investment decisions.

SP #5: Long-term outlook and patience

- To allow for the UU situation to play out into KK and for the positive upside to pay off

With time and patience, the mulberry becomes silk.

— Chinese proverb

“

If none of your investments looks foolish after the fact, you are staying too far away from the unknowable.

”



Step 2: Look for UU situations

- Where the future is discontinuous from the past
- In 3 areas: (1) Business (2) Management (3) Valuation

1. Business UU situations

- Low history of industry and/or company
- Huge size of opportunity with scalability
- Technology intensity of business
- Change (or scope for change) in regulation
- Value migration
- Demand J-curve inflexion point
- Change in competitive landscape
- Turnaround
- Discontinuous corporate action
- Discontinuous change in operating metrics

“

Unknowable situations are
widespread and inevitable

”



Step 2: Look for UU situations

2. Management UU situations

- Management with no track record
- Change in management
- Integrity issues with management

3. Valuation UU situations

Extreme pessimism and optimism in the markets creates UU situations e.g.

- Infosys valuation at the height of dotcom boom
- Indian stock valuations at the height of global crisis in early 2009.

“

If the events are unpleasant, it is not clear when to celebrate their end.

”



Step 3: Be aware of pitfalls

1. Overconfidence

“If you lack Buffett capabilities, you will get chewed up as a bold stock picker.”

2. Hindsight criticism

“One might be blamed for a poor outcome if one invests in ignorance when, in fact, it was a good decision that got a bad outcome.”

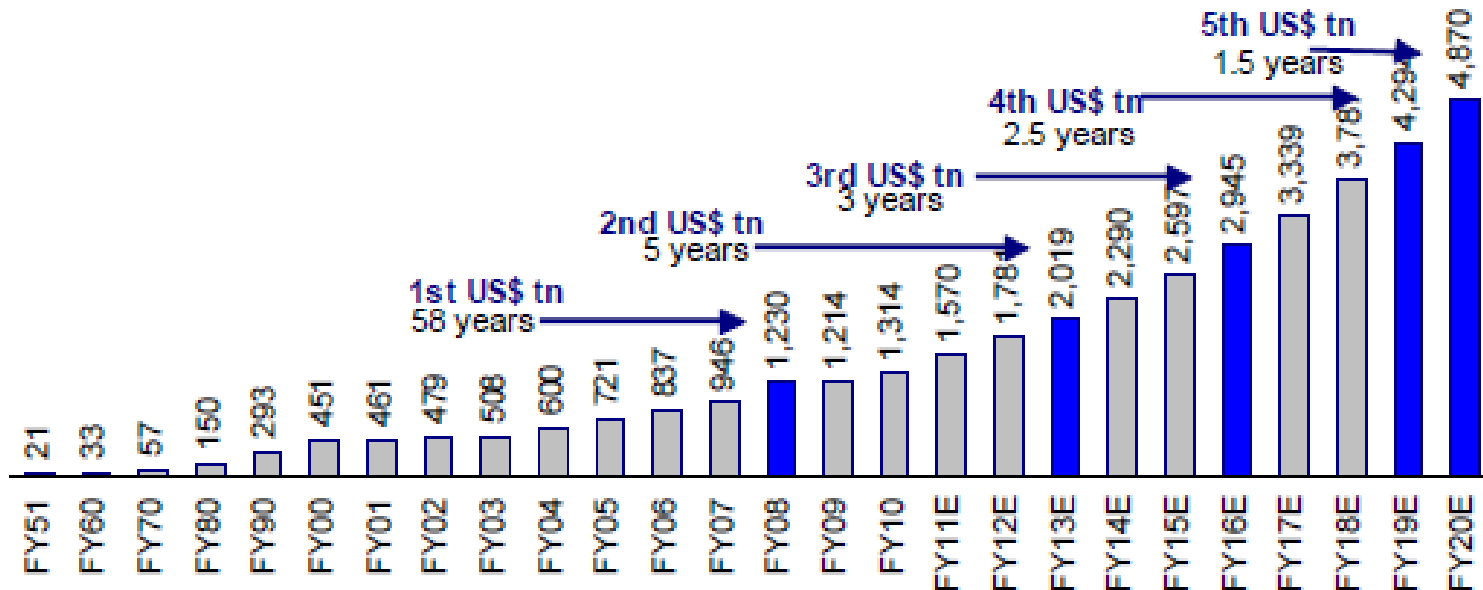


NTD to TTS

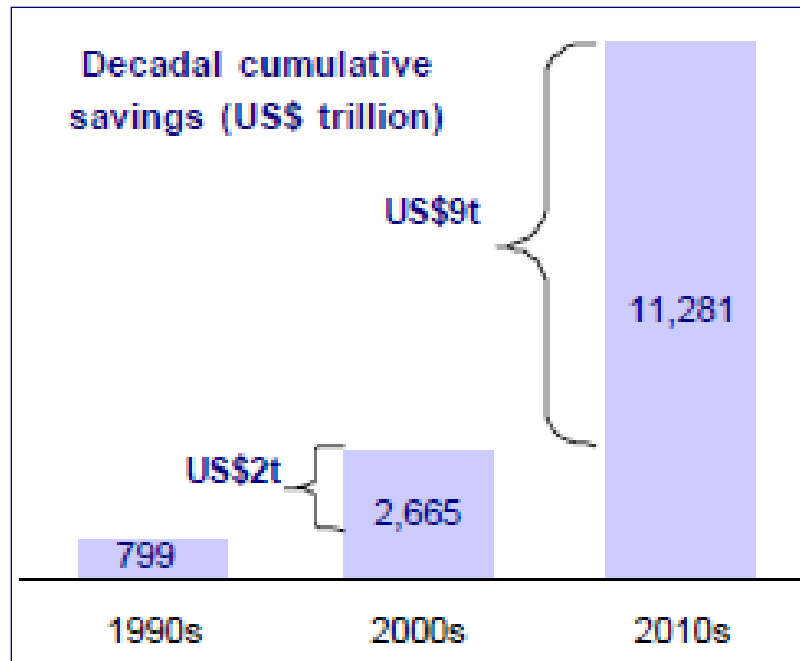
Indian Banking Sector: Stocks for 2020

- **UU situation:** Which bank(s) will deliver superior stock returns through 2020
- **Complementary skills:** Clear NTD framework

By 2020 India's GDP would triple from the current level almost ~5 times the level of FY08



- **Size of opportunity: TTS by 2020 - Ten Trillion Saving (in dollars, decadal cumulative), 5x last decade**



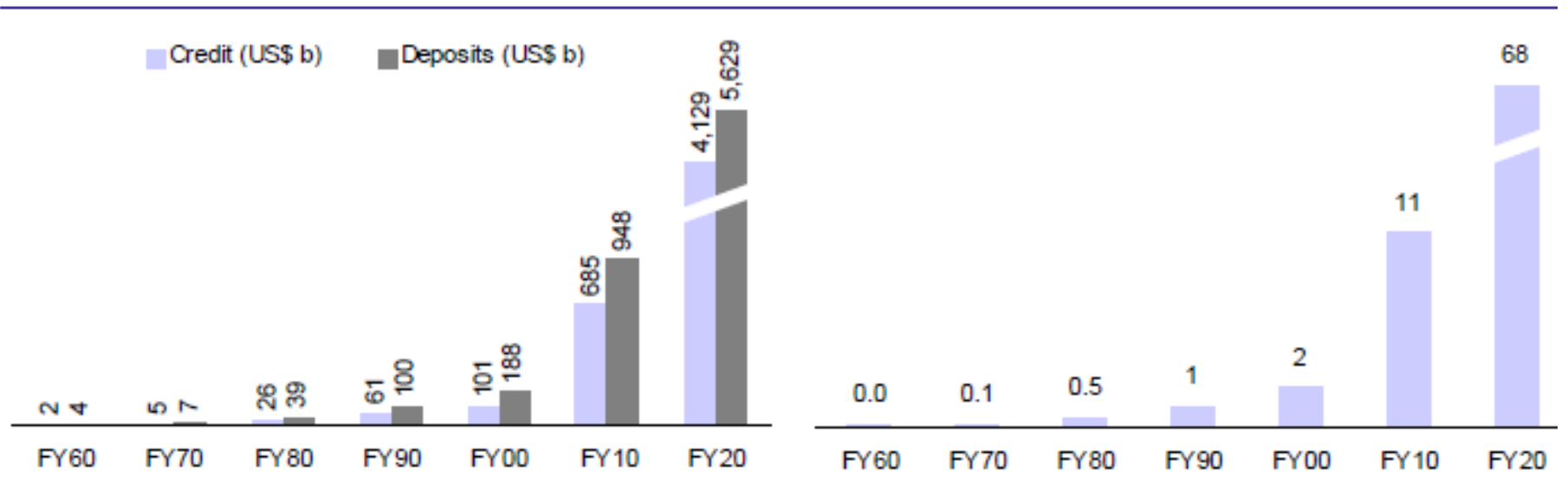
Huge opportunity for financial intermediation



- **Asymmetric payoff possibility:**
 - **Banking sector profit in 2020 will be 6x 2010**

2010 to 2020 – Business up 5x

... and profit up 6x

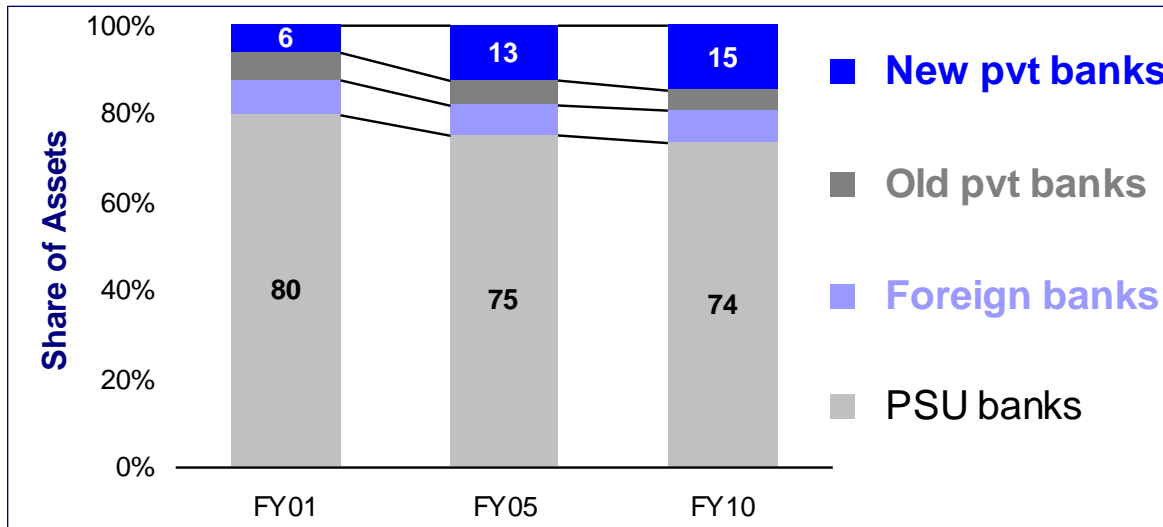


Growth will be even higher for banks with UU potential

• Which stocks to bet on?

Judgement based on several factors including –

- Value migration from PSU to private banks



- Impact of technology on various banks
- Assessment of bank managements
- Past profitability analysis



So, the final unusual judgement? ...

The Final Judgement

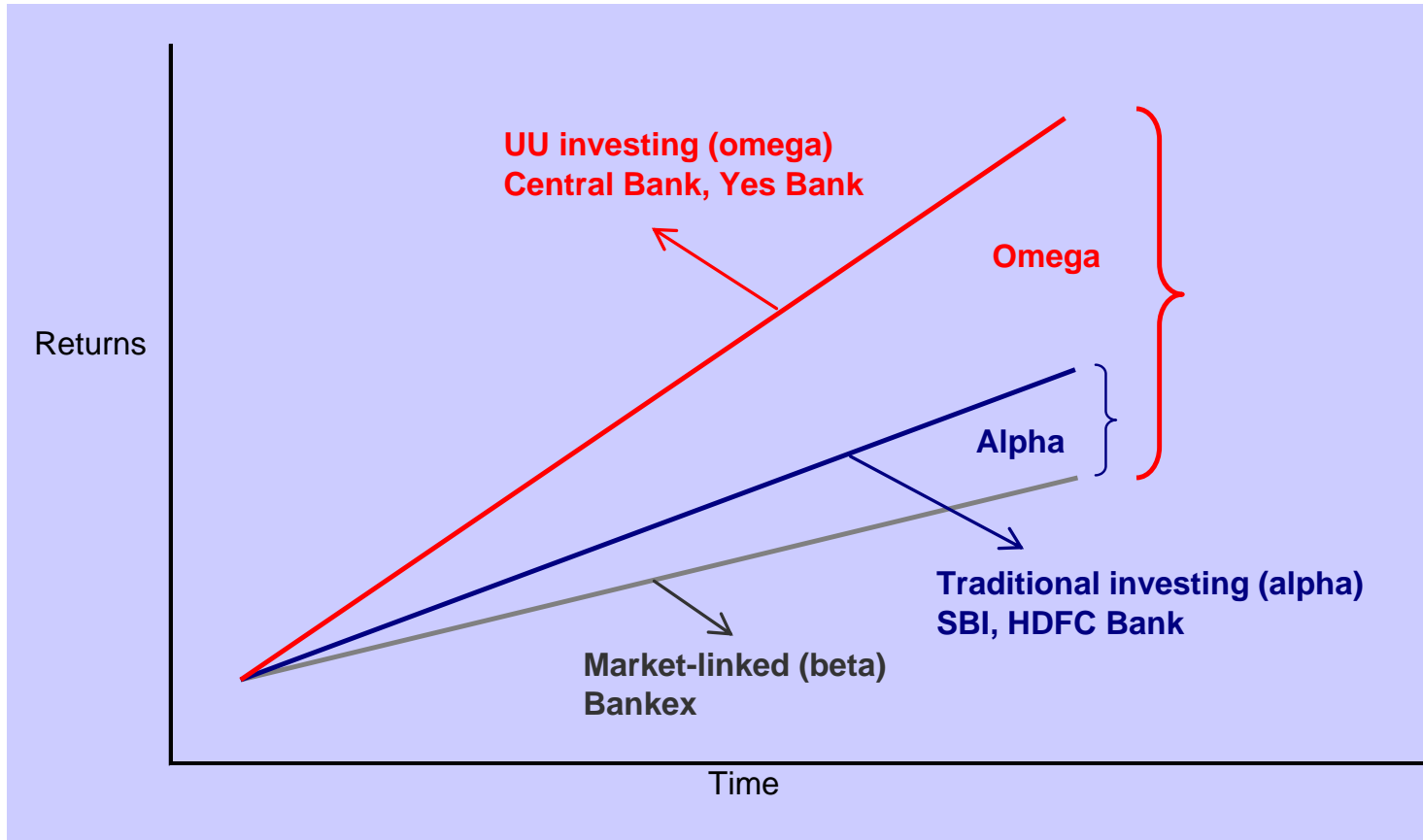
1. **Buy a small/medium high growth bank – YES BANK**
 - Management with established credentials
 - Growing at 2x industry growth rate
 - Branch scale-up plans to increase CASA; expand NIMs
 - Not among the cheapest banks, but absolute market cap low compared to size of opportunity and that of peers

2. **Buy a large, unpopular bank – CENTRAL BANK**
 - Among top 10 banks by asset size
 - Recently completed 100% CBS; benefits to accrue
 - Management focus on margin improvement through focus on high-yielding retail segment
 - Not among the cheapest in terms of P/B, but very attractive in terms of MCap/Assets.



So, the final Alpha, Beta, Omega picture?

The Final Picture



In Conclusion

- **Metals/Mining sector has dominated this year's Study.**
- **Low payback ratio (Market cap/Next 5 years' profits) remains the most reliable indicator of fastest wealth creation.**
- **UU situations offer asymmetric payoffs; these can be exploited only by investors with complementary skills, unusual judgement, and no fear of hindsight criticism.**
- **India's high linear economic growth will create exponential business situations – the perfect backdrop for UU investing.**
- **TTS – Ten Trillion Dollar Savings through 2020 – will throw up many UU investing opportunities in Indian financial services.**



**Wishing you exponential returns in exponential times
with UU investing!**

Thank You & Happy Wealth Creating !!

