UU Investing

Creating wealth from the unknown and unknowable

By Raamdeo Agrawal

December 15, 2010
Theme 2011

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

<table>
<thead>
<tr>
<th></th>
<th>Knowledge of outcomes</th>
<th>Investment environment</th>
<th>Stock market relevance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Known</strong></td>
<td>Outcomes known; Probabilities known</td>
<td>Distribution of returns known</td>
<td>Not very relevant; very few outcomes have known probabilities</td>
</tr>
<tr>
<td><em>(Risk)</em> <em>(K)</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Unknown</strong></td>
<td>Outcomes known; Probabilities unknown</td>
<td>Distribution of returns conjectured</td>
<td>Faced by all stock market investors</td>
</tr>
<tr>
<td><em>(Uncertainty)</em> <em>(U)</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Unknown &amp; Unknowable</strong> <em>(Ignorance)</em> <em>(UU)</em></td>
<td>Outcomes unknown; Probabilities unknown</td>
<td>• Distribution of returns conjectured • Complementary (i.e. special) skills rewarded</td>
<td>Profitably exploited ONLY by intelligent investors</td>
</tr>
</tbody>
</table>

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.
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.

Unknowable

null set

Facts to date

Key investing skill: Information access

Returns: Market performance at best

Future - discontinuous

Key investing skill: Unusual judgement

Returns: Omega

Future - continuous

Key investing skill: Research and analysis

Returns: Alpha

Evolution of investor

Known

Unknown

Knowable

Facts to date

Key investing skill: Information access

Returns: Market performance at best

Evolution of stocks

Known

Unknown
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

**Infosys v/s Sensex**

**Payoff**
Infosys stock appreciated 890x over 7 years post IPO listing

**Market:** 2x (12% CAGR)

**Payoff:** 890x in less than 7 years (173% CAGR)
Past examples of UU investing

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

<table>
<thead>
<tr>
<th>UU situation</th>
<th>Special investing skills</th>
</tr>
</thead>
<tbody>
<tr>
<td>The opportunity size of wireless telephony</td>
<td>The concept of value migration - from wired telephony to wireless</td>
</tr>
<tr>
<td>High level of profitability once the break-even level of subscribers is achieved</td>
<td>The exponentiality of network businesses, where every member added to a network expands the number of transactions manifold</td>
</tr>
<tr>
<td>Management execution capability</td>
<td></td>
</tr>
</tbody>
</table>

Payoff
Bharti stock appreciated 37x in 4.5 years from March 2003

Bharti Airtel v/s Sensex

**Payoff: 37x in 4.5 years (123% CAGR)**

**Market: 6x (49% CAGR)**
Past examples of UU investing

**Pantaloons 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**
Pantaloons stock appreciated over 109x in less than 5 years from March 2003
Past examples of UU investing

Unitech: pioneer of organized real estate

**UU situation**
- Real estate boom
- Unitech’s low-cost land bank
- Management execution capability

**Special investing skills**
- Experience of real estate boom in other Asian countries
- Increase in funding sources for home buyers due to focus of banks on mortgages

**Payoff**
Unitech stock appreciated 64x in 2 years beginning 2006

**Unitech v/s Sensex**

- **Payoff:** 64x in 2 years (701% CAGR)
- **Market:** 2x (48% CAGR)
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**

- **Payoff:** 58x in 10 years (50% CAGR)
- **Market:** 5x (17% CAGR)
Past examples of UU investing

**Tata Motors: recent turnaround**

<table>
<thead>
<tr>
<th>UU situation</th>
<th>Special investing skills</th>
</tr>
</thead>
<tbody>
<tr>
<td>The turnaround in JLR</td>
<td>Domain knowledge of the luxury car business</td>
</tr>
<tr>
<td>The revival in Indian CV sector</td>
<td>JLR’s focus on emerging markets like Russia and China</td>
</tr>
<tr>
<td></td>
<td>Scope for margin improvement following falling commodity prices</td>
</tr>
<tr>
<td></td>
<td>Knowledge of CV business cycles</td>
</tr>
</tbody>
</table>

**Payoff**

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

**Tata Motors v/s Sensex**

- **Payoff:** 7x+ in 2 years (170% CAGR)
- **Market:** 2x (40% CAGR)
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

“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

- Higher the challenge, higher the payoff
- Higher the skill, higher the upside payoff, lower the downside payoff
- Unlimited upside, downside capped at 100%

The opportunity to get a 10 or 100 multiple on your investment as often as you lose virtually all of it is tremendously attractive.
Step 1: Know Success Principles

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

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

<table>
<thead>
<tr>
<th>Easy for you to estimate</th>
<th>Hard for Others to Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Easy for Others to Estimate</strong></td>
<td></td>
</tr>
</tbody>
</table>
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 |

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 #3: Portfolio approach to diversify risks

Initial Portfolio

Healthy final portfolio despite low stock success ratio

Portfolio up 2.5x
Step 1: Know Success Principles

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*
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
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.”
UU Investing case study

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

![Graph showing credit and deposits growth from FY60 to FY20](image)

**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

- **UU investing (omega)**
  - Central Bank, Yes Bank

- **Traditional investing (alpha)**
  - SBI, HDFC Bank

- **Market-linked (beta)**
  - Bankex

**Returns** vs **Time**
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!!