How to Build Conviction

Raunak Onkar (Jan 2017)

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Thanks to Tamil Nadu Investors Association for inviting me to this seminar. As I went thru the history of TIA I realised that it has completed more than 25 years. I think all members deserve a round of applause to keep such an endeavour going for such a long time.

It's a Privilege to address such a great audience of serious investors. I went thru the list of past speakers & realised what an incredibly high bar is set. Since I've also learned from many senior investors who have spoken at this event.

What do we know?

Every good investor talks about conviction.
Some degree of over-confidence is needed to hold on to an idea even when the current data is not pleasing.
But very few have actually articulated what “Conviction” means to them.
Moreover each person has their own portfolio allocation style.
Conviction is one of the main sources of that.

What is Conviction?

All I'm trying to do here is to simplify the idea of what conviction actually means. This is just a reflection on the concept of investment process.

(Next slide discusses what is Conviction)

Allows us to take

Calculated Risks

Conviction allows us to take calculated risks.

This really is the key

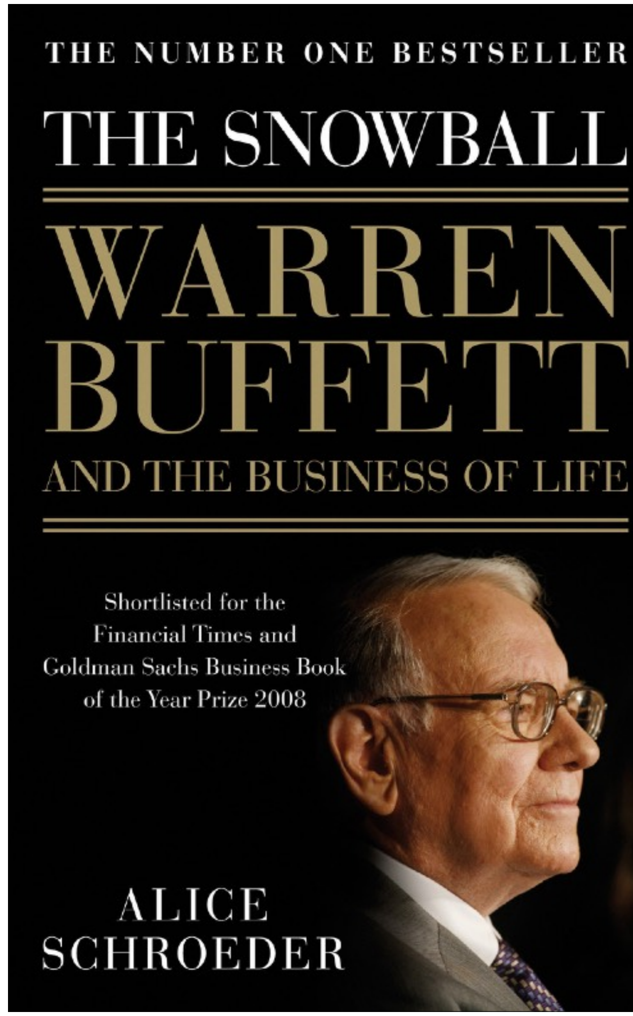
We need to have some measure of how much money should be deployed on any idea & conviction has always been a very convenient metric for it.

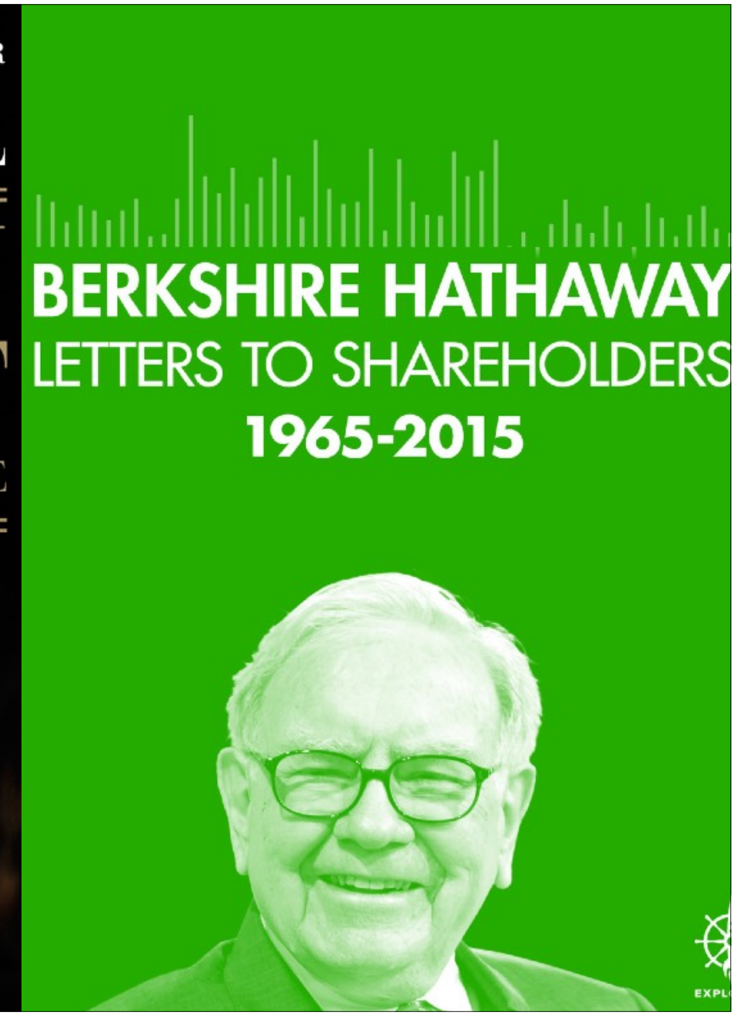
Process > Outcome

It's a trend to generally admire investors based on their past performance (Outcome).
We rarely get to see how that performance was actually achieved.

But we know from reading about investing & actually investing, that the process is more important to keep getting a sustainable outcome.

If we study closely, we do get to see a few examples of how good investors think.
In fact when we analyse our own thought process, we rarely get to see the entire picture of how we end up investing, ourselves.





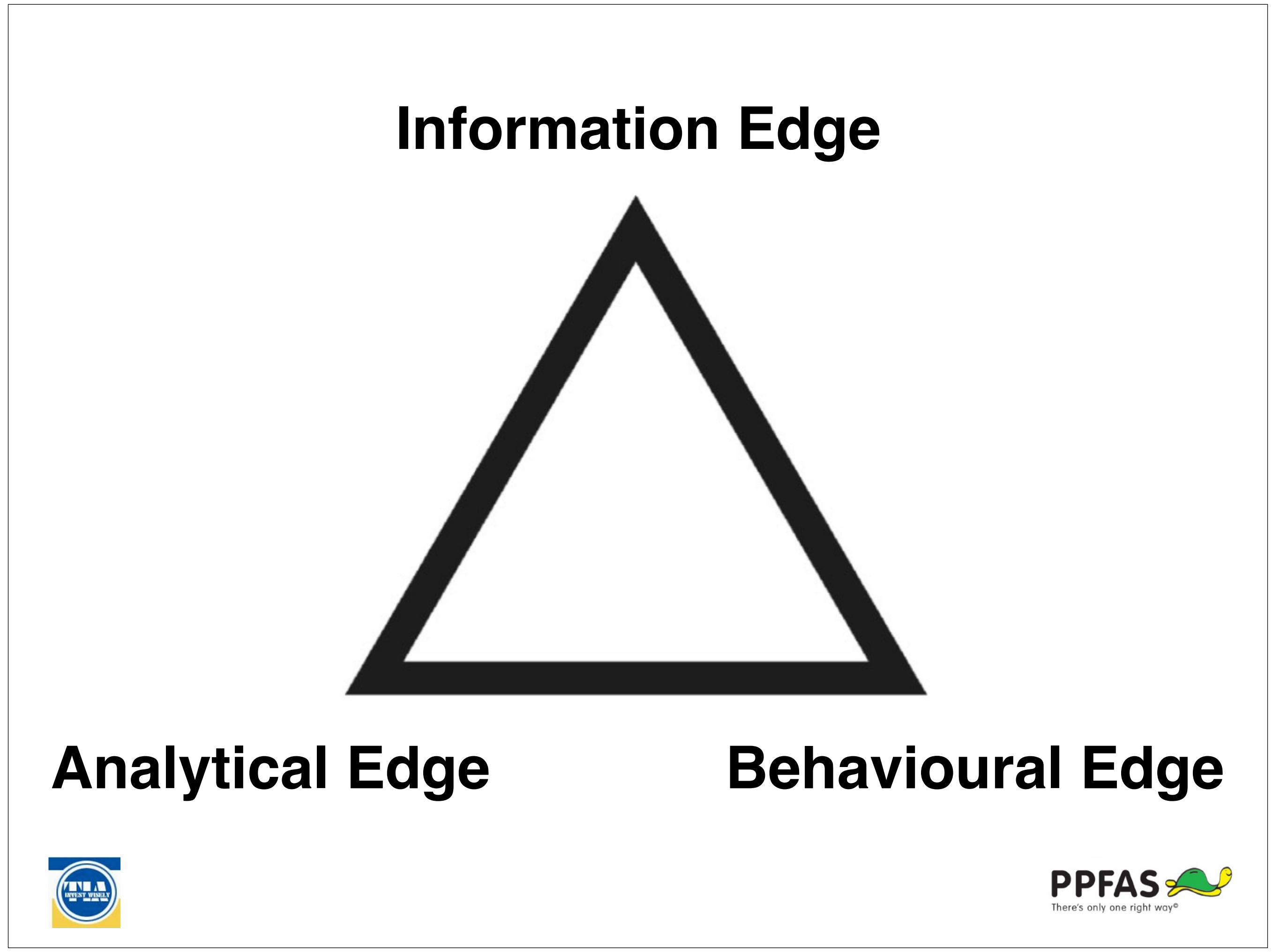
Most of us read Berkshire Hathway's shareholder letters eagerly.
They are a great resource about how Mr Buffett & Munger process their ideas.
When the Snowball (Warren Buffett's biography) was released, I jumped on it almost instantly.
After reading about 10% of the book I had almost stopped reading it because it was too Personal. I didn't care too much about Buffett's personal childhood, I just wanted to know how he invests & how I can apply some of those ideas.

But a senior investor & a friend told me to finish the Buffett biography because it tells us that how we are as individuals in our daily life also affects how we are as investors.

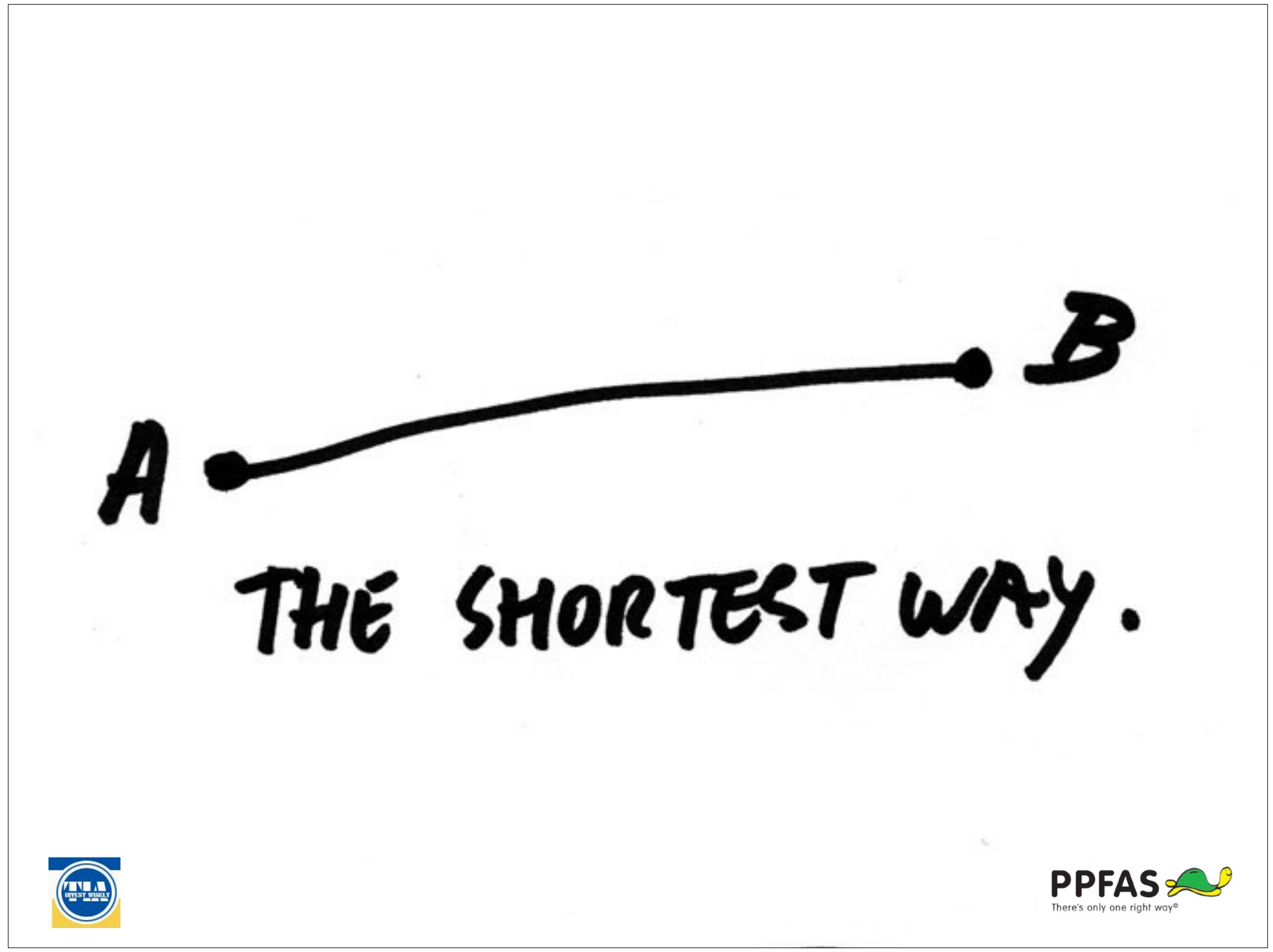
These two personalities (the person & the investor) are part of the same person.

But still, most of the time, Process turns out to be exactly like this - A Black Box

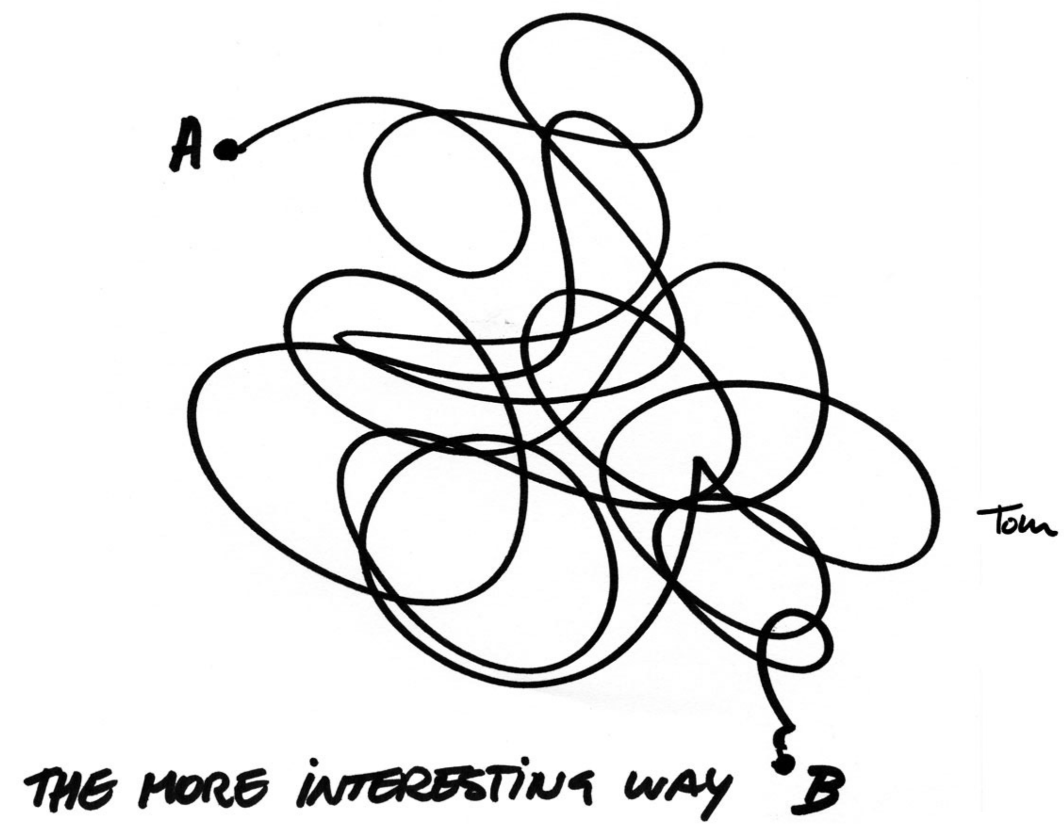
Even we don’t have access to some of our own thought processes. That’s the way we are.



From all the reading about Investment Process I could find these three main pillars for building conviction.
We may not need them all at the same time.
They must be used only when needed but that is too subjective to specify.

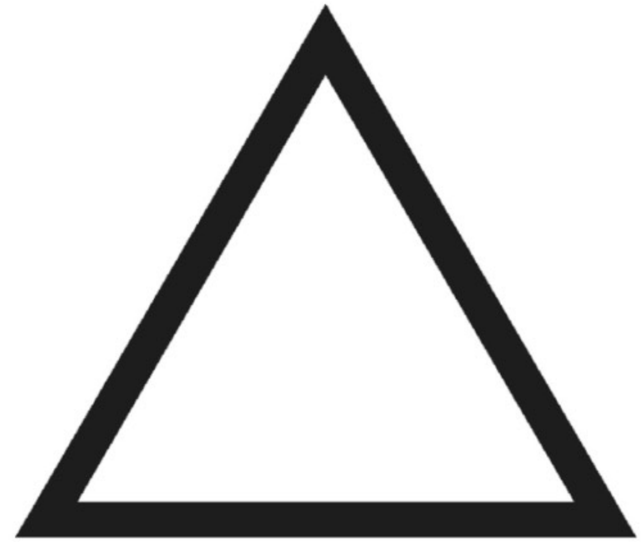


Most of the time, for investors, the Goal is to get from decision to returns in the fastest way possible. :-)
Because in Time value of money, Time comes first.



But in reality, that path can take many interesting turns.

Information Edge



Analytical Edge

Behavioural Edge

Let’s dig down a bit deeper into each of these main pillars of Conviction.

Having information edge is a bit like being The One, from The Matrix.
It gives us the ability to act on data sooner than others, thus giving us a chance to make higher returns.

“Wealth can be built much faster than reputation, but reputation is lost much faster than wealth.”

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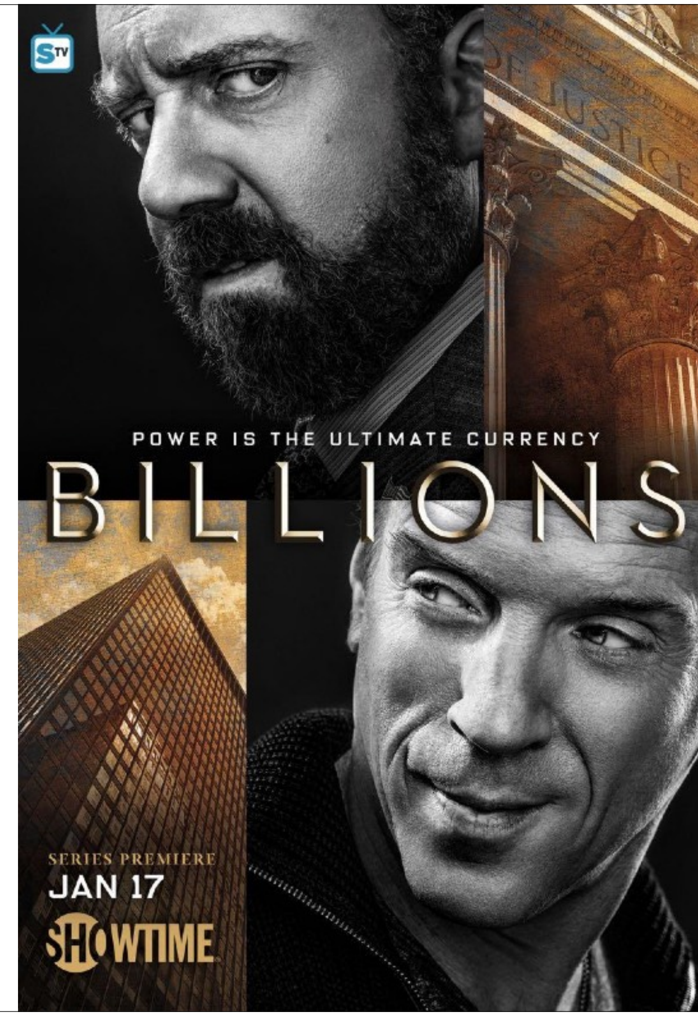
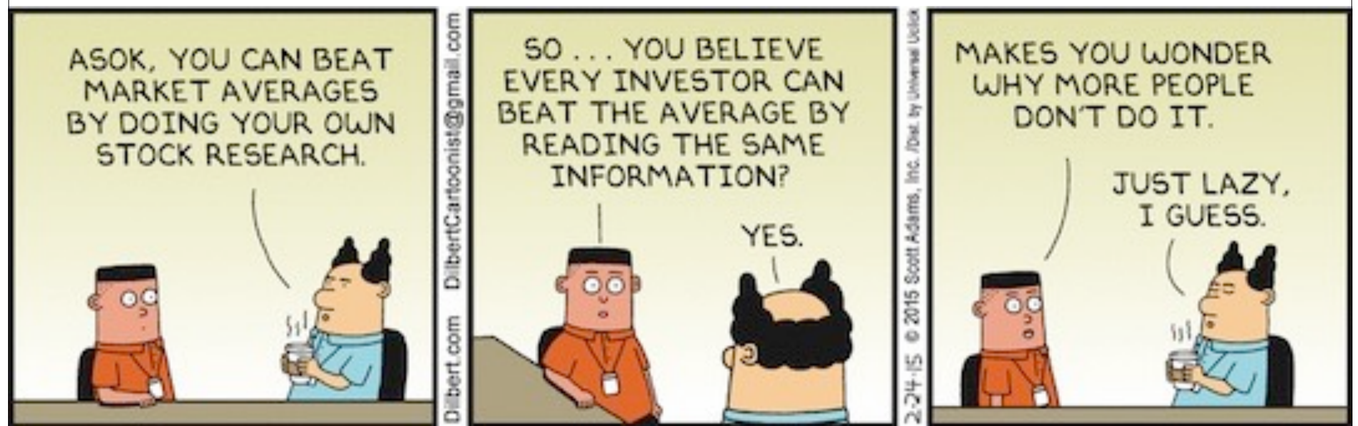
But it also has a dark side.
Most of the time information edge gets lost in its ugly interpretation of insider trading. I don’t intend to make a moral discussion on insider trading. It is wrong & it is also pointless if we are a long term investor,

Because reputations can be easily lost.



In case you're interested to satisfy your urge to understand the moral dilemma caused by insider trading, this is a very nice show to follow.



"Laziness is the ultimate source of ignorance"

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Almost 80% of my management education has come from Dilbert, the comic strip.
The need for having an information edge is simple. Just to avoid being ignorant before investing.
It is so obvious that it sometimes gets overlooked.
Let's see how that happens.

Mostly, we can blame it on Laziness.

Stages of Laziness

There are a few stages of laziness.
This is not some great management theory.
This is something I've observed in myself over time and I keep correcting it.

Stages of Laziness

- I’ve Heard Enough
- I’ve Read Enough
- I’ve Read Too Much

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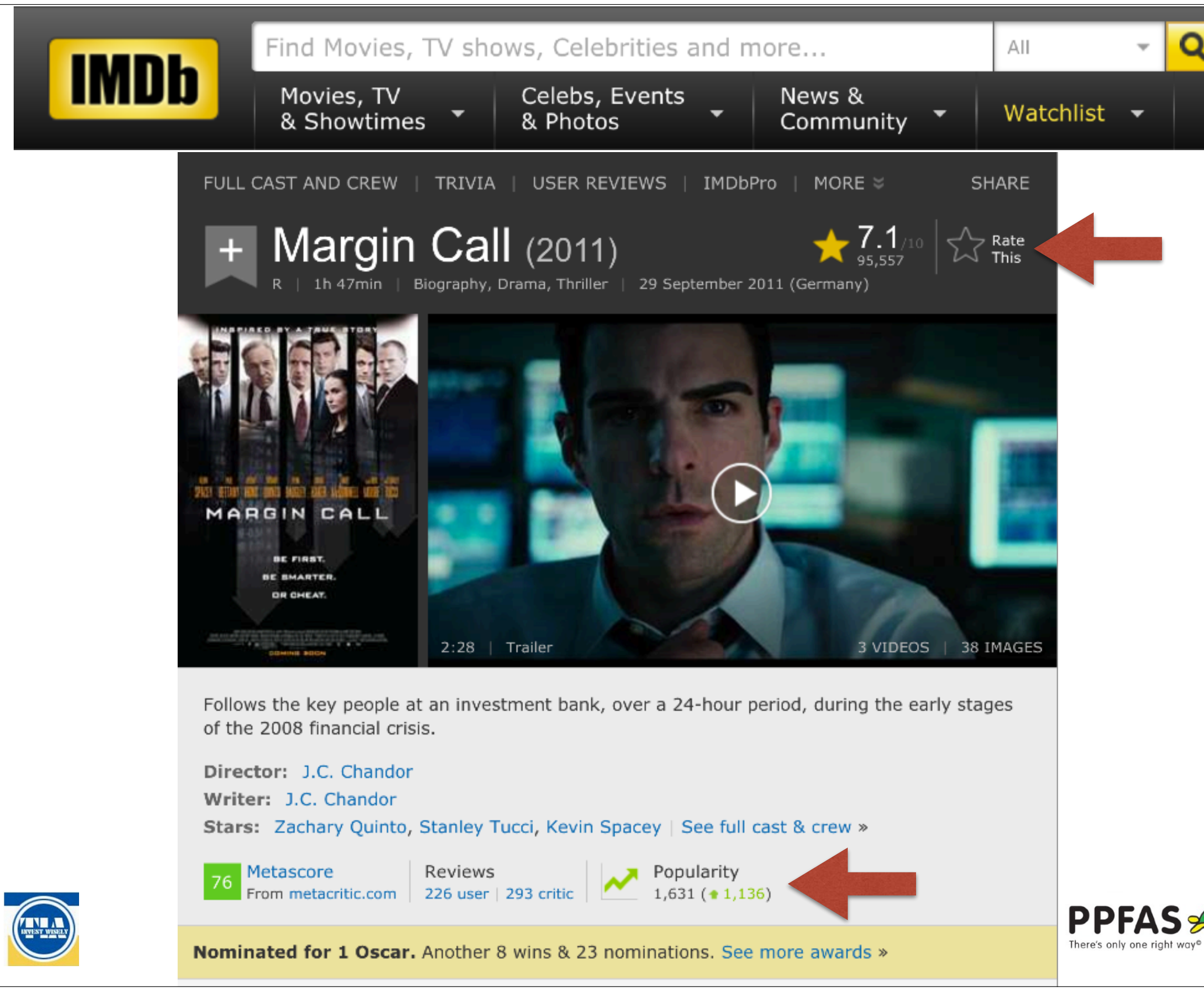
1st: I’ve heard enough.
Some wise investor we respect generously explains the entire investment thesis to us. Then instead of questioning such a wise person, we decide that we’ve heard enough & go out and buy into the investment idea. The moment there is volatility we get jittery because we have no idea where the limits of losing money or making money exist. We don’t even optimally size the position. We are too lazy to do our own work.

2nd: I’ve read enough
Some wise investor explains the thesis to us. We trust their judgement, but maybe age has caught up with them and we need to be at least a bit more aware ourselves. So we open the past 3 years worth of annual reports & find some articles and satisfy our need for doing “some research”. We are in the same boat as before but with a better illusion of knowledge than before. We believe we have read enough.

3rd: I’ve read too much
This is diametrically opposite to the first two forms of laziness. We don’t trust the idea at all, & we put a lot of effort in understanding it. We end up reading 15 yrs of annual reports, we read up all the media mentions about the company and the promoters. We do some scuttlebutt. But we are too lazy to sit down and decide what’re the few most important triggers that will make this investment work. We have worked hard but not worked smart. Despite knowing a lot we may not have the conviction.



We get a wide variety of responses from people when we talk to them about an investment idea.
It reminds me of this website - IMDB. Internet Movie Database.
It has a rating system to show us how popular or how good the film is.

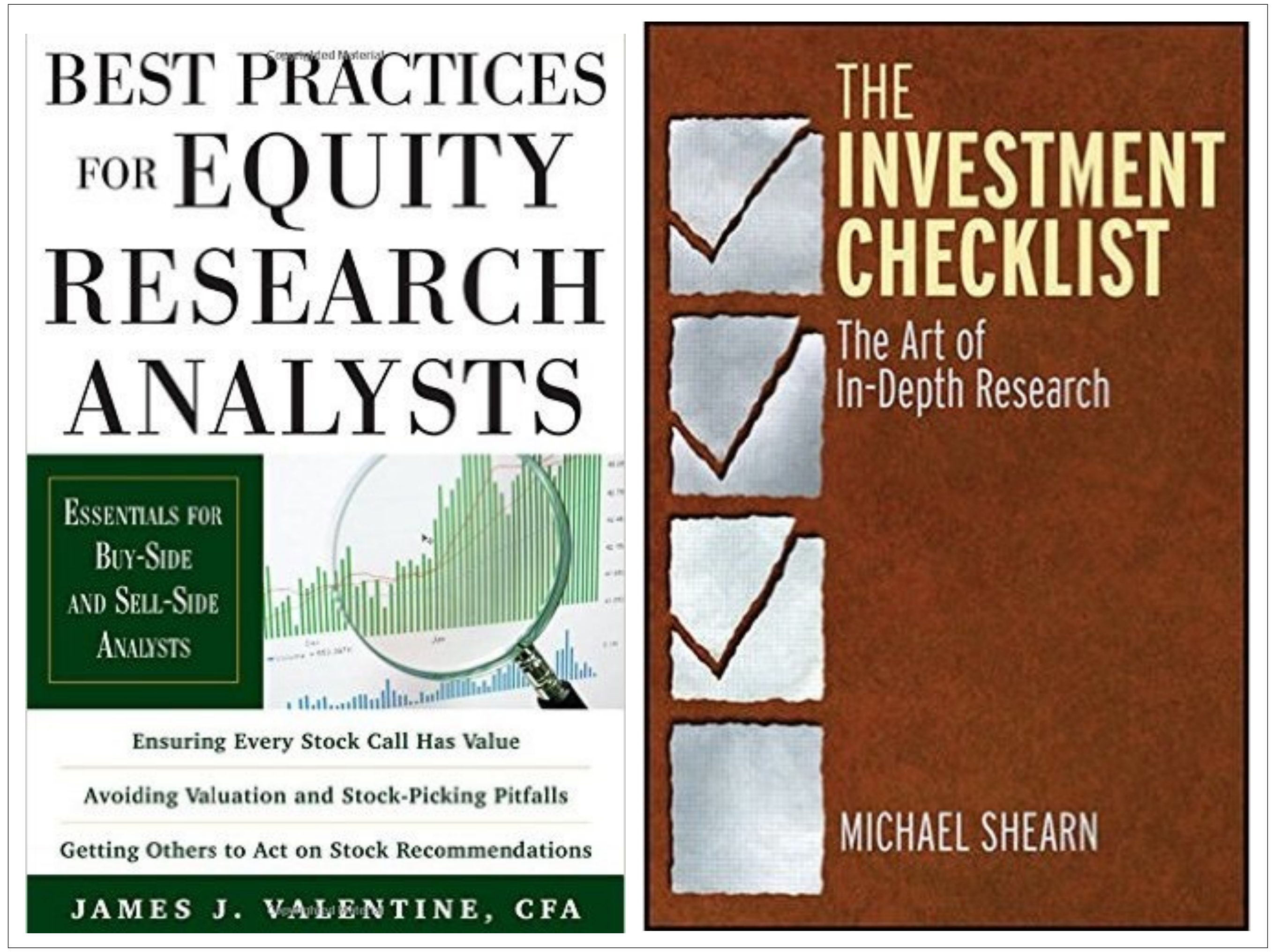
But the problem is it doesn't say how many of the ratings come from those users who have watched the entire film. We don't know if someone has just watched the trailer & mouthing off their opinion or someone walked out of half the film and has come to an early conclusion. That's why we need to watch the entire (investment) film from our point of view to come to our own opinion about how good / bad it is.

The world of investing can sometimes become a big echo chamber of opinions. When a lot of smart & intelligent people think in the exact same way & act accordingly, it rarely benefits all of them.

It is easy to say that we need to think for ourselves. That's one of the hardest things to do for an investor when there is so much stimuli.

But in reality each source of knowledge will add its own layer of bias so we need to be aware of how we learn about the investment idea.

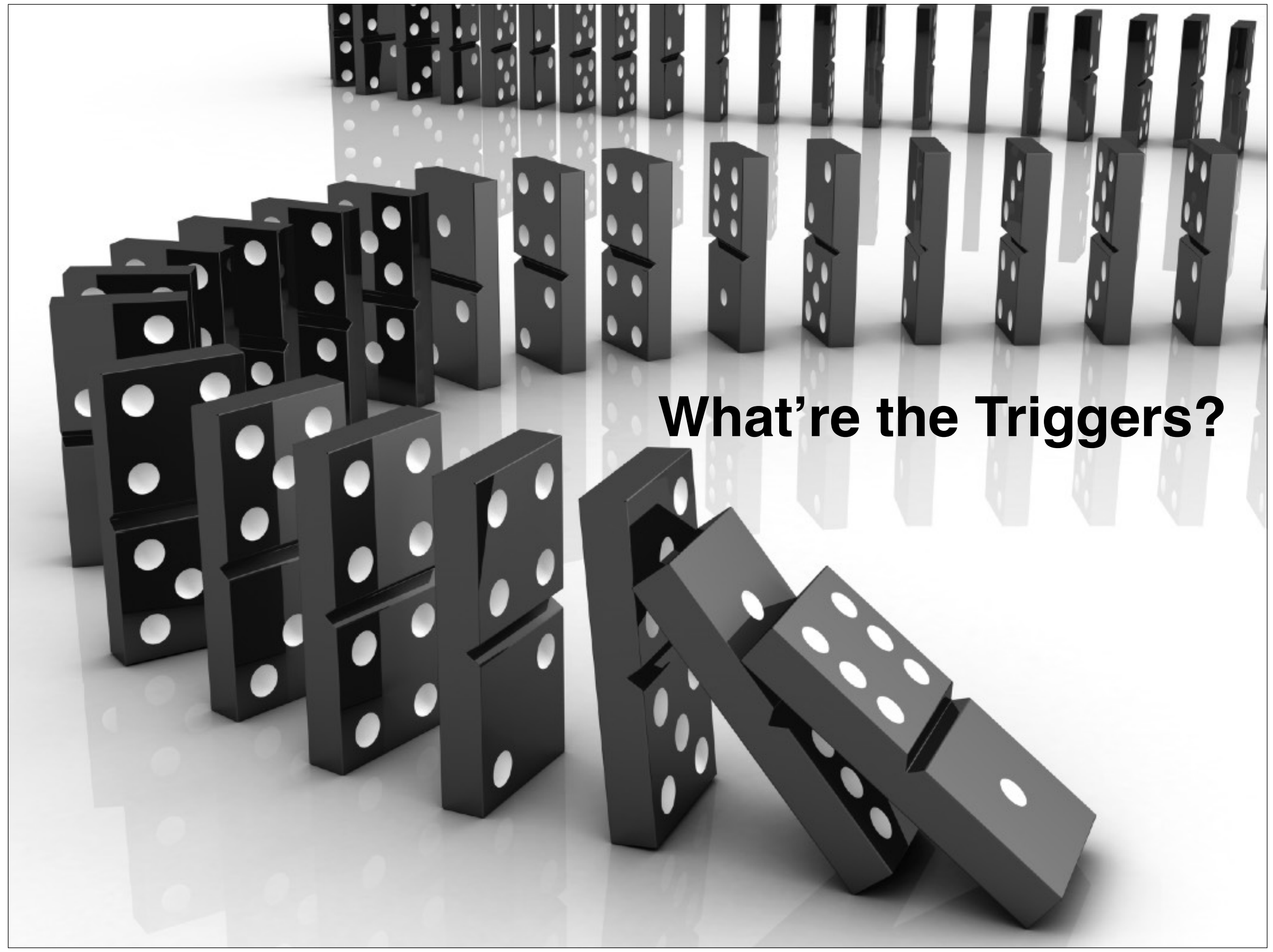
I don't want to complain too much about how we goof up. Here’s a solution.
One obvious solution is to look for knowledge outside the investment networks.
Find independent sources of data / industry experts who can provide insights
Then we can form theories about what can happen in the future with the investment.
Like I said before, we don’t need to do this kind of deep work all the time. But most often it is needed.



These two books provide a very comprehensive approach to build our own understanding of things before we make any investment decisions.

I think in this regard, the process for long term investing helps a lot since it provides the right motivation to go through this lengthy research process. Although I'm aware of some short term traders who also indulge in deep research and use experience & intuition to guide their decision making.

So acquiring knowledge is agnostic of investment style.



One of the most important outcome of the Information Edge is to identify triggers that will make the investment idea work.

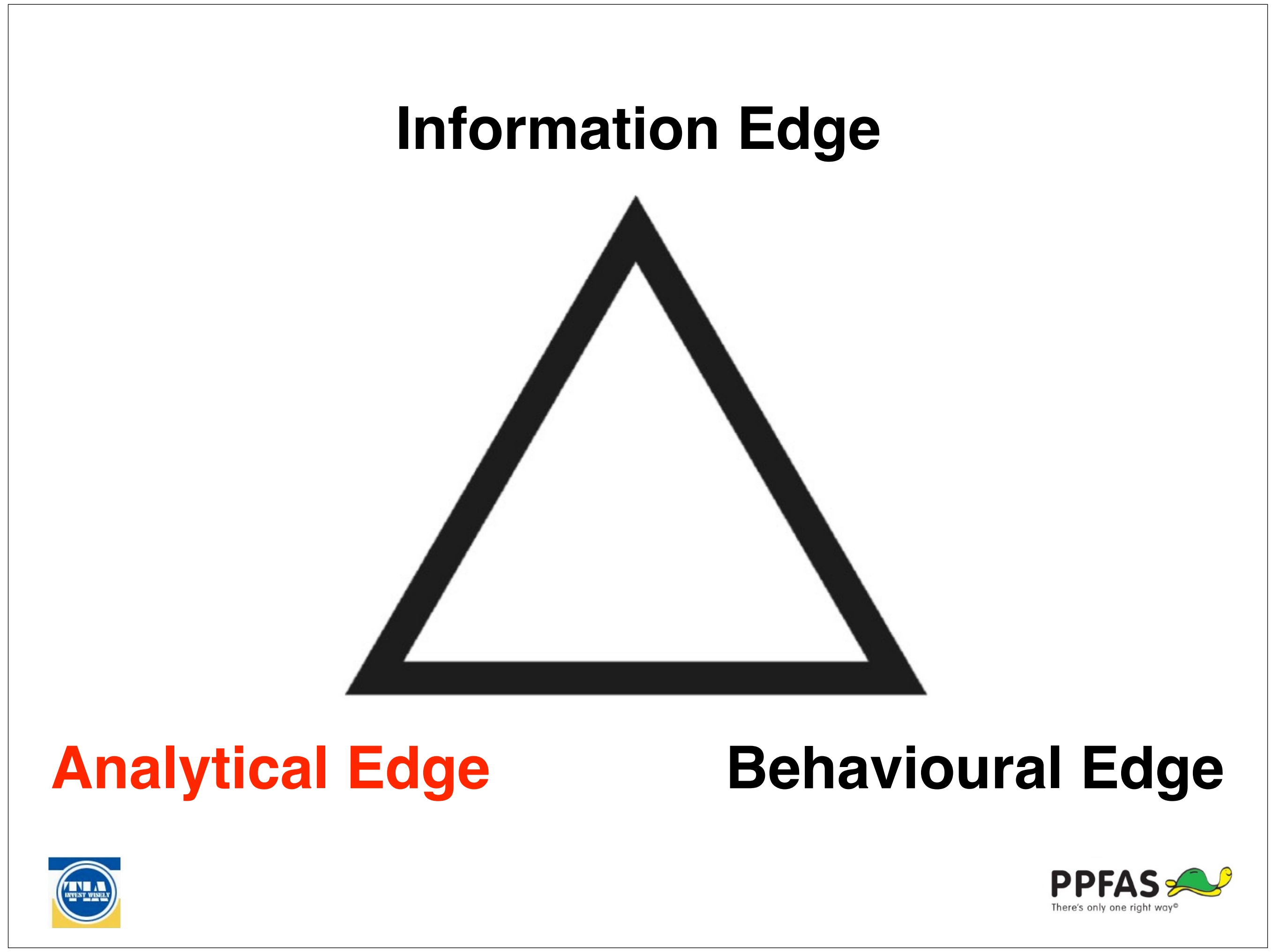
Triggers don’t include posting tweets about what we have bought :)

I mean, truly understanding what can happen with the business to grow earnings & cashflows.

1 Network with the Real World

2 Hope to Build Good Insights

Information edge is not easy to achieve. All we hope to gain from having an Information Edge is to get a real world view of what's happening and hope to build some good insights about how businesses are run.



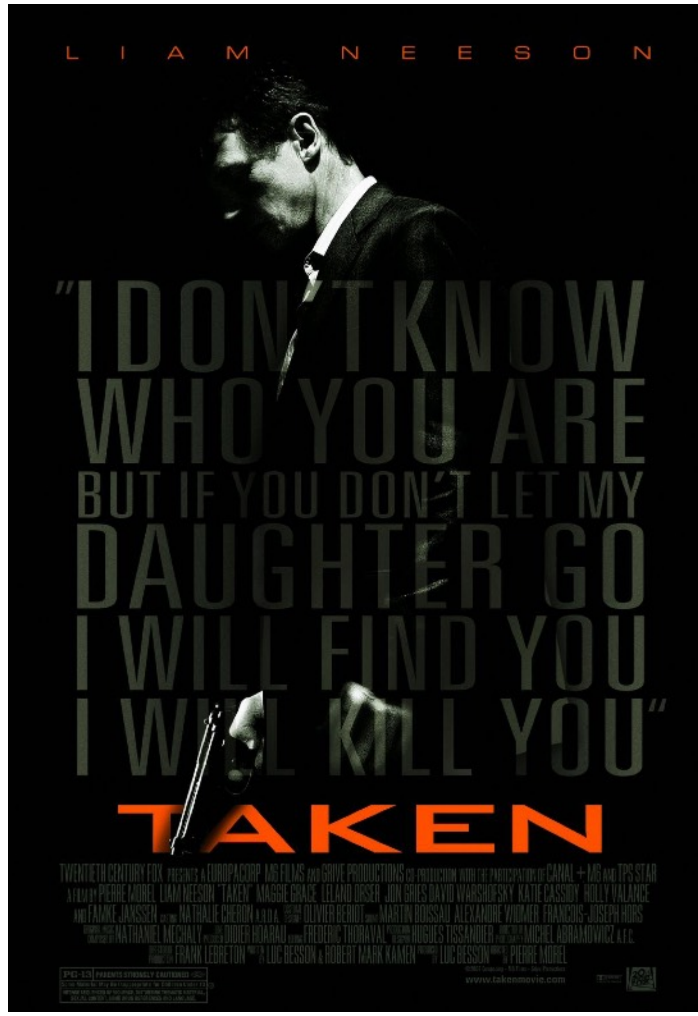
Let’s a take a deeper look into the Analytical Edge.

“Everyone knows the right answers, but very few know the right questions”

Countless conference calls & analyst meets have led me to believe that everyone is extremely intelligent. They know all the answers but very few people ask the right questions.

The right answer is good return on capital, sustainable margins, increasing market share. Very few people understand that none of these things are certain.

They don’t fall from the sky. Lot of effort needs to go in to achieve those results along with a bit of cyclical luck.



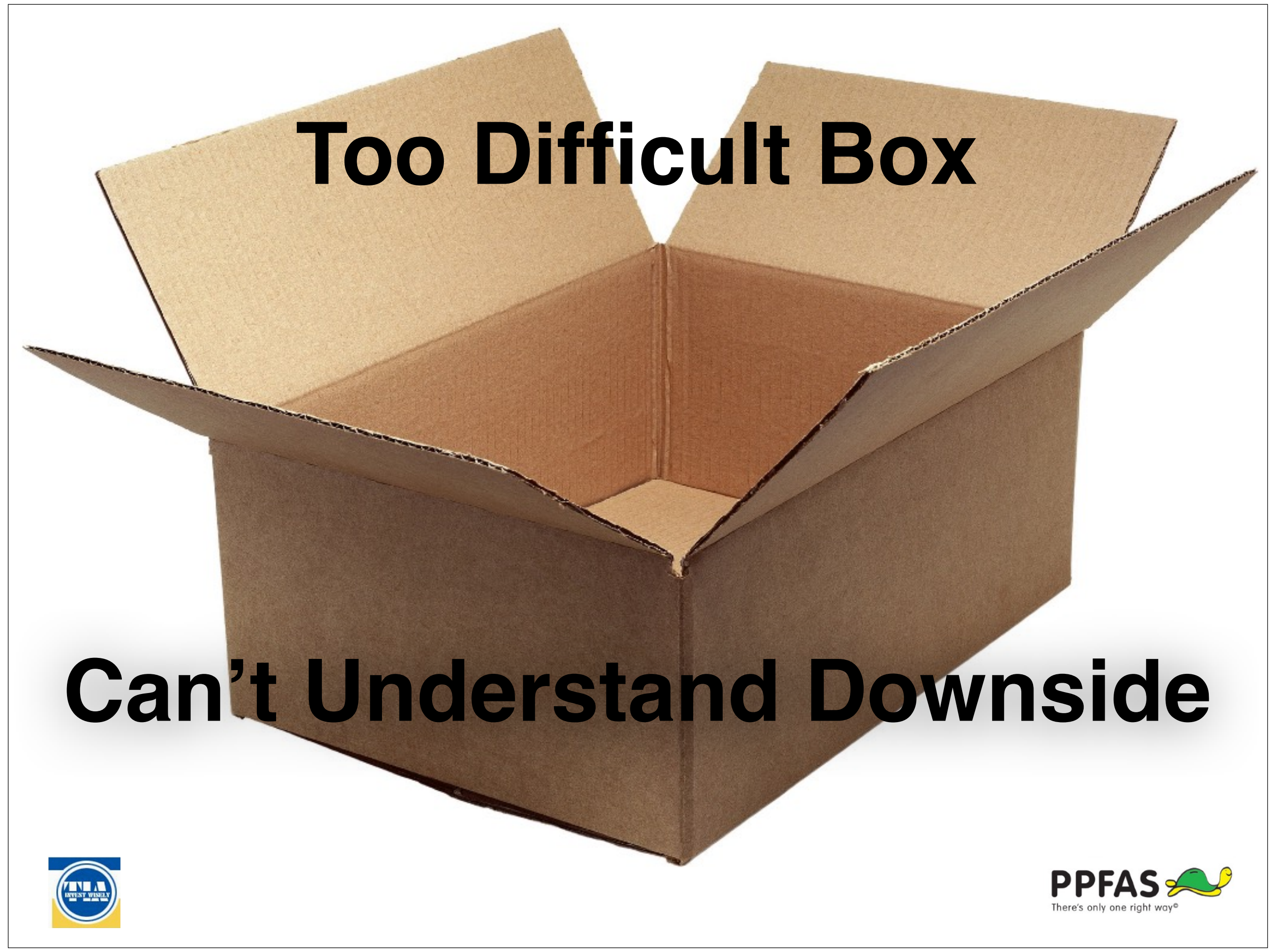
An Unsatisfied Man

Like Liam Neeson from the Taken film series, a lot of investors remain unsatisfied.
As he keeps hunting down bad guys, some investors seek a lot of intellectual satisfaction from the process of investing. But for the sole purpose of intellectual satisfaction, investing may not be the right profession.

Although there's plenty intellectual satisfaction available, along with the chance to make a lot of money.

Look at Private Equity investing, we are practically running the business along with the management, as strategic partners providing them with guidance from our network of entrepreneurs or business managers. That experience can be immensely rewarding.

Outside (public equity) investors don't have such deep & obvious outlets for intellectual satisfaction. We have to rely on being a step outside of how the management thinks about the business. We are most of the time the last people to know if something goes wrong inside.



Because of this lack of intellectual satisfaction some people get naturally attracted to businesses that are very difficult to understand. (including Me)

There is nothing wrong in studying complex / complicated businesses but we must be able to figure out the downside.

So sometimes it is useful to have this box to not let our analytical abilities go unchecked.

Without experience it is very difficult to visualise what a business will really look like in different situations.

Imagine a situation where we have to visualise how the business grows in the future.
We have two tools,
1st: an open imagination without any other tools to freely think how a particular business can grow.
2nd: an excel sheet with historical numbers entered in it.

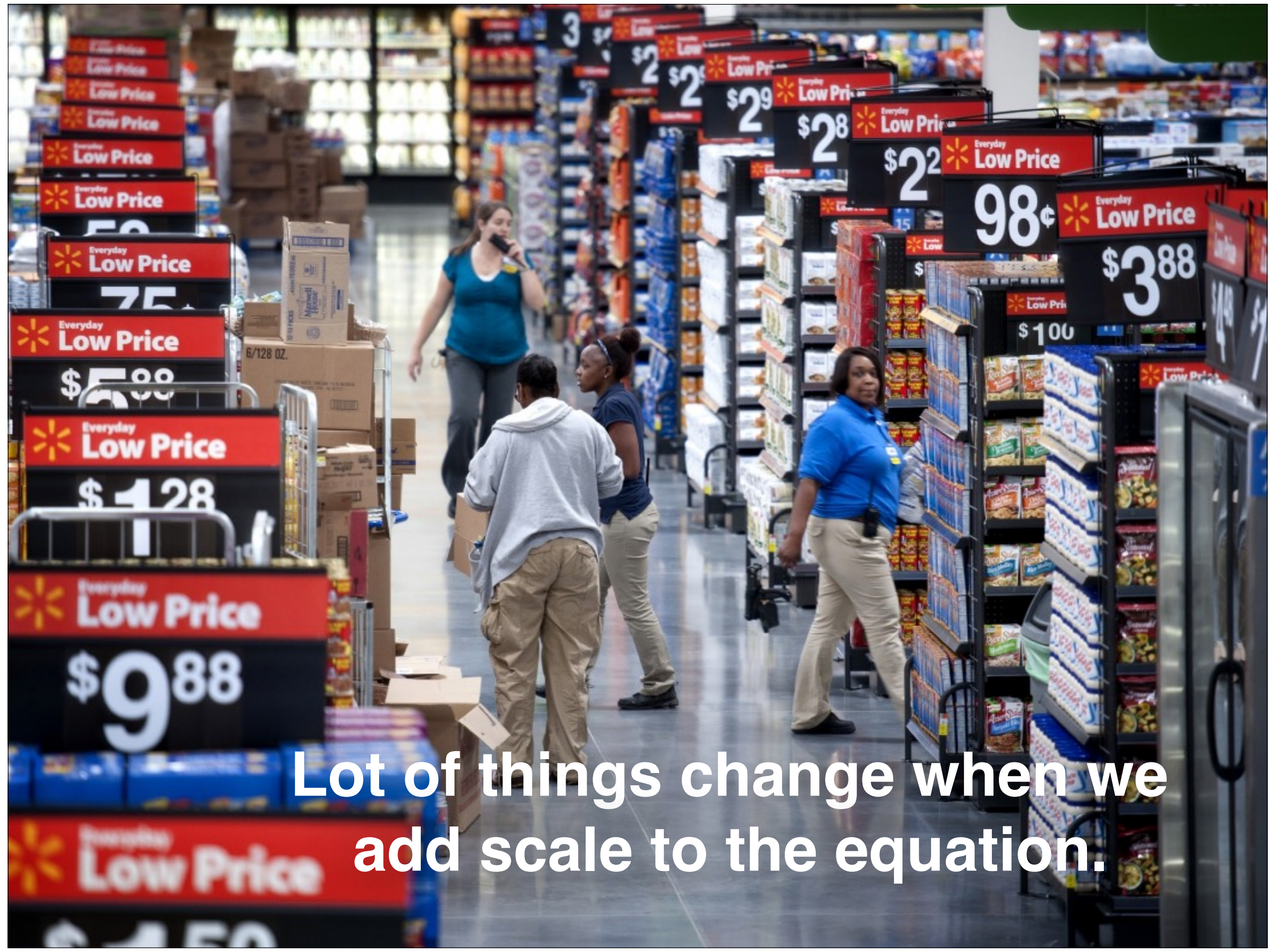
In the first case, without having any prior experience in tracking that industry, it will be very hard to practically imagine how a business can scale up. There are several on the ground issues like supply chain complexity, HR complexity, management bandwidth, etc to figure out, to really know how the future can be.

In the second case, with an excel sheet, we can quickly do a sensitivity analysis by playing with the growth & return numbers to arrive at a very accurate future value of the business without really knowing any on-the-ground issues.

Our power of analysis improves with experience as we become more aware of real world issues & can help us visualise future business outcomes more meaningfully.

When a business is small it is easy to understand.

Promoter is more hands on & we really get to see how the simple supply chain works. We can summarise it in three to four points and build our investment case.



When businesses scale, the organisational needs, to keep growing, are quite different.

The complexity increases and reliance on down-the-line managers increases too.

These things can't be automated beyond a point. So if you're a long term micro-cap investor, that micro cap will eventually scale and hit all these road blocks, which it has to successfully navigate to become a small cap, a mid cap & eventually a large cap.

We only connect the dots we see

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I mentioned I learned 80% of management lessons from Dilbert, the other 20% I learned from Calvin & Hobbes.

This is what a confirmation bias looks like.

So the pursuit of what really happens is a must to get better at analysis.

1 Understanding how we think

2 Finding New Investment Ideas

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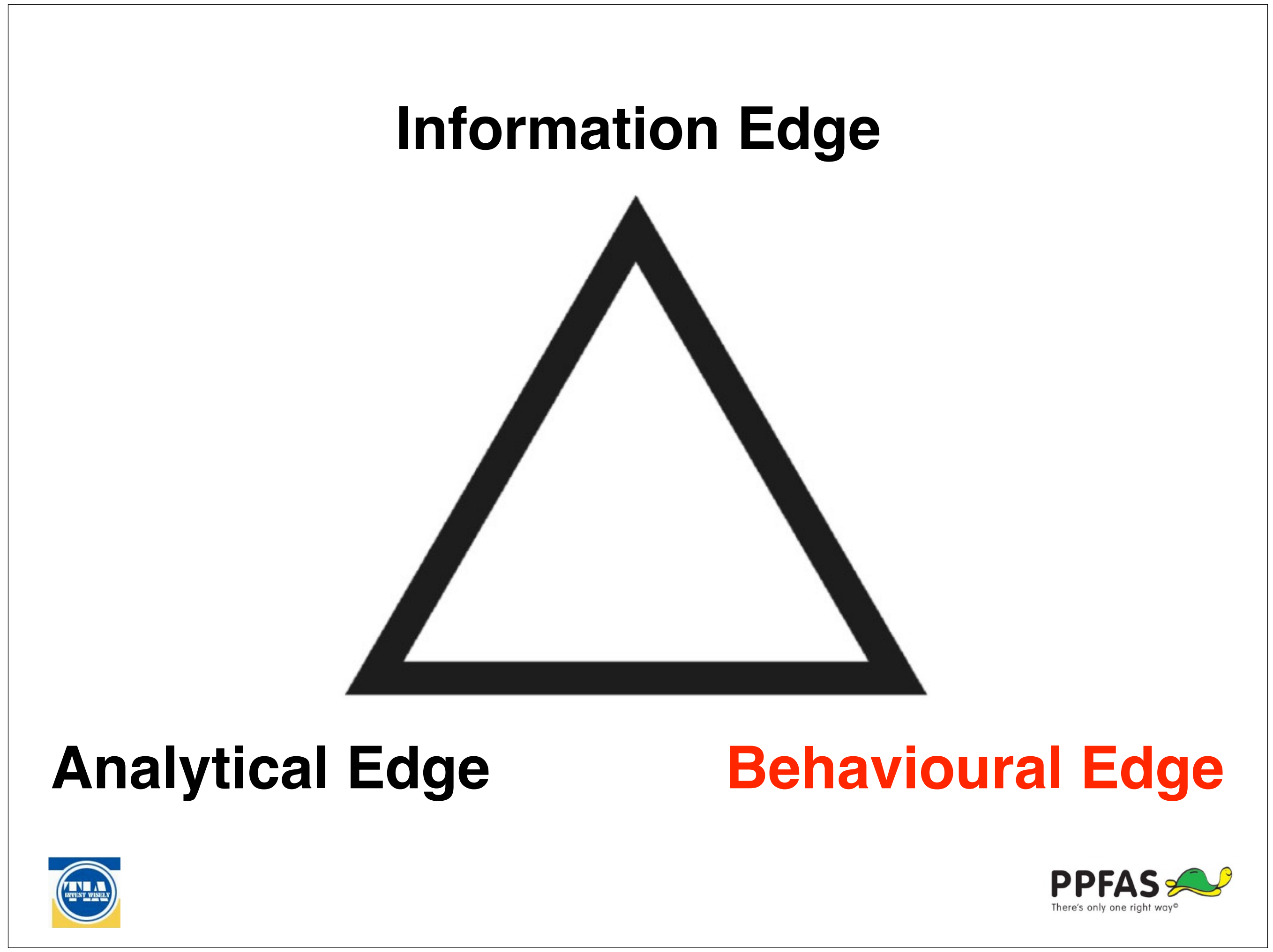
The process of building conviction with analysis can be channelised to understand “how we think.”
What kind of biases do we allow ourselves to have.

You will have noticed that informational edge & analytical edge go together.

Without the ability to analyse properly, information gathering is useless & without good information, analysis is pointless.



Let’s take a look at the final & most important pillar for building conviction.

How will we react When things don't go as planned?

- **Experience**
- **Preparedness**
- **Clinical Calmness**

If you haven't seen this film yet, it is tailor made for investors. It is unclear if Clint Eastwood (the director) spoke to investors before making it, but it has all the components a successful investor needs. It highlights the importance of having experience which gives the ability to being mentally prepared to take advantage of certain situations (using intuition) & also gives us the ability to remain clinically calm when things go wrong.

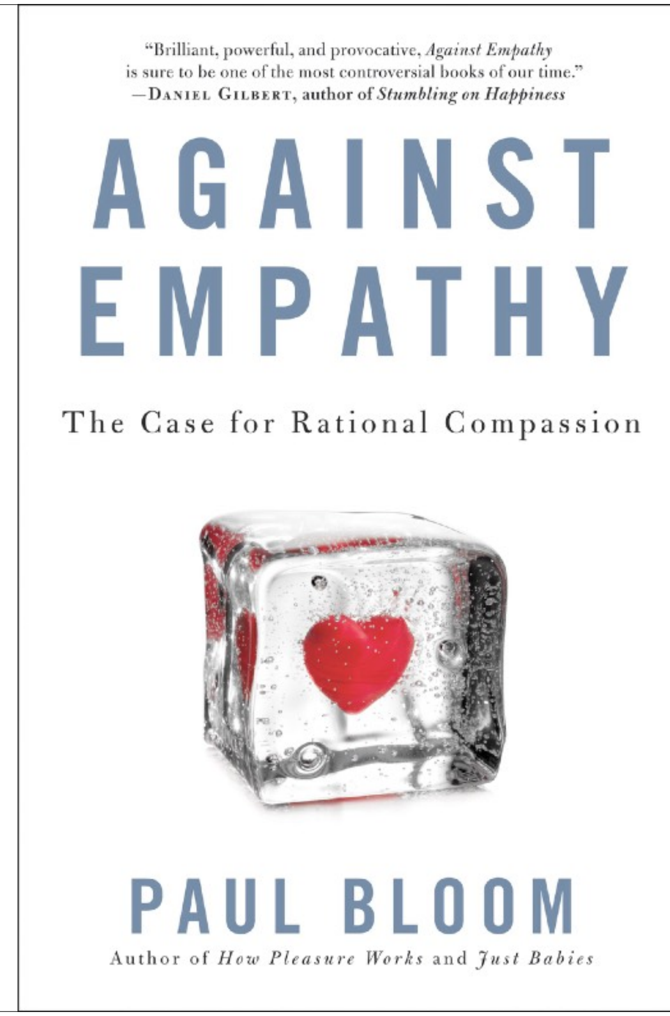
When we invest, we make a lot of decisions. We can’t really escape the outcomes but that doesn’t mean we can’t learn from them. It’s important to write down our decision making. It not only helps us track our evolution as an investor but it also motivates us to improve our thought process from focusing on trivial details to finding out the key drivers for an investment idea.

All the good things in investing come after a while. It’s necessary to have the patience to sit through the investment decision to watch it work. Doesn’t work all the time because we are not in control, but we can get a chance to participate in trends.

Should we empathise with the promoter / management?

One of the most important questions I've faced in terms of having a behavioural edge is should I empathise with the promoters or managements of the companies I'm investing in. I still haven't figured it out.

It's important for me to know this because the promoters / managements, for lack of a better word, are <u>stuck</u> with their business. Whereas we as investors we can go in & out of many investments with relative ease based on our cyclical knowledge. Does empathy get in the way of our decision making??



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I highly recommend this book not because it has an interesting title, but it is perhaps the best articulated discussion on the idea of empathy and how it affects our thought process.

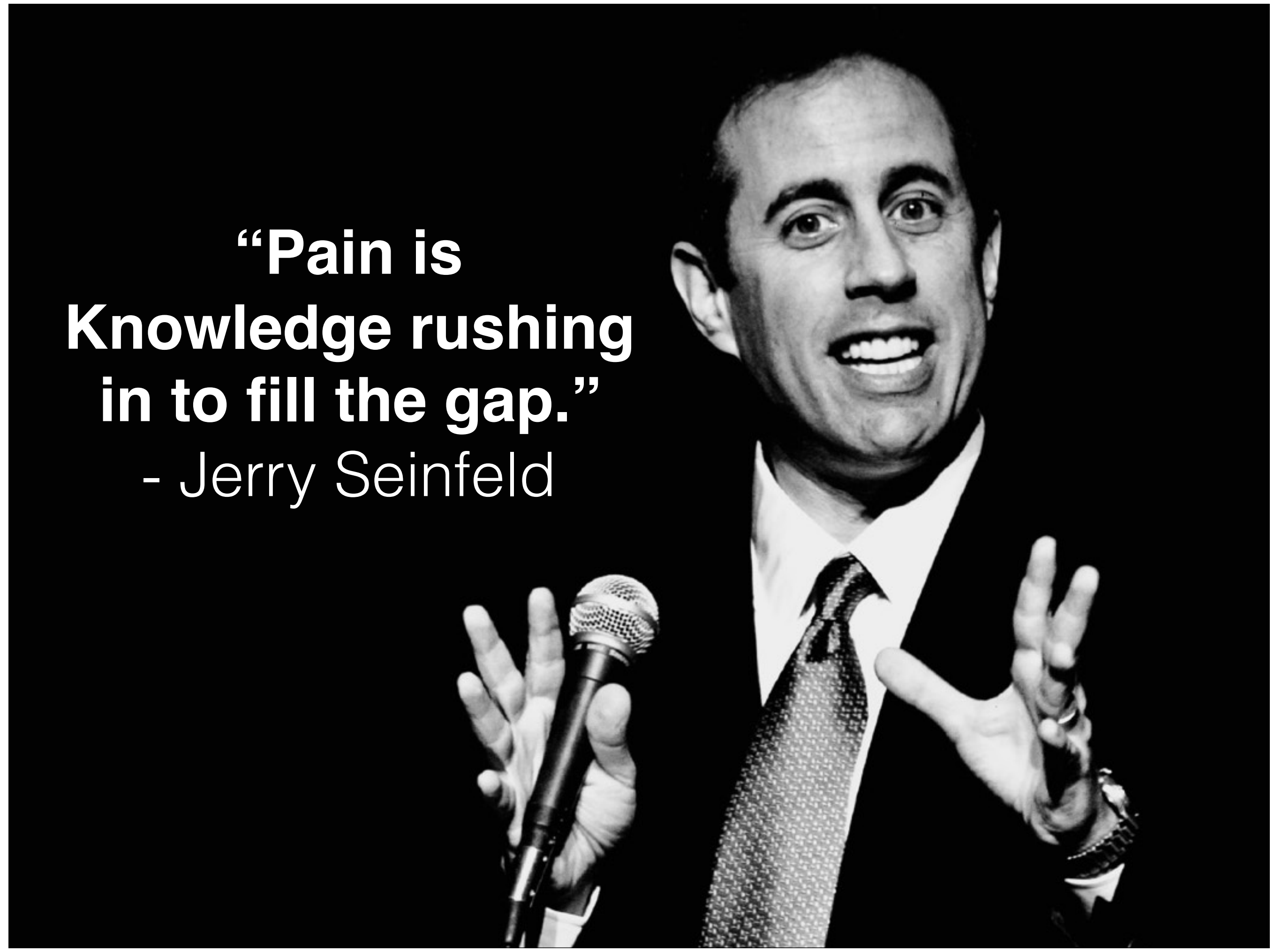
Out of many points, It mentions two (technical) ideas:
Emotional Empathy: We feel the same pain as the person we are empathising with.
Cognitive Empathy: We don't feel the same pain but we understand the other person's pain (commonly known as compassion)

I think we need to be compassionate with the situation of the promoters when they run their businesses.

We Make Mistakes…

When I first read Munger's quote that we must learn from other peoples' mistakes to avoid making them ourselves. I thought, wow, if I can read all the investment books out there I will be able to have a flawless record.

In reality, sometimes we understand things better when we make the mistake ourselves. Look at all the mistakes as learning opportunities but don't get killed.



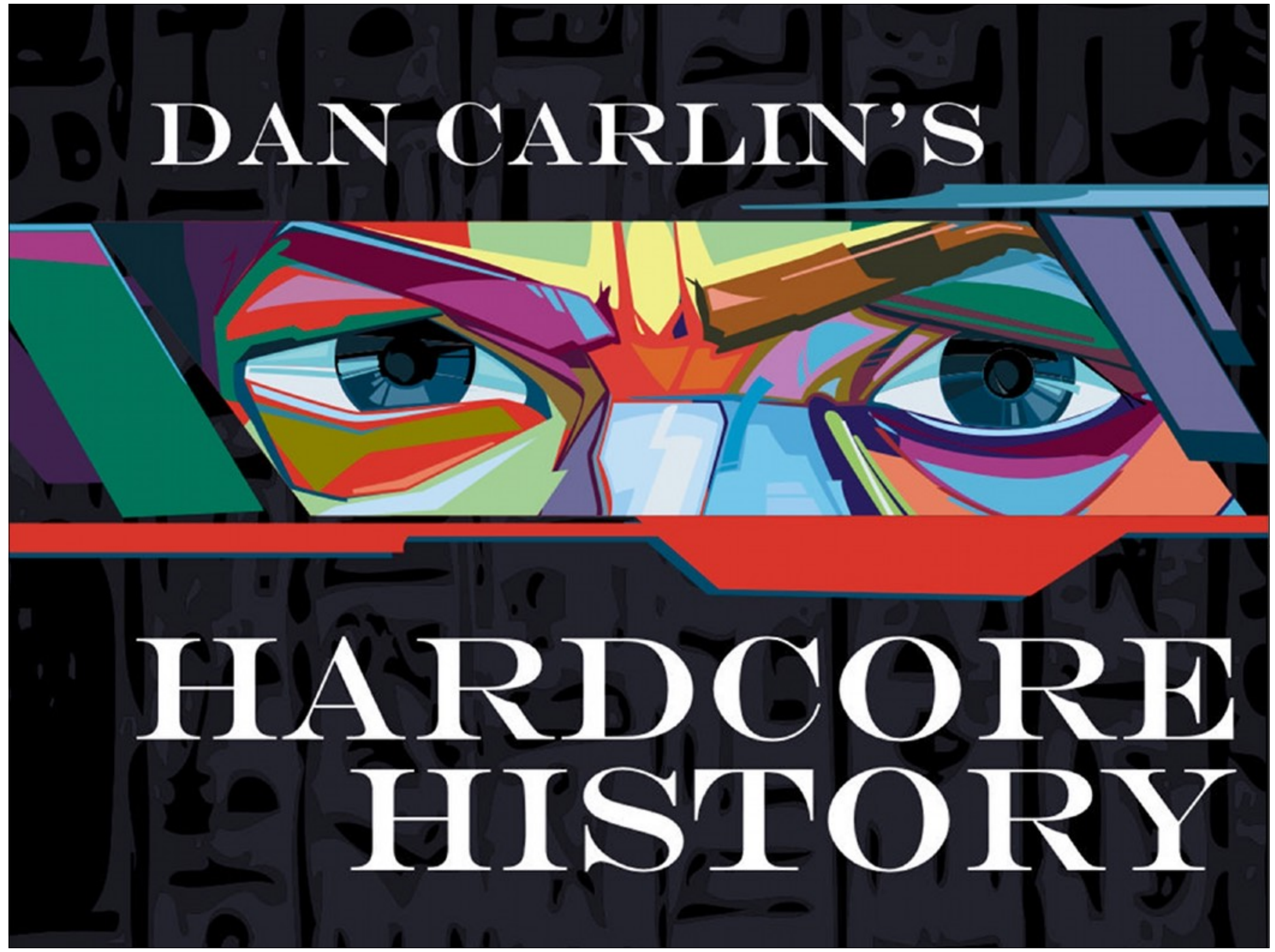
Must watch show - **Comedians in Cars Getting Coffee**
(if you’re a Jerry Seinfeld Fan)
He says this in one of the episodes about the process of making mistakes & learning. The gap is between ignorance & knowledge.

1 Emotional Control

2 Wait for it…

To summarise, having a behavioural edge helps us exercise emotional control on our own actions & helps us to understand the importance of patience to allow our investment ideas to work.

It’s said that we all need to have some investment heroes. Instead of finding one in the field of investing, I thought of highlighting one who is outside the profession.



He's Dan Carlin, who used to be a radio show host & now hosts the epic podcast Hardcore History. The way he learns about history to understand what could have really happened is truly inspiring.

Thank You

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Would love to take any questions…