Intelligent Cloning

Initial write-up

The idea of "Intelligent Cloning" is all about combining Ben Graham thinking on risk aversion with the Munger rule nr. 1 on how to become a successful investor. And to remind you. Mungers first rule is to carefully look at what the other great investors have done. The second rule is to pay close attention to cannibal companies (companies buying back huge amounts of stock) and the third rule is to focus on spinoffs.

If there is one investor out there that takes these simple Munger ideas very seriously it has to be Mohnish Pabrai. Recently he wrote an article in Forbes entitled "Beyond Buffett: How To Build Wealth Copying 9 Other Value Stock Pickers", where he talks about "Shameless Cloning". Actually he wrote it together with Fei Li and you can find the article on his wonderful website Chai with Pabrai.

Shameless Cloning. Isn't that great. You know that there are some great investment minds out here. Don't try to compete against these guys. Instead copy their best ideas and profit from them. I love it! Mohnish Pabrai is not just a great investor, he is a great communicator as well. I like the way he puts forward his ideas. Let me just quote from his article. Here it is:

"Santa knocks on all our doors not once, but four times a year. During his off-season, he reliably shows up bearing profitable gifts on February 14, May 15, August 14 and November 14. These are the deadlines for 13-F filings".

Think about that. Four times a year you get probably the greatest stock picks on the planet on your doormat. For free! Mohnish describes a method to pick 5 stocks and rebalance the portfolio once every year. So, how did this 5-stock portfolio perform over the last 17+ years? It beats the S&P 500 by 10.7% annualized! That's amazing!

A slightly different road

I toke a slightly different road. Not necessarily better, but different. First of all I am a long term investor and hold stocks as long as the company remains a good company. So I will avoid annual rebalancing. And secondly I make an extra effort and try to avoid the investing mistakes of these great value investors. Does anybody know how many mistakes great value investors make? It has been said that George Soros made money on fewer than 30% of his trades.

Now think about this for a moment. Suppose you run a concentrated portfolio of 10 stocks. And you joined the merry band of shameless cloners. So you picked for instance Valeant (Bill Ackman/Sequoia), SunEdison (David Einhorn), Horsehead Holdings (Mohnish Pabrai) and Royal Imtech (for many years the stock market darling of the Dutch stock exchange). These are all companies that went bankrupt or had to raise from the ashes. I mean, the result would have been devastating.

In comes Ben Graham. When investors make mistakes it is usually because they forget the inherent simplicity of the Ben Graham value investing system. I truly believe an investor can make better decisions by keeping things simple. So why not apply the Graham criteria for the defensive and enterprising investor to avoid mistakes? Now you might argue that these criteria are outdated and rightfully so. When Graham wrote them down he didn't had access for instance to cashflow statements. Well. Then let's rewrite them with the knowledge and insights we have right now.

What you want to do is to avoid the "too risky" investments. And to identify these I use 5 criteria. Very straight forward:

- A "balanced" balance sheet. So you try to avoid too much debt, too much leverage and too much goodwill/intangibles.
- Consistency in the per-share figures. I just don't like companies that show a consistently growing earnings-per-share (which is good) in combination with a highly fluctuating operational cashflow per share.
- Substantial free cash flow. As a company, if you don't have free cash flow, you don't have anything. Management could choose to reinvest in the business, buy other businesses, reduce debt loads, buy back stock, or pay out dividends.

- Consistently high return on capital. You probably all know Joel Greenblatts Magic Formula. There are many ways to calculate ROC, so you have to figure out what suits you best and why.
- Margin of safety. There is no such thing as a company that's worth an infinite price. So you want a price that makes sense. I believe it was Chuck Akre who once said that he is willing to pay up to 20 times free cash flow for a high quality company. You might want to figure out what Warren Buffett paid for Precision Castparts.

By using this simple set of criteria you would have avoided Valeant, SunEdison, Horsehead Holdings and Royal Imtech. Instead you would have probably invested in John Deere (Team Berkshire) and Allison Transmission (Lou Simpson). As of recently team Berkshire sold John Deere. Probably not because it is a bad investment, but just to free up money to invest elsewhere. I will keep John Deere in my portfolio as long as the company remains a good company.

You might argue that team Buffett found better opportunities, so why not follow them for example into airlines. Well. That's not who I am. If I find a low-risk solid-return opportunity I buy it and forget it. The same for Heineken. It's not trading at an attractive price right now, but if the markets would go way down and I could buy Heineken below 55 euro, I buy it and forget it. And it makes life a lot easier, you know. If you continually keep hunting for "the best opportunity", eventually that will drive you mad. In Value Investing your worst enemy is probably your own brain.

One final twist. Dependent on how many great value investors you want to follow you very well might end up with more than one investment opportunity. So which one to choose? You might want to use a simple Joel Greenblatt ranking system. So you rank e.g. 10 candidates by ROC. The highest gets 1 point and the lowest 10 points. And then you rank them by margin of safety. The highest gets 1 point and the lowest 10. You add the numbers and choose the lowest number.

Now let's go back to Mohnish. He beats the the S&P 500 with 10.7% annualized over the last 17+ years. That's like indexing on steroids and you can probably boost returns even further by using the above set of criteria. But you have to be very rational and unemotional to successfully implement a long-term cloning strategy. And most people unfortunately are impulsive and irrational. The average investor is probably too restless and the smart investor too smart to just follow a simple strategy. For most of us investing periodically in a low cost index fund probably remains the best low-risk solid-return proposition on the planet.

Mohnish and Fei end the article with the hope we will join the merry band of shameless cloners. Well. Just count me in.

Happy Santa Claus!

Cordially,

Peter

Peter Coenen, 11 March 2017
Founder & CEO of The Value Firm®