INTERVIEW

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'Lose the least to make the most'

With a wide canvas of investment management experience, IIM-Ahmedabad alumnus **E A Sundaram** clearly loves dabbling in money. After spending over 26 years in the profession, Sundaram, Chief Investment Officer - Equities at DHFL Pramerica Asset Managers Pvt. Ltd, says that the best thing about the profession is that here returns are not a function of the extent of effort that is put in. His approach towards investment is simple: the person whose focus is to lose the least ultimately makes the most. In an interview with **Kumar Shankar Roy**, Sundaram shares his views on the portfolio-management-services (PMS) business, his secret sauce for selecting winners, avoiding losers, and how to deal with greed and fear.

How did you enter the world of managing investments and what attracted you to the profession?

I have been fortunate in joining the asset-management industry just when it was beginning to take off in the country. I was doubly fortunate in joining the private-sector asset-management industry just when it was starting off in the country. To compound it, I have been fortunate in entering the PMS business just as it was beginning to take off in the country.

I understood the beauty of this profession only after joining it. This profession is probably the only one in the world where the returns are not a function of the extent of effort put in.

How do you assess and understand the quality of a business?

A good business has the following characteristics:

- A good track record (the longer, the better)

- A history of consistently earning more than the cost of funds employed in the business
- A history of generating positive free cash flows
- Being managed by a set of competent and investor-friendly people

We are not venture-capital investors. Therefore, we do not look at anything new (however revolutionary the idea may sound). There is a specific need that we try to satisfy. We do not try to be all things to all people.

What are the top things that you look for in a good management? Conversely, what are things that set off your alarm bell? Do you like family-run businesses?

The things sought in a good management are:

- Consistency in delivering returns greater than the cost of funds
- Consistency in efficiently allocating capital
- A demonstrated hunger to grow market share, revenues and profits sustainably
- The demonstrated ability to enter new markets or expand the markets by introducing newer products
- Taking active and proactive steps to protect the company's turf
- A friendly attitude towards minority shareholders.

In all of these, we are indifferent whether the company is 'family run' or 'professionally run'. There are good and bad family-run businesses, and there are good and bad professionally run businesses.

Alarm bells are usually set off when there is a capital-allocation decision which we believe would harm the long-term return ratios of the company. A diversification into a totally unrelated business (especially, if it is capital intensive) would be a definite alarm bell.

How do you approach business valuations? How important a role does earnings growth play for you?

Earnings growth is certainly important, but something more important is the demonstrated earnings power that has not been permanently impaired. We are perfectly OK buying companies where there is no earnings growth foreseen for the next few quarters, as long as we are satisfied that the company's ability to grow has not been impaired.

We seek companies when their valuations are below their long-term averages, and/or below their estimated (sustainable) growth rate in earnings. In select cases, we compare market prices with the DCF (discounted cash flow) valuation.

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When you judge a stock, what are the things that you look at? How do you account for excessive optimism in the stock price?

We ideally would like to buy such a stock when it is quoting at a valuation level below its long-term average valuation levels or below its estimated (sustainable) growth rate in earnings. Of course, this is not always possible. But we would definitely like to avoid stocks where the valuations are well above their historical averages and/or estimated growth rate in earnings, as this reflects the 'excessive optimism' that you are referring to.

Does your selection of a stock depend on broader stock-market valuation indicators?

No. It does not.

We have to remember that even during times when the overall stock market (BSE Sensex or Nifty) was trading at extremely high valuations, there were shares of companies that were reasonably priced. Industrials, FMCG and banks in late 1999/early 2000s or FMCG/multinational pharma in 2007 are good examples.

The basic idea behind our portfolio is to identify a strong business, preferably one that is not very popular at the time of purchase. The lack of popularity should, in our opinion, be for strictly temporary reasons. When a company is unpopular, its shares are available at reasonable prices. When we buy at reasonable prices, the chances of success in that investment are enhanced. But this method works only when the company concerned is of fundamentally acceptable quality.

How would you describe yourself: growth, value or a combination? Are you a buy-and-hold investor or you believe every stock has a target price/ fair value?

I think that such pigeon-holing is unnecessary. All investors seek growth and value. We all invest in equity shares with the intention of participating in the future growth of the company. Secondly, the potential appreciation of the stocks we buy is a function of how much less we pay for the stock. In other words, all investors seek growth and all investors seek value.

Buying a share irrespective of these two considerations, with only the intention of selling it off to somebody else at a higher price, cannot be classified as 'investing' at all.

Some shares are held for a much longer period than some others, but it should never be a case of 'permanent hold'. Every now and then, the assumptions with which the stock was purchased in the first place should be validated. Also, a fund manager is expected to scan the environment continuously trying to spot if there are opportunities that are superior to the ones already in the portfolio.

Excluding liquidity reasons, how do you decide when to sell a great performing stock?

We sell a stock in the following cases:

1. If, in our opinion, the assumptions with which the share was bought in the first place are not valid any more
2. If the share price has risen well above what it is worth
3. If for the same perceived level of risk, there is a superior opportunity
4. When there is a full or partial redemption request

If these conditions are not satisfied, we are happy to continue to hold the share for as long as is necessary.

Have you ever paid a lot of money to buy exceptional businesses? Tell us about those experiences

Yes, there have been such occasions. Experience teaches us some valuable lessons. There was, many years ago, an occasion when I have purchased shares in Gillette, even though the valuation was extremely high.

Tell us about one good and one bad experience with companies you have invested in.

The worst experience (the one that I hope would never be forgotten) was when our portfolio was overloaded with companies of inferior quality. This was in the mid-1990s. Thankfully, we decided to bite the bullet and clean up the portfolio and did not wait for the tide to turn in our favour.

In retrospect, it turned out to be one of the best things we did as a team. The company gained in reputation after this trial by fire.

The best feeling an investor can ever get is when he sticks to his conviction even in the face of overwhelmingly opposing views across the board and is eventually proven right. It happened in 2012–13 when I had purchased Indraprastha Gas at the peak of its 'uncertainty' over the PNGRB case. Subsequent events justified our

optimism. But the important thing was there were enough pointers and evidence to support our case. It was just that these pointers were ignored by a majority of those in the market. Aldous Huxley had noted, "Facts do not cease to exist because they are ignored."

We are after all human beings. Many managers, even after many years at the game, fall prey to emotion. How do you avoid emotion when it comes to investments?

I do not believe that emotion can be totally eliminated by an investor. And I am not talking of futuristic computer-driven investment programs. As long as portfolios are being managed by human beings, there will be emotions at play. But emotion can be controlled.

The most important emotions to contend with are fear and greed.

The stock market will continue to display manic–depressive tendencies. There will be times when some stocks or sectors are completely ignored and times when they are raised to the skies.

If we continue to remind ourselves what we are investing for, then I believe that the emotion of greed can be controlled to a large extent. An effective way to counter the emotion of greed is to focus on earning a 'good' return, rather than the 'best' return. We are investing for our benefit, not to convince the world that we are the best investors. I am reasonably convinced that running after the best or highest return is the primary cause for recklessness in the stock market. And recklessness is a recipe for poor overall returns.

An effective way to counter the emotion of fear is to focus on buying businesses with a strong ability to compete effectively in the market place. If we know what we have bought, a fall in its share price does not cause fear or panic. Fear is caused by the unknown. When traversing through uncharted territory, isn't it better to be with strong companions? Strong companies make strong companions. The only way to reduce fear in investing is to increase the effort of finding out more about the companies that we buy (but this should be done before buying the shares and not after).

There are good stocks out there. But the trick is often to concentrate on a few. How do you carry out this process of focusing on a few stocks out of hundreds?

We have a robust filtering process,

where only the companies that qualify on the parameters that we have set for ourselves will qualify to be in the investment universe. The parameters are:

1. A minimum of 15 years' track record
2. A minimum revenue threshold
3. Consistency in return on capital employed
4. Consistency in the ability to generate free cash flow

In all of these, we are completely neutral to whether the company is Indian-owned or a multinational, whether it is in the public or private sector or whether it is a large-cap, mid-cap or small-cap company.

What we are seeking is an efficient company (that is expected to remain efficient), run by people who have demonstrated both their competence and their attitude towards minority shareholders. Such a company is sought to be purchased when it is not exorbitantly expensive.

We are not interested in buying at the bottom price, nor are we interested in selling at the peak price. All that we want to do is (1) purchase the share of a company that qualifies on the aforementioned parameters and (2) buy it when it is not exorbitantly expensive.

This is a very boring process but has a greater chance of being profitable and does not subject the investor to reckless risks. This process has a greater chance of succeeding simply because it is in sync with the basic principle of the capital market. If the capital market is supposed to reward efficiency in the use of capital (and conversely punish inefficiency in the use of capital), then this method seeks to (1) invest only in businesses that efficiently use their capital and (2) use the clients' capital more efficiently in trying not to overpay for what we buy.

How do you identify companies with strong competitive advantages? When you have identified them, how do you decide 'value'?

The idea is to identify a company where there is something that would be difficult for competition to emulate. It can be a strong set of brands with loyal customers; it can be sheer physical scale; it can be technological edge backed by strong R&D or a combination of these. These should result in a sustained market share or market share gains and sustained levels of profitability.

Precise estimation of value is a futile exercise. We need to be approximately right and not waste time in trying to make extremely precise estimates of value. If we refrain from buying into exorbitant valuations (defined as valuations well above its historical average and/or its sustainable growth rate in earnings), we would have a decent result. And that is more than what we really need.

> **"Buying a share irrespective of these two considerations [growth and value], with only the intention of selling it off to somebody else at a higher price, cannot be classified as 'investing' at all."**

Can you give some example of value traps and the methods adopted by you to avoid such traps?

In my experience, such traps exist more in cyclical businesses. A stock sharply corrects after a cyclical peak. Its present price may be much lower than the recent peak, but the investor pays too much attention to the stock-price movement and forgets that the industry itself is in a cyclical downturn.

In cyclical businesses, it is better to have earnings smoothed out having a rolling three-year or rolling five-year average earnings and then calculate valuation histories.

How long are you willing to wait for a stock in your portfolio to perform?

A three-year waiting period is reasonable. Beyond that it gets difficult to justify holding the stock. More important than that is the continued validity of the assumptions with which the stock was purchased in the first place.

We hope to have a long-term success rate of 70 per cent in our stock selection. We simply cannot be right in all our bets.

Do you invest in loss-making businesses? If so, what is the approach adopted by you?

Yes, loss-making businesses are OK as long as we are confident that the long-term earnings potential of the company is intact and is much superior to the present temporary loss-making period. Also, the valuation of such a company should offer a sufficient margin of safety.

What are your key lessons from decades of stock-investing experience?

We are here to manage somebody else's money. We are not here to prove how intelligent we are. Therefore, avoiding the big mistakes is far more important than doing anything spectacular.

In the stock market, the person whose focus is to lose the least ultimately makes the most. WI