Bullish

or

Bearish?

“I don’t know”

Investing for “I don’t know” dummies

Chamath Palihapitiya

Sohn Conference
NYC

Tesla Motors Convertibles

“Some people are more certain of everything than I am of anything.”

– Robert Rubin (“In an uncertain world”)

“Those who have knowledge, don’t predict. Those who predict, don’t have knowledge”

– Lao Tzu

“All the value of a common stock is in future cash flows. All the financial statements reflect is the past”

– Aswath Damodaran etc.

Things I don't know

- What will be the impact of GST on the Indian economy?
- Will Insolvency and Bankruptcy code resolve the debt crisis in India?
- Will the real estate sector revive post RERA?
- Will there be and India-China war on account of tensions in Sikkim? …………

"Heads you win, tails you don't lose too much."

The concept of **Asymmetric returns**

A factually correct statement

"In equities, if you invest Rs. 100. The max you can lose is Rs. 100. There is no cap on the maximum amount you can gain. If it is a 100 bagger, the value grows to Rs. 10,000."

Question

"Are returns from equity investing asymmetric?"

Annual portfolio returns

- Manager A: 35%, 75%, -55%, 25%, 20%
- Manager B: 15%, 20%, 9%, 20%, 14%

Annual portfolio final values

- Manager A: 35%, 75%, -55%, 25%, 20% (1.59)
- Manager B: 15%, 20%, 9%, 20%, 14% (2.05)

Understanding equity (multiplicative) returns

-25% = +33%

-50% = +100%

-75% = +300%

-90% = +900%

-95% = +1900%

Example

- You start with Rs. 100
  - Year 1: Loss of 50%, capital reduces to Rs. 50
  - Year 2: Gain of 100%, Rs. 50 doubles to Rs. 100, back to square 1.
- Order does not matter - You start with Rs. 100
  - Year 1: Gain of 100%, you have Rs. 200 at end of year 1
  - Year 2: Loss of 50%, you are left with Rs. 100 at end of year 2, back to square 1

On their own, the following are NOT Asymmetric

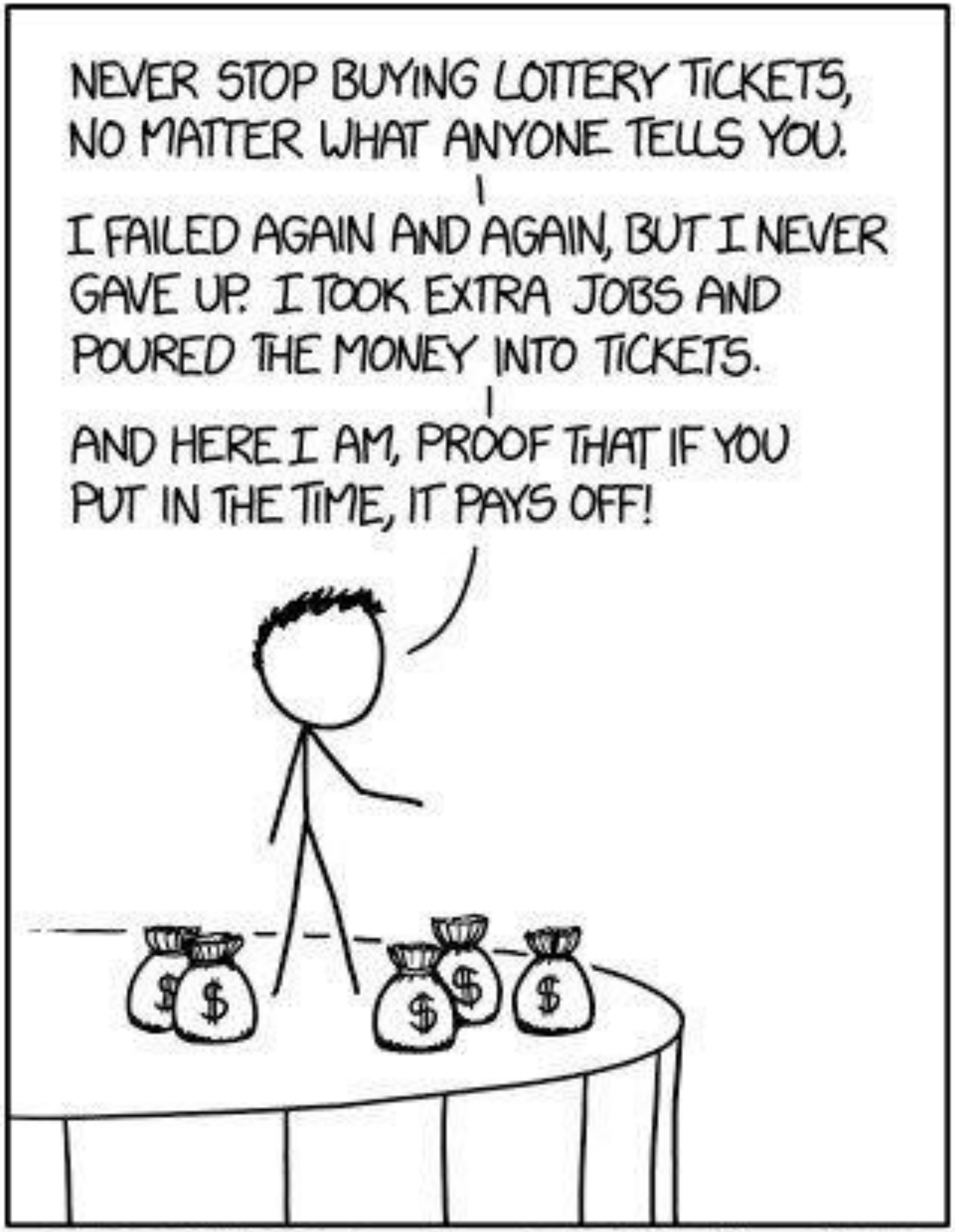
- Equity investing
- Leverage, Equity Futures
- Concentrated portfolios / big bets

Diversified portfolio risk

- Additive NOT multiplicative
  - Say you buy 10 stocks for equal weights of 10% of portfolio
  - 5 stocks will with guarantee double
  - 5 stocks will with guarantee halve
  - Terminal value is 125 !!!

Concentrated portfolio risk

- Drawdown in one stock may result in overall portfolio drawdown
- Stocks may be correlated
- Risks become multiplicative instead of additive
- Knockout punch?



EVERY INSPIRATIONAL SPEECH BY SOMEONE SUCCESSFUL SHOULD HAVE TO START WITH A DISCLAIMER ABOUT SURVIVORSHIP BIAS.

Giovanni Franchi @giovfranchi · Jun 20

All true!... On the other hand, I believe it is very difficult to know the future of any business with certainty. If you ask me, I'll tell

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Giovanni Franchi @giovfranchi · Jun 20

you that sincerely I don't know the future of the two businesses I've founded and I manage on a daily basis... let alone businesses we

2 5

Giovanni Franchi @giovfranchi · Jun 20

invest through the stock market! Of course, do your homework and try to know all you can about those stocks you choose to invest in... but a

1 3

Giovanni Franchi @giovfranchi · Jun 20

reasonably diversified portfolio of high quality stocks purchased periodically is imo a prudent way of investing.

1 9

Typical equity investing

- Game of probabilities - NOT certainty
- Play when expected value positive
- Play many times. Over time, law of averages pushes out luck
- Casinos and slot machines in other words
- Examples
  - 1: Win probability 75% Lose probability 25% equal payoff
  - 2: Win : lose probability 50:50. Payoff 75 on win, Loss of 25 on lose.
  - and so on ……………

Typical equity investing works …..

.. but asymmetric investing
(when available)
is even better

Masters of Asymmetric returns

“What is asymmetric investing?”

Free Hit


BAN 157/7
Overs: 35.1
SKY

Asymmetric investing = when the market / world bowls you a no ball

Examples

Graham on convertibles

- Issued since at least 1946 and analysed by Graham
- Written about in both “The Intelligent Investor” and “Security Analysis”
- Surely not a big fan of Convertibles / Warrants / Preferred’s
- More later …..

Buffett investments in 2008

- $ 5 Billion of Goldman Sachs preferred stock + $ 5 billion warrants
- $ 5 Billion Bank of America preferred + $ 5 billion warrants
- $ 3 Billion General Electric preferred + $ 3 billion warrants
- $ 2.1 Billion in Wrigley (preferred + option structure)

Buffett on convertibles

- Student of Graham
- Use in 1977 or earlier
- Letter to shareholders in 1989
- Extensive use of convertibles, preferred, warrants over his career
- "Gillette's business is very much ……….."

Indian example

- A live one - Housing Development Finance Corporation
  - Bonds issued at coupon of 1.43% vs market yield of 8.54%
  - Warrants
- Reliance Petroleum Triple Option Convertible Debentures
- Various FCCBs issued

Bonds + Options combinations (Structures)

2 routes

- Index linked non convertible debentures (structured products offered to HNIs)
- DIY using bonds + Long term options
  - Mind you, long term options are illiquid

CARE Ratings
Professional Risk Opinion

March 22, 2017 I Banking & Financial Services

<u>Market Linked Debentures:</u>
Issuances at 5-year high

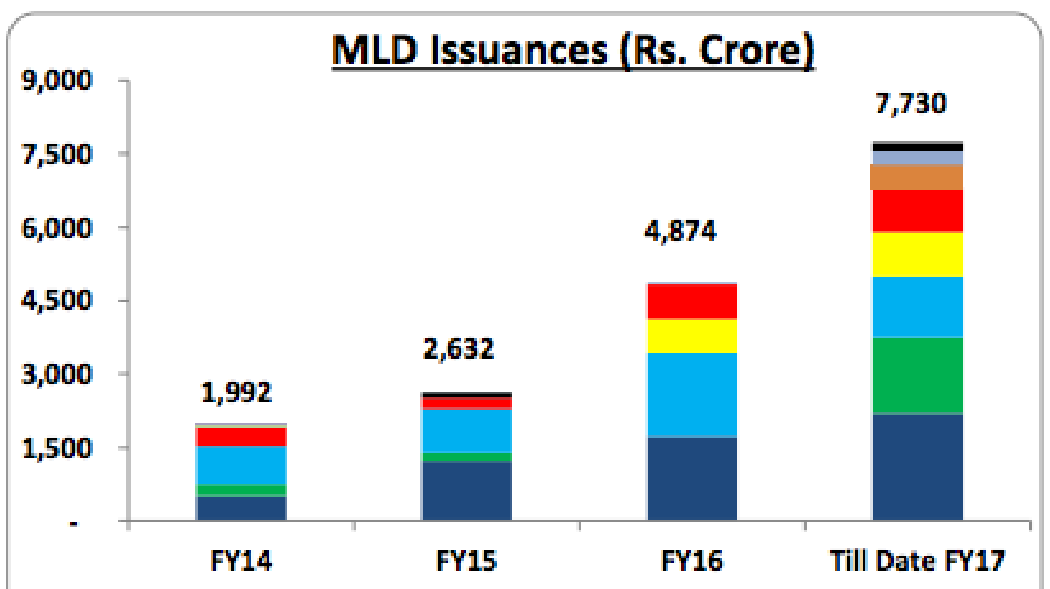
The Indian Market linked debenture (MLD i.e. structured product) segment witnessed an astounding rise in FY17 *(refers to the period Apr 1 2016 to date in 2017)* as the issuances reached a size of Rs. 7,730 crore in FY17 as against Rs. 4,874 crore in FY16. The average monthly issuances have gone up to Rs. 600 crore in FY17 from around Rs. 300 crore in previous years. ***CARE Ratings expects the issuances to stay strong and reach Rs. 8,200 crore by Mar 31, 2017.***

This is primarily due to both demand and supply side expansion. The demand of MLDs grew on account of

- Higher participation from corporates in addition to existing HNIs,
- Increase in ticket size
- Acceptance of MLDs with underlying other than Nifty (i.e. G-sec, corporate bonds etc.)
- Investors' emphasis on downside protection in volatile market conditions.

The supply side of market grew on the back of

- Rise in number of issuers and
- Increase in number of distributors.



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Question:

“What is the longest tenure for which Equity Derivatives trade on National Stock Exchange?”

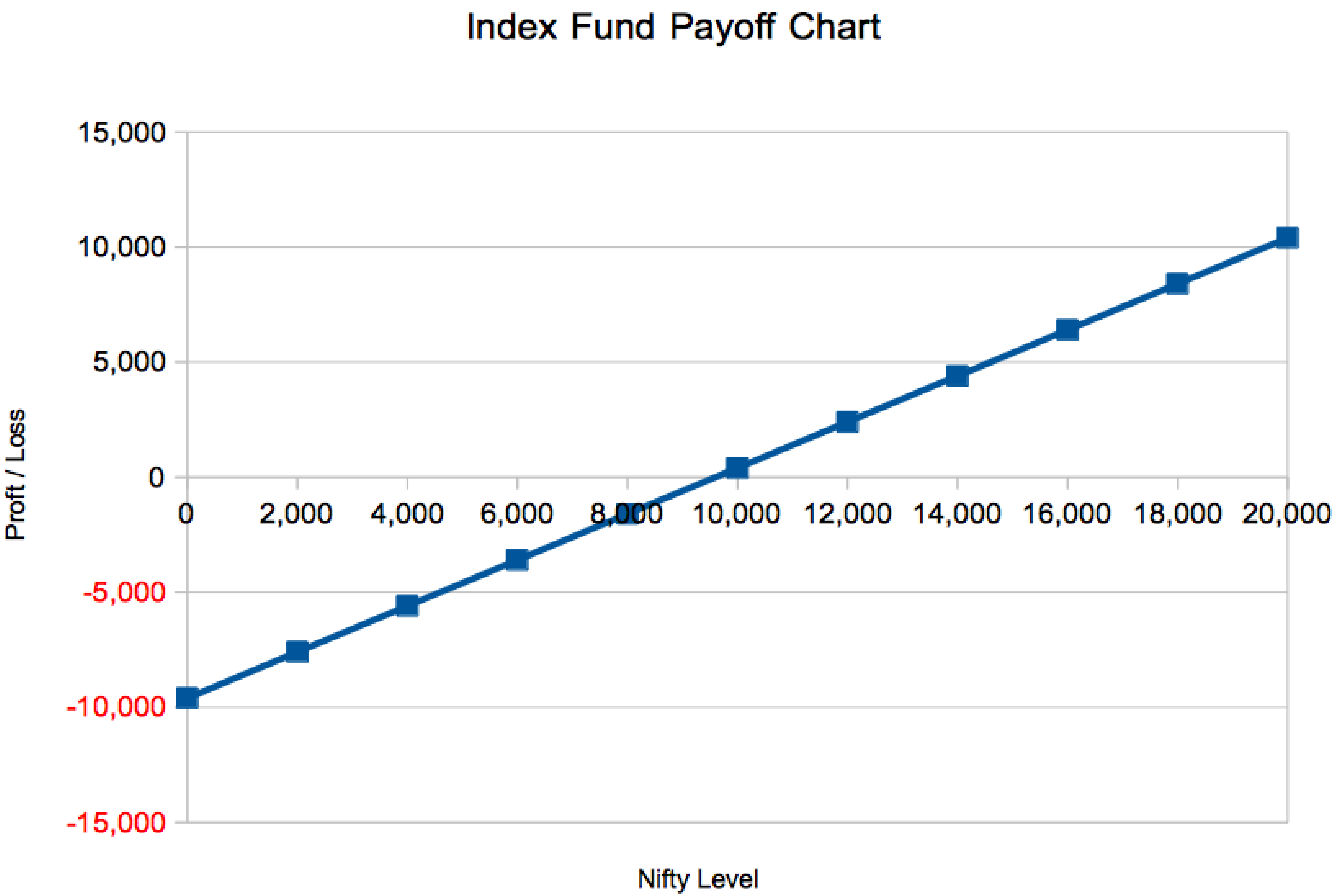
Answer: 5 Years on Index options!!!

Example

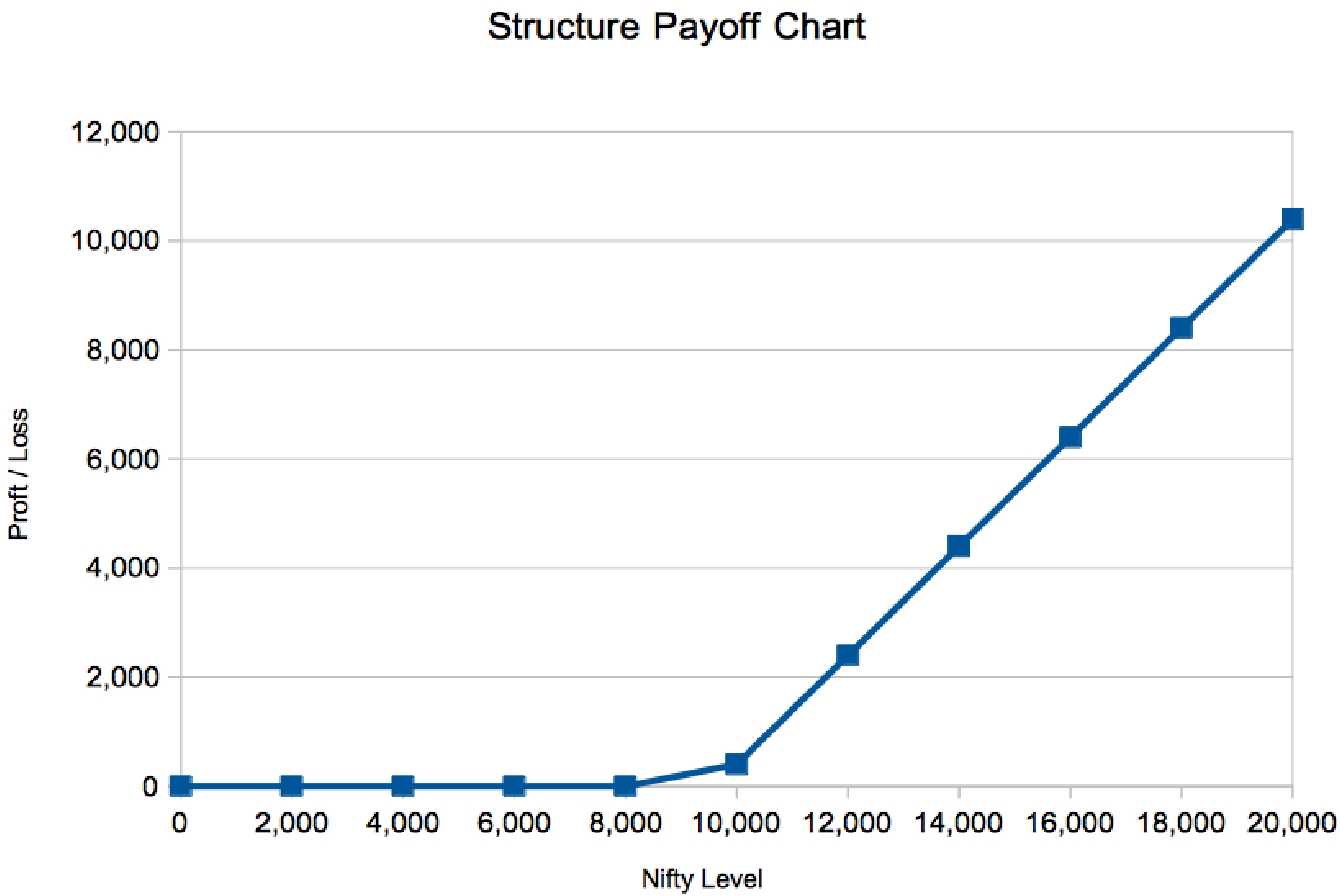
- Say you have Rs. 9,600
  - You can buy index fund
  - Or create a structure

Structure

- Invest Rs. 7,620 @ 8% p.a. for 3 years
  - This amount will grow to Rs. 9,600 after 3 year with interest
- Buy 3 year call option with SP of 9,600 @ 1,980
  - If market goes up - you have full upside
  - If market goes down - you principal is protected due to FD



Index Fund Payoff Chart
15,000
10,000
5,000
0
-5,000
-10,000
-15,000
Proft / Loss
0
2,000
4,000
6,000
8,000
10,000
12,000
14,000
16,000
18,000
20,000
Nifty Level


Structure Payoff Chart
12,000
10,000
8,000
6,000
4,000
2,000
0
Proft / Loss
0
2,000
4,000
6,000
8,000
10,000
12,000
14,000
16,000
18,000
20,000
Nifty Level

ESOPs

Derivatives are Financial Weapons of Mass Destruction

- Yes if used to leverage, but……..
- They are securities contracts and like securities they can be under / fairly / over valued at different point in time
- Used smartly, they can give opportunities for asymmetric returns

Essentials for a good structure opportunity

- High interest rates on bonds / fixed income
- Extremely low volatility implied in option prices (typically when thing are going very smoothly for markets)
- Paucity of high conviction outright buy ideas

Graham on convertibles

"……, for you cannot by a mere ingenious device make a bargain much better for both sides. In exchange for the conversion privilege, the investor usually gives up something important in quality or yield or both."

Problems with convertibles / Structures

- Issuer & investors do not provide for interest expense in the true sense
- Profits are inflated
- Issuer / Investors also do not account for the equity dilutive effect
- FCCB fiasco in the last bull run
- Stock Price “management” at the time of issuance
- Do not forget credit risk

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Thank you