InvestorInsights: Samit Vartak

Samit Vartak, an enterprising and inspiring value investor shares his invaluable insights and experiences in sensible, long-term investing and money management.

Samit is one of the founding partners and Chief Investment Officer at SageOne Investment Advisors. He is responsible for ensuring SageOne's adherence to its core investment philosophy and discipline of risk management. His focus is on building long term wealth for the clients even if it means sacrificing short term money making. He believes in risk management not by seeking extreme diversification or buying sub-par businesses at low multiples, but by building a reasonably diversified portfolio of high quality businesses having long term competitive advantages in attractive and high growth industries.

Samit returned to India in 2006 after spending a decade in the USA working initially in corporate strategy with Gap Inc. and PwC Consulting, and then with Deloitte and Ernst & Young advising companies on business valuation and M&A. This experience forms the backbone that helps him better understand businesses and their fair value. Samit is a CFA® charter holder, an MBA from Olin School of Business of the Washington University in St. Louis and holds a Bachelor of Engineering degree with Honors from Sardar Patel College of Engineering (SPCE), Mumbai University.

In his interview with Safal Niveshak, Samit shares his wide investment experience and how small investors can practice sensible investment decision making.

Safal Niveshak (SN): Could you tell us a little about your background, how you got interested in value investing?

Samit Vartak (SV): I come from a village named Mahim which is along the Konkan coast about 100 km north of Mumbai. My father is a farmer, who does that for living even now. As a kid I grew up on the farm and studied there until the 10th standard after which I came to Mumbai for higher education and completed my engineering. Financially, my father had to struggle immensely to educate me and my two younger brothers from his illusive farming income. Experiencing and living through my family's struggle for money is the background that has influenced my investment style.

After working with Mahindra and Mahindra for 3 years, I received scholarship from a prestigious US university to pursue an MBA for which I left for the US in 1997. Post MBA, I worked in the US until 2006 with the likes of PwC Consulting and Deloitte Financial Advisory Services. Half of my US experience was in Management Consulting, advising companies on improving operational efficiency, business processes and strategy. The other half was as a valuation professional advising PE/VC funds and corporates on valuations for their investments and M&A. This experience has helped me with the two most important aspect of investing – understanding businesses and understanding fair valuation for them.

I caught the stock market bug in 1999 at the peak of the dot com bubble when making money had become very easy. This was the time when I followed exactly what is currently in my "what not to do" list as an investment process. I followed analyst recommendations, looked at simple valuation metrics such as PE ratio/PEG ratio, believed in forecasted numbers of analysts, and invested in companies where buy recommendations were the highest. No surprise that as the markets peaked, I started losing money and to recover my losses quicker I used derivatives/margin money and the result was that by 2001 my entire portfolio was wiped off.

I cannot describe the agony that I went through in losing all I had earned and especially given my family's financial struggle during my childhood. The guilt of wasting money which would have been so valuable for my family back home left such an indelible mark on me that I took a break from investing to introspect my mistakes and learn before investing again.

That was the turning point and blessing in disguise in my investment journey. To further my learning, I decided to enrol for becoming a CFA (Chartered Financial Analyst) wherein I really learned the fundamentals and theory behind investing. I read about different investment styles, about experiences and methods used by successful investment gurus and tried to figure out what suits me and my temperament. My ultimate goal was to develop an investment style in which protecting capital was the primary goal and return on capital was a secondary goal.

Currently I am the CIO and cofounder of SageOne Investment Advisors LLP, wherein we advise an offshore fund and few large domestic HNIs. We are three partners (Kuntal Shah and Manish Jain being the other two) who have been working together for the past 8+ years.

SN: Pretty inspiring journey you have had, Samit. Thanks for sharing that. How have you evolved as an investor and what's your broad investment philosophy? Has your investment policy changed much through the years?

SV: Before talking about the evolution of my investment philosophy, let me start with our current investment philosophy we employ at SageOne. My personal portfolio replicates that of the clients' and hence the philosophy is common. My path from engineering to business consulting to valuation professional to becoming a fund manager has been different and long compared to most and my philosophy has evolved accordingly.

When you look at a business and if you get a feeling "I wish I owned this business", that's the kind of businesses we are looking for. We look for a business with long-term competitive advantage, in a stable industry, that has a huge and growing market for its products/services. If a business is inferior, then the price of the stock does not matter and it would not interest us. For improving the probability of finding such businesses, you need to focus on the right sectors.

To put it other way, if you want to find the best marathon runner, first you need to know the right countries to focus on. Focusing on the right sectors is half the battle won in finding the right companies. I have written in detail regarding our philosophy and process on our website as well as in our quarterly newsletters found on the website.

During my initial years, my sequencing was the other way around. Cheap valuation was the primary focus and then came the business. I would say, that has been the biggest change over the years and this has changed the downside risk profile associated with investing for me.

SN: Apart from managing your own money, you are also managing others'. So, how is it being a money manager, especially during the extreme situations – euphoria or market crashes? How do you keep yourself sane when dealing with clients with undue expectations?

SV: As an advisor or a money manager, choosing the right clients is extremely important. We are extremely choosy when it comes to accepting clients. You don't want investors who would call you each time the market is down few percentage points. You want to make sure that the investor is sophisticated enough to understand the risks associated not only with equities but more importantly with the manager's investment strategy. This is easier said than done, but continuous education of the clients regarding the risks and returns definitely has helped us.

I came back to India in 2006 and it took me a while to get comfortable with investing in India and understanding the business environment here. Until then, I was just managing my own money to make sure I don't use clients' money for my education. I started advising external money only in April 2012.

I think it's very easy in this field to become insane with the kind of information overload with respect to global risks, industry risks, company risks, management risks and a never ending list. I moved to Pune in 2008 to stay away from market noise in Mumbai. Too much interaction with fellow investors can lead to diverting your focus from finding strong businesses to things like global macro, short term trends/changes in some industries, etc.

SN: Choosing your clients well is a very important lesson for future money managers I believe. This is exactly what Rajeev Thakkar of PPFAS Mutual Fund told me when I interviewed him a few months back. Anyways, what has been the best and worst times in your experience as a money manager? How did you handle, say, a situation like 2008?

SV: Given that I started advising external money only 4 years ago, the best times were 2011 to 2013 period when the expectations of most investors from India were so low that it reflected in the valuations of companies and one could pick really strong businesses at really attractive valuations. Last couple of years have been the really tough, since nothing really changed in India on the ground but the expectations from the new government went through the roof. In fact, the valuations rose when earnings were coming down in reality with global environment worsening. I have done a detailed analysis of the situation and the risks in my latest newsletter.

As far as 2008 goes, it was period when I was managing my own money. One can't escape the carnage if you are a long only investor in such periods, but what saved me relatively was the cash levels I maintained.

I track valuation multiples and margins at sector levels over a long period of time. I try to keep cash levels based on risks associated with the current absolute valuation multiples as well as my assessment of sustainability of current margins. In 2008, the P/E multiples as well as profitability were at all-time highs and the Indian market faced dual risk of not only the P/E multiples contracting but also the net profit margins contracting to a more sustainable levels. Assuming that the P/E multiples as well as margins would contract to the mean levels, P/E faced downside of 40% and net profit margins downside of 24% with combined downside risk of 55% which unfortunately for everyone more than played out. I have presented a detailed analysis on this in our July 2015 and October 2015 newsletters if anyone is interested in historical levels.

SN: Good that you talked about the idea of sitting on cash when there is a dearth of opportunities, or when you find things heated up. For most investors, it is a painful decision i.e., not doing anything with cash and sitting tight on it especially for a longer period of time. What would you advise other investors, and especially money managers, on how to remain liquid when the situation demands and while defying the steady drumbeat of performance pressures?

SV: It's much easier for an individual investor to remain liquid as he is not answerable to investors. For a fund manager, it's a very complicated situation with uncertainty of markets. If you are sitting on high levels of cash because you believe that the valuations are high and the markets are risky, the market can continue its uptrend for much longer and each such month can be extremely painful to watch. You may be eventually right, but answering questions of investors who are paying the opportunity cost can be frustrating and with that building pressure you may end up deploying that cash at higher levels.

Opportunity cost is extremely difficult to handle even for the best of investors. See how even Stanley Druckenmiller flip flopped during the dotcom bubble. Even Warren Buffet was written off as past during that period since he stayed away from the best performing sector.

I believe that you have to lose the small battles to win big in the long term and patience is the key. Investment is a test match. I invest my money the same way I advise our clients and if I personally find it risky to be fully invested, how can I take the risk with clients' money?

SN: Great thought! Anyways, what are some of the characteristics you look for in high-quality businesses? What are your key checklist points you consider while searching for such businesses?

SV: As I have said before, the starting point for finding a high-quality business is to finding a high-quality sector. I am very numbers oriented and love tracking and analyzing various metrics at sectoral levels. You can't judge a sector by looking at short term performance but evaluating how it did during couple of down cycles. As a process we have broken down the top 1,600 companies in terms of market cap into sectors. For each sector we evaluate parameters such as sustainable profitability (ROE/ROCE), volatility in margins, leverage, topline growth and cash generating history. Based on these, we had shortlisted top sectors and about 300 companies within those. Next step was to painstakingly look at each company to eliminate companies having history of bad corporate governance, loose/questionable accounting policy and inefficient capital allocation. Post this we came to our "fishing pond" of about 150 companies.

Out of these strong businesses we look for companies that, based on our analysis, have potential to grow topline at more than 20% (ideally > 25%) with sustainable net margins over a 3-5 year period. Generally, 20-25% growth isn't easy for companies when the nominal GDP is around 14%. The only way it's possible is if the company can capture market share from unorganized players or public sector competitors or organized private competitors within the country or from competitors in other countries if export oriented. So we consciously look for such enablers of growth.

SN: Nice process I must say. Well, if it's possible, can you suggest a few sectors/industries you find appealing (based on their past performance and future prospects)?

SV: Sectors such as building material where the unorganised segment is huge (70%+ in some industries) and where brand is still valued by customers is appealing. Even batteries segment has a big unorganized segment and it's a consumable, so demand isn't cyclical and relatively less affected by capex cycles.

I prefer sectors where demand isn't dependent on favourable environment and product replacement can't be postponed for too long. It's very important to pick the right company in each. Once you study the sector, pick the one which you believe has the right targeted customer segment, has the right marketing strategy and the management is focused on that exciting opportunity versus having diluted attention on multiple businesses.

SN: How do you think about valuations? How do you differentiate between 'paying up' for quality and 'overpaying'?

SV: Having worked as a valuation professional has helped me significantly in this area. Valuation is about your input assumptions or else it's garbage in and garbage out. For coming up with reasonable inputs, you not only need to understand the company but also the industry, the competitive environment, business model, strategy of key competitors, etc. to be able to estimate the factors such as growth, profitability, re-investment rate and return on future investments. This may sound complicated, but if you have done thorough work on understanding the company and the industry/competitors you won't find it difficult to judge whether the current valuation is a bargain or expensive. Rather than trying to come up with a specific number, I try to evaluate what's a reasonable multiple for the company and if I feel that the probability of the current multiple contracting is very low, I get comfort.

"Paying up" or "overpaying" are terms we have started using based on our perception of whether the P/E multiple is high or low. P/E multiples can be very deceiving. For e.g. let's consider an example of a company from two analysts' perspectives who are ascribing it a fair P/E multiple. A company generating ROE of 50% and both analyst expect earnings to grow at 25% for the next 2 years. So theoretically the company needs to deploy 50% of the profits for this growth (Growth = Reinvestment x ROE). The residual profits are paid out as dividends. Beyond two years, one analyst expects the growth to drop to 10% up to the 20th year. The second analyst expect the 25% growth to continue up to the 20th year. Let's assume the terminal value of the company is the book value at the end of the 20th year. For the first analyst the fair one-year forward P/E multiple would come to about 12x, but for the second analyst it would be 32x *(see workings on the next page, or click here to download)*.

So the point I am trying to make here is that the duration of high growth has a huge impact on the eventual P/E multiple. If the company is trading at 20x, the first analyst would find it expensive but the second would find it a bargain. If your business analysis is in-depth, your chances of accurately evaluating the duration and hence the valuation would be much better.

Please note that if a company's ROCE is above its weighted average cost of capital (WACC) and if the company continues to grow above the WACC forever, the valuation and hence the P/E multiple would tend towards infinity. Conversely if the ROCE is below WACC and the company continues investing in new capex at ROCE lower than WACC, it's valuation would tend towards zero. So theoretically no P/E multiple is low or high.

Years		1	2	3	4	5	19	20
Capital		100.00	125.00	156.25	195.31	244.14	5,551.12	6,938.89
PAT		50.00	62.50	78.13	97.66	122.07	2,775.56	3,469.45
Earnings Growth			*25%*	*25%*	*25%*	*25%*	*25%*	*25%*
Return on Capital (ROE)		*50%*	*50%*	*50%*	*50%*	*50%*	*50%*	*50%*
Reinvest		*50%*	*50%*	*50%*	*50%*	*50%*	*50%*	*0%*
		25.00	31.25	39.06	48.83	61.04	1,387.78	-
Payout		25.00	31.25	39.06	48.83	61.04	1,387.78	3,469.45
							TV=BV	10,408.34
Extected Return/Discount Rate	15%	0.87	0.76	0.66	0.57	0.50	0.07	0.06
		21.74	23.63	25.68	27.92	30.35	97.51	635.95
Present Value	**1,604.86**							
fwdPE	**32.1**	ttmPB **16.05**						

Years		1	2	3	4	5	19	20
Capital		100.00	125.00	156.25	171.88	189.06	717.96	789.76
PAT		50.00	62.50	78.13	85.94	94.53	358.98	394.88
Earnings Growth			*25%*	*25%*	*10%*	*10%*	*10%*	*10%*
Return on Capital (ROE)		*50%*	*50%*	*50%*	*50%*	*50%*	*50%*	*50%*
Reinvest		*50%*	*50%*	*20%*	*20%*	*20%*	*20%*	*0%*
		25.00	31.25	15.63	17.19	18.91	71.80	-
Payout		25.00	31.25	62.50	68.75	75.63	287.19	394.88
							TV=BV	1,184.64
Extected Return/Discount Rate	15%	0.87	0.76	0.66	0.57	0.50	0.07	0.06
		21.74	23.63	41.09	39.31	37.60	20.18	72.38
Present Value	**618.99**							
fwdPE	**12.4**	ttmPB **6.19**						

If anyone is keen on learning more, you may find my lecture, given at Flame Investment Lab, useful.

SN: That's a brilliant way to look at valuations, Samit, and it solves a lot of questions in my head. Let me ask your thoughts about selling stocks. Are there some specific rules for selling you have?

SV: For me the highest numbers of my exits have been driven by deterioration of the business environment. So either the business model has deteriorated because of regulatory changes such as what happened recently in cotton seeds, or the competitive intensity has changed and that makes it incrementally difficult to meet my 20% growth hurdle. Other reasons are management decisions regarding capital allocation or in financials the lending standards been relaxed. Valuation running beyond comfort is another common reason, but I am a little more flexible here versus brutal in the first two aspects.

SN: Can you please share a real-life stock example when selling turned out to be a great decision for you, and one when it turned out to be a mistake?

SV: J&K Bank worked out well when we exited it at the first signs of its lending standards deteriorating. La Opala exit didn't work out well as we exited too early because of concern on valuations. The growth continued and with that the multiples kept increasing. We exited with a 5x return and the stock continued going up 5x further.

SN: When you look back at your investment mistakes, were there any common elements of themes?

SV: There have been many mistakes. The most common is in the event of any bad news (significant enough to trigger an exit) coming with regards to a portfolio company that you have held for some time and have developed connect with. The natural tendency is to find arguments against the bad news and try and shove it under the carpet. You try talking to the management and typically they are the worst people to talk to in such events because they will give you great comfort in their business as always.

Holding something in your portfolio is as good as entering that stock at current market price. Many a times, I have held on to positions even if I would not be comfortable buying at current market price. You may justify it by giving false comfort of having bought at much lower price, but it's a behavioural mistake that has to be rectified as a part of improving decision making.

SN: Yeah, that's true. Talking about behaviour, any specific biases that have hurt you several times as far as your investments are concerned? And what have you done to minimize the mistakes caused by such biases?

SV: One very common mistake that has hurt me is that if you buy even a small quantity at low price, it's much easier to add at higher level. But if you miss that first entry at extremely juicy price, it's very difficult to buy later as you keep repenting that lost opportunity.

Other mistake that is common is the cost of purchase. The entry point if low gives a lot of comfort to hold on even if you see business environment deteriorating for the company or if you find valuation uncomfortable. In reality we know that the exit point should be independent of the entry, but it's very difficult to de-link. These are tough decisions and I consciously try to be aware of such biases to avoid them. I can't say that I have mastered them 100%.

SN: How can an investor improve the quality of his/her decision making?

SV: As I just said, an investor needs to look afresh at his/her portfolio without the bias of having the stock already in the portfolio. This discipline would surely help in making better decisions.

Other aspect which is extremely important and underappreciated in investing is *temperament*. For this, keeping your mind relaxed and away from "noise" is critical. I find exercise, meditation and frequent breaks away from investing very helpful. Each individual needs to find a way to relax and keep his/her mind fresh and peaceful. One can read and learn a ton about behavioural aspect, but if the mind is stressed, tired or confused, the chances of taking wrong decisions significantly rise.

SN: How do you think about risk? How do you employ that in your investing?

SV: I am not going to talk about the theoretical aspects of risk such as diversification, illiquidity, etc. which are a given for a money manager. I am sure your readers would have heard and read about them multiple times. I will stick to specific things that I follow.

Once I am broadly excited about a business, my major analysis is on digging holes into my excitement. Once you like a stock, the natural tendency is to just jump in before the price runs up. When you take short cuts that's exactly when risk crops in. As part of my analysis, I avoid talking to co-investors who already have vested interest and are also excited about the stock. Talk mainly to the company's competitors because they generally will give you a different point of view on the industry and about why certain strategy is inferior. Talk to analysts who have negative view on the company. Find a strong devil's advocate who will try and destroy your hypothesis. In that respect, having partners helps each of us as the other two play that role.

Equity investments involves considerable risk. The key is to find ways to reduce it. There is no better way than to understand the dynamics of the business and run stressed scenarios of how it would survive in the toughest of economy.

For me, mitigating risk is about building margin of safety and I try to use it in the outlook when I am valuing the business. E.g. If based on your study, you are confident that the business can grow at 25% for 7 years, assume only 4 years and see if you still find the price attractive.

One other factor I would like to bring up is to be careful when blindly copying investment theories and strategies used by legendary investors in the United States. You have to remember that the US is one of the most successful and innovative countries in the world. When you companies with strong brands, IP and technology which is recognized all over the world things like "moats" and extremely long term investing works there.

India is an emerging economy and many things such as regulations, government incentives, tax structure, FDI policies, IP policies, etc. keep evolving. Plus, we are relatively much weaker on brands, IP, technology and hence your investment strategy has to change accordingly. One has to be very vigilant about the above changes on your portfolio companies and be ready to exit with changing business dynamics. Following wrong investment strategy can be hugely risky.

SN: That's a nice insight. Well, what's you two-minute advice to someone wanting to get into value investing? What are the pitfalls he/she must be aware of?

SV: Most people want to be independent and for that they would have liked to own and run a great business, but for majority of them starting a business is too big a risk. Investing in stock market should be considered as a much lower risk option because you are able to partly own diverse set of already successful businesses.

Look for businesses with the same passion as you would to start an exciting business you like. Set that priority and purpose right, and only then think about the price to pay for it. Learning about valuation is much easier once you do this. Don't fall into the trap of scanning for value first and forgetting the real purpose of investing.

SN: Which unconventional books/resources do you recommend to a budding investor for learning investing and multidisciplinary thinking?

SV: Here are the three I would recommend –

1. Understanding Michael Porter: The Essential Guide to Competition and Strategy *by Joan Magretta*
2. The Little Book that Beats the Market *by Joel Greenblatt*
3. The Five Rules for Successful Stock Investing: Morningstar's Guide to Building Wealth and Winning in the Market *by Joe Mansueto and Pat Dorsey*

SN: Which investor/investment thinker(s) so you hold in high esteem?

SV: Being a numbers oriented guy, I like Joel Greenblatt's way of scanning for great businesses. History and right parameters could be a great starting point to shortlist companies. There are different aspects to learn from many great investors.

SN: Hypothetical question: Let's say that you knew you were going to lose all your memory the next morning. Briefly, what would you write in a

letter to yourself, so that you could begin relearning everything starting the next day?

SV: Before investing, I will surely focus on writing about my family and people I love and are important in my life. I will write about the philosophy I follow in life. It's too little a time to spend on writing about investing. In any case, I can always refer to my newsletters and our website to remind me of the philosophy I had followed. So some documented help is available on that front.

SN: What other things do you do apart from investing?

SV: I love sports and many of them, so watch and play whenever time permits. We came back to India in 2006 and one of the purpose was to make some difference to our home country. I involve myself during weekends in various activities such as cleaning garbage in our area, tree plantation in the forest that had been completely destroyed over the years, but my real passion is education.

We all know the quality of education in our municipal schools. Students are not failed until grade 8th, but beyond that many find it extremely difficult to continue and the dropout level jumps.

If quality help is provided at this stage, many can be helped not only from dropping out but also to complete graduation so that they can find meaningful employment. Even better, if they are provided good guidance to find their passion, many could become employers and big contributors towards development of our country.

I am currently just helping monetarily in education of about twenty 8th to 10th grade students from a poor community, but I am working with an NGO in Pune which is doing phenomenal work in this area. My goal is to adopt an entire class of 8th graders and help them in the above aspect until graduation.

SN: That's very kind of you Samit! You definitely have inspired me and a lot of people reading this interview. Thank you so much for sharing your wonderful insights on investing. Thank you!

SV: You're welcome Vishal.