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CFM Quarterly in Finance, a publication of the Centre for Financial Management, Bangalore is primarily a practitioner-oriented journal. It seeks to discuss contemporary developments, analytical concepts and techniques, research insights, perspectives, and state-of-the art practices. By and large, the CFM Quarterly in Finance seeks to convey important developments in the theory and practice of finance in a rigorous, but relatively non-technical, manner.

SECTION A: ARTICLES/CASES

1. VALUE INVESTING

Dr. PRASANNA CHANDRA

As an investment paradigm, value investing refers to purchases of securities or assets for less than their worth. When we say value investing, both the words are significant: value and investing. First, value investors do careful valuation. Second, value investors believe in investing, not trading or speculating.

Almost all value investors seem to swear by Benjamin Graham and Warren Buffett. Value aficionados regard Benjamin Graham as the intellectual father and Warren Buffett as the most pre- eminent practitioner of value investing.

In 1934, Benjamin Graham., along with David Dodd, published Security Analysis, a monumental work, which is regarded as a basic text for serious students of investing. Jason Zweig, an eminent investment writer, notes: “Graham was not only one of the best investors who ever lived; he was also the greatest practical investment thinker of all time. Before Graham, money managers behaved much like a medieval guild, guided largely by superstition, guesswork, and arcane details. Graham’s Security Analysis was the text book that transformed this musty circle into a modern profession.” In 1949, Benjamin Graham published The Intelligent Investor which appeals to almost all readers and which according to Warren Buffett is: “By far the best book on investing ever written.”

Hailed as the world’s most successful stock market investor, Warren Buffett’s track record in accumulating wealth through successful long term investments is nonpareil. No wonder value investors pay close attention to the actions and writing of Warren Buffett.

Central Tenets of Value Investing

A careful perusal of The Intelligent Investor, Security Analysis, and other seminal works on value investing suggests that its central tenets or ideas are as follows

- Mr. Market and Mr. Value
- Fractional ownership
- Margin of safety
- Bottom up approach
- Skepticism of Wall Street recommendations

- Long-term investment orientation
- Different perspective on risk.
- Simplicity
- Selling discipline

Mr. Market and Mr. Value The stock market is very exciting and misleading in the short turn, but boringly reliable and predictable in the long run. These two facets of the market may be called Mr. Market and Mr. Value.

Introduced by Benjamin Graham in his classic work *The Intelligent Investor* Mr. Market is emotionally unstable. At times he feels euphoric and sees only positive things and at times he feels depressed and looks at only negative things. Depending on the mood of Mr. Market, stock prices rise and fall. Mr. Market constantly fascinates and provokes investors by changing his prices. He will knock at your door every trading day with his quotations and give you the option to trade with him. He will faithfully come to you every trading day, irrespective of whether you do business with him or not.

Mr. Market constantly titillates investors with a variety of gimmicks such as earnings surprises, corporate takeovers, bonus declarations, grim news about recession, announcements of technological breakthroughs, corporate scandals, and political changes.

While Mr. Market teases and attracts our attention, Mr. Value hardly appears and rarely evokes any emotions. A remarkably stolid and reliable person, Mr. Value steadily plods in the real world. As Charles Ellis put it: "He works all day and night investing, making and distributing goods and services. His job is to grind it out on the shop floor, at the warehouse and in the store, day after day, doing the real work of the economy."

Mr. Value's role may not be exciting, but it is extremely important. Although Mr. Market may tickle us all the time, Mr. Value prevails in the long run. As Benjamin Graham said, the stock market is a voting machine in the short run but a weighing machine in the long run.

Value investors seek to exploit the discrepancy between value and price. If the price is significantly less than value, they buy. If the price exceeds, value, they sell. For them the market is there to serve them, not instruct them.

Fractional Ownership Value investors regard securities as fractional ownership in the underlying business and not as speculative instruments. So the value of a security refects the value of the underlying business.

Warren Buffett has said that he is not bothered if the stock market is closed for ten years after he purchased a stock. That is because he does not look at stocks as pieces of paper to be traded frequently. Rather he buys them with the objective of becoming a part-owner of the entire business. Given such as approach, value investors do careful due diligence when they purchase a stock and concentrate on how well the business is progressing.

Margin of Safety Value investors buy stocks at a significant discount to their intrinsic value, implying that they look for a large 'margin of safety.' In theory, the intrinsic value of a stock is equal to the present value of the cash flows generated by it in future. As a practical expedient, the intrinsic value of a company may be defined as the price a company would fetch in the open market if it were sold in its entirety to a private investors.

Bottom Up Approach There are two broad approaches to portfolio building: top- down and bottom-up. Top down investors begin by looking at the macro-economic environment and market trends. Then they identify sectors or industries that are expected to do well. And, finally they choose individual stocks that fit into these themes. By contrast, bottom up investors (and value investors are typically bottom up investors) pay little heed to macroeconomic and sectoral analysis. Instead they assess individual stocks, one at a time, on the basis of fundamental analysis. They do not try to time the market, but sift the financial markets to identify undervalued securities and then buy them regardless of the level or recent trends of the market or economy. It they cannot find bargains, they hold cash by default.

Skepticism of Wall Street Recommendations Value investors are wary of the recommendations of Wall Street analysts because of potential conflict of interest. As Jean-Marie Eveillard, a highly respected international value investor, says; " We look at outside research, but we don't trust anybody. There is a conflict of interest associated with investment banking and research. Most of the research is done for growth investors who are looking for securities to move into today and out of in six or nine months."

Value investors, of course, look at research reports to deepen their understanding of a company's working. As Ron Muhlekamp, a value investor, comments: "(The research) certainly can be useful, but I never ask an analyst what stock to buy. I want an analyst to tell me what's going on in the industry and what's going on in the company. "He adds: "Their job is know their companies. My job is to figure out what the values are and what companies I want to own."

Long- term Orientation Instead of paying constant attention to the company's stock price, value investors focus on the progress of the business, which will lead to increased returns in long run. As Bret Stanley, a successful value investor, notes: "We re not trying to find companies that are going to go up in the next six months." He adds: "We're truly adopting long-term horizon. We think about whether it's a business we want to be involved in, and whether there's a big gap between perception and reality that's causing a disconnect between price and value."

As Warren Buffett puts it; "I should emphasise that we do not measure the progress of our investment by what their market prices do during any given year. Rather we evaluate their performance by two methods we apply to the businesses we own. The first test is improvement in earnings, with our making due allowance for industry conditions. The second test, more subjective, is whether their moats- a metaphor for the superiorities they posses that makes life difficult for their competitors- have widened during the year."

Different View of Risk When financial academics refer to risk they almost always mean only *market risk* and that too very short- run market risk. For value investors, such risk is of little concern. What matters most to them is *investment risk*- the possibility that something could go wrong with the company or securities covenants. Value investors think about risk as the probability and amount of potential loss. So, they find beta, a measure of historical volatility, to be meaningless. In fact, a volatile stock may become deeply undervalued, making it a very low risk investment.

Simplicity A shared characteristic of eminent value investors is simplicity, which is a powerful construct. As Thoreau said, "Our life is frittered away by detail… simplify, simplify." Einstein recognized that simplicity was the key to his breakthroughs is physics. The genius behind $E = mC^2$ embodied simplicity and elegance. Einstein noted that the five ascending levels of intellect were, "Smart, Intelligent, Brilliant, Genius, Simple." Likewise, the hallmark of Buffett's style is simplicity. Indeed, thinkers like Einstein and Buffett, who exemplify simplicity, achieve great heights.

Selling Discipline The decision to sell a stock is often harder to make than the decision to buy. Value investors try to achieve selling discipline by laying out well defined criteria for determining when to sell. As James Gipson, a value investor, says: "We will sell a stock when it reaches intrinsic value. It can reach intrinsic value in two ways. Either the price can go up, or the value can go down." Another reason value investors may sell is when they find something more attractive.

Some Eminent Value Investors

Among the pantheon of value investors, three names stand out, viz., Warren Buffett, John Templeton, and Bill Miller. It might be instructive to look at some of the value picks of these investment wizards.

Warren Buffett Warren Buffett, Chairman and CEO of Berkshire Hathaway (Berkshire, hereafter), a holding company, is a quintessential value investor. Whenever he finds some asset (stock, bond. commodity, currency, or derivative contract) mispriced, he tries to exploit that mispricing. Here is a sampling of his decisions:

- When the price of Coca Cola stock crashed in 1988, Warren Buffett started buying up Coca Cola like an addict. Within a few months, Berkshire acquired 7 percent of Coca Cola's stock for about $ 1 billion. Within three years, Berkshire's Coca Cola holding was worth more than the entire value of Berkshire when the investment was made. When Coca Cola's price was depressed, Buffett considered it as a compelling bargain for three reasons. First, consumers have a very strong brand preference for Coca Cola. Second, an average American, once he starts drinking Coca Cola, requires five bottles a day for the rest of his life. Third, forty percent of Coca Cola is just fizz.
- When the stock of China Petro was selling cheap Warren Buffett invested $ 488 million. Subsequently, he divested his holding for $ 4 billion.
- In 2002, the 6.875 percent 2010 euro – denominated bonds of Amazon.com were selling at 57 percent of par. These bonds were selling at a steep discount because they were priced as junk bonds, though they were anything but junk bonds. Perceiving them to be hugely under-priced Berkshire purchased 310 million Amazon.com bonds and later sold them at a gain of $ 246 million. He commented: "Yes, Virginia, you can occasionally find markets that're ridiculously inefficient-or at least you can find them everywhere except the finance department of leading business school."
- In 2002 Berkshire purchase Brazilian real which in Buffett's assessment was undervalued vis- a –vis the U.S. dollar. This position yielded a profit of $ 2.3 billion over a five year period.
- In 2007 Berkshire sold put options on four stock indices (the S & P 500 and three foreign indices). These puts had original maturities of 15 or 20

years and were struck at the market, meaning that they were exercisable at a price equal to what was prevailing in 2007. These contracts are exercisable only at their expiration dates, which occur between 2022 and 2027. This means that Berkshire will have to pay only it the index in question quotes at a level below the level that existed when the put was written. For writing these contracts Berkshire received premiums of $ 4.5 billion. Buffett believed that these contracts, in aggregate, will be profitable. Further, Berkshire would receive substantial income from its investment of the premiums over 15 to 20 years.

John Templeton John Templeton has excelled in bargain hunting. His style is characteristically reflected in an order that he placed with his broker in 1939. "I want you to buy me a hundred dollar's worth of every single stock on both major exchanges that is selling for no more than one dollar a share."

Templeton is considered as one of the most outstanding fund managers of twentieth century. A pioneer in the global investing, he was one of the first to make money in different markets. In 1972-74 he cleverly shifted most of his fund's assets in Canadian and Japanese stocks, saving his shareholders from the collapse of the US market. Further, he was one of the first to take advantage of the Japanese market by moving there in 1960s, ahead of other. In recognition of his global investment skills, in 1999 Money Magazine called him "arguably the greatest global stock picker of the century."

Templeton invested in Peru in 1985 when Lima's Bolsa de Valorex index in U.S. dollar terms, was around 50. "That was for me a point of maximum pessimism," says Templeton. By 1995, the same index was quoting at 6800. "Peru is a good illustration that when you're buying publicly traded investments, you have to do the opposite of what you do in all other aspects of life," says Templeton. "That's why successful investing is so difficult. To buy when others are despondently selling and to sell when others are airdly buying required the greatest fortitude and pays the greatest reward."

On Being a Contrarian

John Templeton "It is crucial to understand, and very few people do, that attaining superior investment performance has nothing at all in common with succeeding in 99% of other occupations. If you were building bridges and a dozen consulting engineers experienced in bridge building all gave you the same advice, you'd be stupid not to build your bridge that way .. But the very nature of investment selection turns that scenario topsy – turvey. Let's assume that every securities analyst you see says, "That's the stock to buy!" You might think that if all the experts are saying "buy," you should. But you couldn't be more wrong. To begin with, if they all want it, they will buy it and the price will build up enormously, probably to unrealistic levels. By the same token, if all experts say, "It's not the stock to buy," they won't buy it and the price will go down. It's then, if research and common sense tell you the stock does have that potential, that you might pick up a bargain."

Bill Miller Bill Miller, the manager of Legg Mason Value Trust (Legg Mason, hereafter), has one of the most impressive record in the world of investment. An ardent value investor, he does extensive and detailed analysis to establish intrinsic value following the "rule of present worth." He tries to figure out the underlying intrinsic value of the company on a continuing basis, using dynamic valuation, wherein the models are updated every quarter or more often as warranted by data. Here are some examples.

- In February 1996, a time when everybody thought that recession was coming, Dell was trading around $ 1-2 on a split – adjusted basis. Miller saw a company that had a superior business model, excellent competitive advantage, robust growth (of 25 to 30 percent a year), high ROIC (30 percent), and low PE (5). Sensing a wonderful bargain, Legg Mason took a huge position in the company. When it exited in 2001, it made 30 to 40 times.
- In the fall of 1996. AOL was a controversial company. Many thought AOL, which had lost three- fourths of its value from May to November, would become bankrupt. Based on a scenario analysis of the company, Miller calculated the probability weighted average value of the company. He found it to be higher than the prevailing price. Based on this discrepancy, Legg Mason bought huge quantities of AOL stock which were later sold for 30 to 40 times the acquisition price.

Prospects for Value Investing

With the growing competition in the investment business, one may argue that market inefficiencies and mispricings may correct. With more well capitalized and skilled investors, what are the prospects of value investing? Better than what many think for the following reasons:

1. Even with a growing value community, market participants tend to pay meagreattention to value criteria. Most managers focus on growth, momentum, or indexing, as they find value investing unappealing.
2. Money managers, including some hapless value managers, have an absurdly short investment horizon as they are driven by the performance pressures (real or imaginary) of the investment business.
3. It is difficult to take a contrarian approach. Under the relentless message from the market that they are wrong, even highly capable investors may succumb to the prevailing market mood.
4. While it appears that anyone can be a value investor the personality traits required for value investing- patience, diligence, discipline, independence, and risk- aversion- are perhaps genetically determined. As Seth Klarman, a distinguished value investor, put it “When you first learn of the value approach it either resonates with you or doesn’t. Either you’re able to remain disciplined and patient, or you’re not.”

Value investors are inherently value- conscious people. As Kirk Karanzian says in his book Value Investing with the Master, “By and large, they look for bargins in life as much as they do in the stock market. As several of them point out, you don’t really learn to become a value investor. You must have these inherent beliefs within you in the first place. If you never buys anything on sale, and doesn’t pinch pennies, it will likely be harder for you to truly adopt the value philosophy.”

Why There Are So Few Value Investors

If Graham and Dodd's *Security Analysis* is so widely read and respected, why so few follow their advice? The answer perhaps lies in two human traits: aversion to boredom and a tendency for emotions to dominate reason.

Aversion to Boredom Careful research requires time and effort and seldom provides an unambiguous case for taking a large position. It may be quite boring to review company after company only to discover that most are not significantly undervalued. Also, it is tedious to hold shares of a good company for an extended period of time because most of the time it appears that it is not going anywhere. The continuous quotation provided by the market induces people to trade.

Dominance of Emotion Over Reason A major challenge for people is to maintain logical conviction when faced with the excessive volatility in the market caused by bouts of euphoria and gloom. It appears that you need as much rationality and judgement in being a stockholder as in becoming a

2. CHALLENGES TO GLOBAL CAPITALISM[10]

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Market capitalism has been a remarkable engine of wealth creation for over a century in the western world and nearly 25 years in the developing world. However, there are several disruptive forces which can threaten the system of market capitalism: inequity and populism, protectionism, environmental degradation, failure of the rule of law, decline of public health and education, inadequacy of institutions, rise of state capitalism, radical movements, terrorism, pandemics, and so on.

According to Bower et al. there have been four typical responses by business to the above mentioned challenges.

- *Business as usual* Yes, there are problems but they are not overwhelming. Basically sound, the capital market can address these problems.
- *Business as bystander* The government is responsible for addressing these problems. The best contribution that business can make would be to run its operations as efficiently as possible.
- *Business as innovator* Business can address these challenges better than

[10] Joseph L. Bower, Dutch Leonard, and Lynn Paine, Capitalism at Risk: Rethinking the Role of Business, *Harvard Business Press*, October 2011.

the government. It should do so through innovations in products, services, strategies, and business models and not by influencing public policy.

- *Business as activist* Business must actively engage in shaping public policy. It should prod the government toward policies aimed at strengthening the market system. CEOs, board members, and other non-financial executives should internalise the principles of value creation. Doing so will help them make independent and rational decisions in the face of myths and conceptions about what creates value.

Bower et al. call for business to be both innovator and activist in protecting and strengthening market capitalism. As they say, "… business leaders must spearhead entrepreneurial activity on a massive scale-devising strategies that provide employment for the billions now outside the system, inventing business models that make better use of scarce resources, and creating institutional arrangements for coordinating and governing neglected and dysfunctional aspects of market capitalism." In sum, they want the business as leader. In a similar vein, Dominic Barton, McKinsey's managing director, argues that business must assume leadership in renewing capitalism or risk losing popular and political support for the global economic system.

3. GOLDMAN SACHS: THE REDOUBTABLE INVESTMENT BANKER

Dr. PRASANNA CHANDRA

For many years, Goldman Sachs has been the most successful and the most profitable investment banking organization in the world. Obviously, it benefited immensely during the boom period, 2003-2007. The global financial crisis that began in September 2008 affected almost every financial institutions, including Goldman Sachs. Thanks to its inherent strength and timely infusion of funds by the U.S. government and Warren Buffett, Goldman Sachs recovered very fast. It reported an impressive profit of $3.4 billion for the second quarter of 2009, way ahead of street expectations.

Goldman Sach's stellar performance may be attributed to several factors:

- *Restricted competition*: The demise of two major players, Lehman Brothers and Bear Stern and the big blows to other competitors have certainly helped Goldman Sachs
- *Unusual risk taking*: It appears that Goldman Sachs did not assume excessive risk. Its profits were generated primarily by client–driven trading and not proprietory trading (which involves risk).
- *Superior access to information*: Given its impressive global clientele, Goldman Sachs has access to superior information. As Philip Augar, a former investment banker, argues in his book, *The Greed Merchants*, large investment banks benefit from superior information gained from the work they do. For example, knowledge about clients gained from

underwriting or advisory business can be profitably used in trading activity.

- *Ability to influence regulation*: Goldman Sachs benefits from an influential network of its former employees working in key government positions. They help in getting a favourable dispensation from the government.
- *Human and organizational capabilities*: Undoubtedly, the human talent and well- designed organizational architecture of Goldman Sachs has been a significant contributor to its superior performance and leadership over the decades. As Hank Paulson , former CEO of Goldman Sachs, observed, "The more I observed the most effective leaders, the more I became convinced that the key is to have the right people in your own organization working for you and with you."

Adoption of Rigorous Quantitative Models

For decades Wall street traders and academics inhabited different worlds. As Charles Ellis observed in his book *Partnership*, "For many years, Wall Street traders and academics were worlds apart and each group was proud of both not respecting and not liking the other. Each group was articulate in dismissing the other as knowing nothing of importance, understanding nothing that mattered, and doing nothing of great value." But with the development of financial derivatives, the rigorous quantitative models of academic finance, supported by powerful computers and massive data bases, came into a powerful confluence with the creativity and Wall Street traders.Goldman Sachs was a pioneer in this intellectual revolution. In 1977, it hired Mark Winkelman from the World Bank to set up a Fixed Income business to trade financial futures. Subsequently, it hired Fisher Black, the co-developer of the famous Black- Scholes option pricing model, from MIT. Black exploited the Value Line Index mispricing anomaly. Since the Value Line Index was a geometric average—a geometric average is less than an arithmetic average—the futures contract was overpriced. The firm went long all the stocks in the Value Line index and shorted the futures. This generated a risk-free profit of $20 million, earned a partnership for Black in 1986, and opened a new line of business in basket trading. Black's disciplined analytics gradually became part of the fabric of Goldman Sachs. According to Ellis, "Black was the very model of what Goldman Sachs wants its people to be: unselfish about credit, honest, client focused, and intellect-driven."

SECTION B: SNIPPETS

RIL Earns Nearly ₹8,000cr from Treasury Ops in FY13

Sitting on a huge cash pile of nearly₹83,000 crore, polyester- to – petroleum-to- retail conglomerate Reliance Industries has earned close to ₹8,000 crore through its treasury operations- investments of surplus funds in financial markets –during the last fiscal. The company's full –year treasury income of ₹7,998 crore accounted for a whopping 38% of its annual net profit of ₹21,003 crore in FY13 showing a performance better than even some of the full-fledged financial services groups. Announcing its FY13 annual results, RIL said last week that it had an"other income" of ₹ 7,998 crore, while its net income grew 32% to ₹21,003 crore.

Common Errors in Applying Relative Valuation

The relative valuation method is a useful and popular tool for valuing unlisted companies. However, in applying this method, you should exercise care and good judgement and avoid the following errors that characterise its use in practice.

- Inadequate search for comparable companies.
- Failure to make appropriate adjustments to the financial statements of comparable companies.
- Mismatch or inconsistency between the numerator and denominator of the multiples used
- Naïve reliance on the average multiples of comparable companies.

Occupy Wall Street

Capitalism or market- oriented economic system presupposes fair and perfect competition. In practice, it often degenerates into crony capitalism, an alleged capitalism in which success in business hinges on close relationships between business people and government officials. In its worst form, crony capitalism consists of collusion among market players. While market players may compete lightly against each other, they will present a unified front to the government.

'Occupy Wall Street' is a call to reform capitalism, the dominant mode of market economy, as it is currently practised. In their book, Saving Capitalism from the Capitalism Raghuram Rajan and Luigi Zingales made a powerful case against regulatory capture by capitalists. In his book, The Price of Civilisation, Jeffry Sachs has critiqued the current state of capitalism. Joseph Stiglitz's influential essay, "Of the 1%, by the 1%, for the 1%," inspired many protesters to participate in the 'Occupy Wall Street' movement. Stiglitz argued that the socialisation of losses and privatisation of gains is a clear distortion of capitalism or market economy that needs to be corrected.

SECTION C: WIT AND WISDOM

Humour

- A double trailer truck loaded with cash came to a Swiss bank. Two sheiks stepped out of the trailer and told the bank manager that they wanted to deposit $ 6 billion, which was there in the truck, in their joint account. The manager and his assistant spent s hours to count the money. After the count, the manager told the senior sheik, “Sir, the truck has only $ 4 billion.” The senior sheik rapped is junior on the head and scolded, “Idiot, you brought the wrong truck.”
- Bernard Baruch, the famous American financier, was famous for his lavish parties that were attended by highly renowned people. A newspaper reporter asked Bernard Baruch “Sir, how do you arrange the seatings for all the notables who attend your dinner parties?” Bernarch Baruch replied, “I never bother about that because those who matter don’t mind and those who mind don’t matter.”

Wise Saws

- People in distress will sometimes prefer a problem that is familiar to a solution that is not.
- A pessimist forgets to laughs and an optimist laughs to forget

Perspective

- There is an ancient and widespread tradition that we can apprehend and Eternal Being with directness and immediacy. When the Upanishads speak of jnana or gnosis, Buddha of bodhi or enlightenment, Jesus of truth that will make us free they refer to the mode of direct apprehension of the supreme in which the gap between truth and Being is closed. Spiritual experience, as distinct from religious feeling of dependence or worship or awe, engages our whole person. It is a state of ecstasy or complete absorption of our being. When the flash of absolute reality breaks through the normal barriers of the conscious mind it leaves a trail of illumination in its wake. The excitement of illumination is distinct from the serene radiance of enlightenment. The experience is not of a subjective psychic condition of man. This is the fulfillment of man. This is to be with God- of God.