THE STOIC INVESTOR
REALIST | RESILIENT | RATIONAL
January 30, 2020, Issue #3
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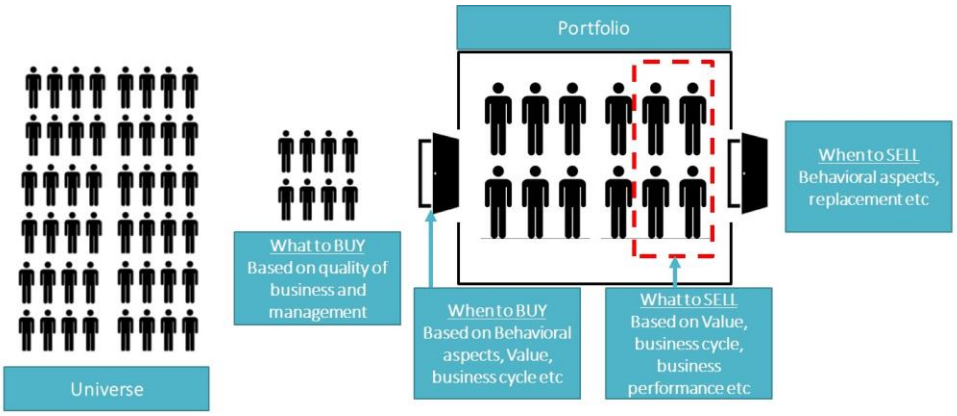
## The Two gatekeepers of a good portfolio

In Indian mythology, *Vaikunth's* (God's heavenly abode) gates are guarded by two gatekeepers – *Jaya* and *Vijaya*. They screen visitors who come to meet *Lord Vishnu*. In many *Vishnu* temples, across India, their idols can be seen standing at the gates of the temples. There are also stories in *Vaishnava* folklore about how they were landed a curse for their mistake in identifying a set of visitors.

Taking inspiration from this, we can use the gatekeepers as a metaphor to create a mental model of buy and sell discipline for an investor's portfolio (Go ahead! Feel Divine!). The process of investing consists of a) buying the best investment and b) making room for it by selling the less attractive one from the portfolio. Both processes are linked yet different. They may use similar tools but with different applications. For our model, (as shown graphically in the image below), lets visualize an investor's portfolio as a room with two doors, the entry and the exit. We will put a guard at each door. Let's name the two guards – *Nivesh* (the *Hindi* word for investment) standing at the entry and *Vinivesh* (the *Hindi* word for disinvestment) standing at the exit. While *Jaya* and *Vijaya* are synonyms, *Nivesh* and *Vinivesh* are antonyms (lucky for us!).

**For a financial model, let us visualize an investor's portfolio as a room with two doors, the entry and the exit.**



## THE "BUY" DISCIPLINE (NIVESH)

The buy discipline reflects the investment philosophy of the investor. The main job of this gatekeeper is intelligent and disciplined selection. *Nivesh*, standing at the entry door, has two important decisions to make: 1. What to Buy (who qualifies to get in), and 2. When to Buy (when to allow entry). He has to actively scout for ideas in the market that match with the investment philosophy. The parameters for screening should be economically sound after considering those investment principles which have historically delivered good returns for the investors. *Nivesh* may arrive at an investible universe by either a top-down approach or using a combination of qualitative and quantitative screeners based on some micro or firm-based parameters.

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Traditionally, companies with robust business model (with competitive advantage, high return on capital, strong brand franchise, scalability etc.) and good management (ethical, experienced, competent etc.) qualify as good long-term investments. Sifting through business fundamentals, *Nivesh* identifies who he would like to invite inside. But he still has to figure out when to allow the entry, a job easier said than done. On one side of the risk curve, there are companies that you want to avoid for being extremely risky, which are easier to identify. On the other side of the curve, there are companies which may be perceived extremely safe and as a result may be available at a price that doesn't deliver good returns to investor. All that *Nivesh* has accomplished till now, is a VIP queue that has a preference to come inside the room.
When would a company which is attractive in terms of business fundamentals be available at a reasonable valuation? The few reasons such opportunities come up are:

- **Myopic vision of investors:** Good companies also undergo the risk of business cycle working against them. Investors who are looking for immediate gains may either stay away from such companies or actively sell them from their portfolio. A long-term horizon is the advantage that a good investor benefits from.

- **Markets may over-estimate the new negative information:** stock price of a company can become undeservedly low due to an over-reaction for a negative development. Also, new investors may not want to catch a falling knife.

- **Underestimating the positive:** Market may also frequently underestimate the longevity or the strength of a company's competitive advantage.

As is evident, in the question of *"when the company enters your portfolio"*, a lot of behavioral issues also come up along with valuation of the company. A good buy discipline hence combines the aspects of fundamental and behavioral investing. The problems for *Nivesh* arise if he deviates from the discipline to accommodate the investments that would otherwise not qualify. This can happen due to:

- **Fear of missing out:** Investors frequently dilute their selection criteria to accommodate stocks which their peers are buying, due to the fear of missing out on an opportunity. This generally happens during a roaring bull market.
- **Impatience to complete due diligence:** Many a times, after hearing a bullish commentary from a CEO/CFO of a company, the stock prices rise. The move feeds into the confirmation bias of the investors and they rush into the investment.
- **Paying the wrong price:** The bridge between a good company and a good investment is the price. There is no company so good that it is worth paying any price. To avoid this mistake, one needs to be a second level thinker and needs to ask oneself, "why is the other guy selling me this company? What is the edge I have compared to the market that it looks attractive to me?"
- ***Vinivesh* driving *Nivesh*:** Sell decision should not be driving buy decisions. Investors frequently worry about cash sitting in the portfolio and hence force themselves to accommodate investments which they otherwise would not have made. This is like your guard at the exit driving your guard at the entry.

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## THE SELL DISCIPLINE (VINIVESH)

*Vinivesh* has an equally important job as *Nivesh*. Unfortunately, he gets much less attention than *Nivesh* in investment literature. One of the reasons could be that investors take pride in long time horizons and holding periods. However, high competition, technology changes and shortening business cycles can hurt "BUY and HOLD" investments. The "new BUY and HOLD" = "BUY and WATCH" minus "trade". In this scenario, *Vinivesh* becomes quite important. Unlike *Nivesh*, *Vinivesh* doesn't have to monitor too many companies. His area of work is only the invested set. If the buy discipline has been properly adhered to, then the sell discipline has clues of what to monitor and when to act.

Typically, investors trim or sellout of an investment because:

- **It has become a very large part of the portfolio**
- **One realizes a mistake made and hits a stop loss**
- **Stock price reaches a target level or target valuation**
- **There is change in fundamental attributes of the company making it unattractive**
- **A good replacement is available**

**A sell discipline is likely to deliver better results when high valuations are combined with another factor to trigger a sell.**

I believe valuation alone is not a reason to sell out of an investment. For a company that is growing its intrinsic value year over year, the price temporarily moving ahead may not be a sell trigger. Of course, based on the experience and judgement of the investor, he can sell if the price is exorbitantly high.

A sell discipline is likely to deliver better results when high valuations are combined with another factor to trigger a sell. The first step is to identify and highlight the investments that reach high valuations for further evaluation. If any of these companies show signs of optimistic forecasts that are difficult to meet or fundamental deterioration, then a decision to sell can be considered. Having a good replacement which is ready to enter the portfolio is also a valid reason to sell.

*Vinivesh's* job is hence to focus on existing holdings, unlike *Nivesh*, who evaluates many businesses for opportunities. *Vinivesh* also gives feedback to *Nivesh* about how his process performed. The learnings from monitoring the investments, revisiting the investment case and ultimate realization of returns need to be fed back in the buy discipline.

What mistakes can *Vinivesh* make? Two mistakes stand out. One is holding on to losers too long and second would be to exit winners too early. The origin for them can be best understood when looked upon from the behavioral angle.

- **Loss aversion:** Investors love to take profits but hate to book a loss, which is psychologically more painful. Many a times, even after one realizes their mistake, it's difficult to admit to it and exit.
- **Cognitive dissonance:** *Nivesh* allowed entry to a company into the portfolio for a reason. Sometime later, the reason for entry was invalidated. However, *Vinivesh* changes the reason to continue to hold on to the investment. That's cognitive dissonance.
- **Trading too much:** Remember we put a "minus Trade" in the formula? When investors continuously watch the developments in a company or stock price, they become vulnerable to noise which makes them trade too much. They may miss out on a good investment purely because of excessive trading.

Both, 'Buy' decisions and 'Sell' decisions, are important for an investor. A stoic investor is the one who allows both *Nivesh* and *Vinivesh* to work in tandem and in a disciplined manner to create a robust portfolio, thereby increasing the probability of generating good returns.

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**ABOUT STOIC INVESTOR:**

The word "Stoic" is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the "Stoic investor" as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).