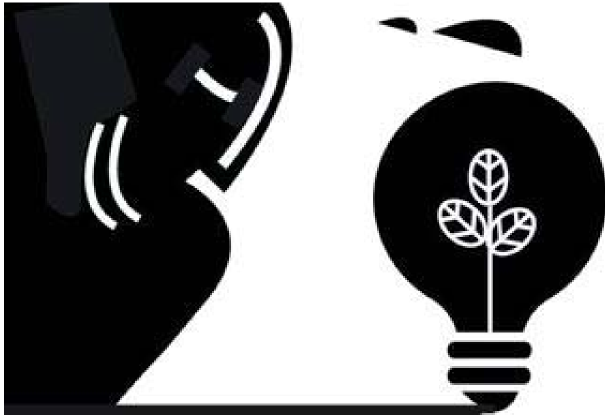
Resolve to be a smart investor

With today's highly sophisticated availability of financial ratios in an easy-to-analyse format, the smart investor can carry out the exercise of elimination of risky and unsound businesses with little effort and time

Vikas Gupta



Shyamal Banerjee/Mint

Benjamin Graham classified investors into two categories: defensive investors and enterprising investors. According to him, the defensive (or passive) investor focuses on avoidance of losses and freedom from effort, annoyance and the need to make frequent decisions. The enterprising (or active, or aggressive) investor is willing to devote time and care to selection of securities that are both sound (i.e. high quality) and more attractive than average (i.e. available at a discount to the intrinsic value). A defensive investor should expect more or less market returns, whereas an enterprising investor should expect better-than-market returns as a compensation for the extra skill and efforts.

We think that the time has come for the smart investor, i.e., the modern value investor. This sort of investor combines the characteristics of both defensive and enterprising investors. She is focused on avoidance of large losses and prefers freedom from effort, annoyance and the need to make frequent decisions. But, she also expects to create a portfolio of high quality equities, or investment grade equities which are available at a discount to the intrinsic value. Further, she expects that since she is less likely than the market to lose capital and buying at a discount to intrinsic value, she should end up with higher-than-market returns.

So how does the smart investor invest? She starts out being defensive and hence eliminates companies which are likely to be risky. For example, from the full investment universe, she can eliminate very small companies. These are the companies which are likely to have unstable business models and can be held at ransom by their suppliers, customers, employees, management, bankers and financiers. Further, the remaining companies with stable business models could still be housed in a financial structure that is risky, or in other words, highly leveraged. These companies could be at risk of near-term default on payment of interest or long-term default on payment of principal or have limited ability to refinance. She eliminates these companies.

The companies with stable business models housed in strong financial structures, i.e. having strong balance sheets, could still have the risk of losing the reinvested capital by investing it in value destroying projects. This could be due to lack of reinvestment opportunities for value creating growth, or incompetent management that could not capitalise on opportunities, or dishonest management that does not share the fruits of value creating opportunities with the passive minority shareholders. All of this is visible based on a careful analysis of the equity reinvestments over the past several years. The smart investor eliminates companies without a solid track record of capital allocation in value creating opportunities. By now she has transformed from a defensive investor interested in not losing capital to an enterprising one focusing on sound, high quality businesses. Now there is just one last step left.

The stable businesses, with strong balance sheets and a track record of value creating capital allocation are likely to be available at a premium to intrinsic value. If the smart investor maintains discipline now—this is the most crucial step where the not-so-smart investor fails—and eliminates companies which are sound but not available at a discount to intrinsic value, she will be very close to achieving investment nirvana.

The smart investor restricts herself to only those companies which are available at a significant discount to intrinsic value, thus creating a huge margin of safety. Choosing 10-50 stocks from this pool of investment grade equities that are sound and of high-quality with low risk of default, can create a smart portfolio.

So, will this generate higher-than-market returns? While there is no guarantee, our extensive and rigorous analysis of the application of the smart alpha approach outlined above across various geographies and capital markets and capitalisations suggests that over the long run, the smart investor is likely to have significant outperformance over the market return.

But doesn't this approach require lot of effort? It can take a lot of effort, but if one goes the Graham way, which is to focus on quantitative aspects based on published financial statements, all the information that is needed is there. With today's highly sophisticated availability of financial ratios in an easy-to-analyse format, the smart investor can carry out the exercise of elimination of risky and unsound businesses with little effort and time. What is required, is to understand that as long as one has selected stocks with sound business models and financials and is buying them cheap, one need not worry too much about the results. One should not worry about "beating the markets", but

should be more focused on “investing the right way”, i.e. the smart alpha or smart investor way, that way one will end up with “satisfactory results”. In fact, it is likely that a focus on investing the right way will increase the likelihood of beating the market in the long run. In the short run, though, one has to be able to take some notional downfall in the market value of the portfolio.

This brings us to the characteristics of a smart investor. This investor believes in originality. This trait ensures that what one finds to be attractive will differ significantly from the market and hence the results will differ significantly from the market; whether, better or worse will depend on the specifics of the original thought.

The smart investor believes in having character. Character helps in going against the herd. Original thought, rightly implemented, will result in a set of stocks that are not popular and hence will be available at a discount to intrinsic value. The smart investor has the character to buy these stocks when they are unpopular. Courage and character comes from the knowledge that one has eliminated a lot of risks, or ways of losing capital, and so is choosing from sound companies, or investment grade pool.

And lastly, this investor practises patience. It is required since the market is not going to quickly turn positive on stocks which it considers unpopular. That requires time and change in internal conditions of the company or external conditions of the sector or economy. The smart investor is able to practice patience as she knows that Graham has exhorted that in the long run, the market is a voting machine.

Vikas Gupta, executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd