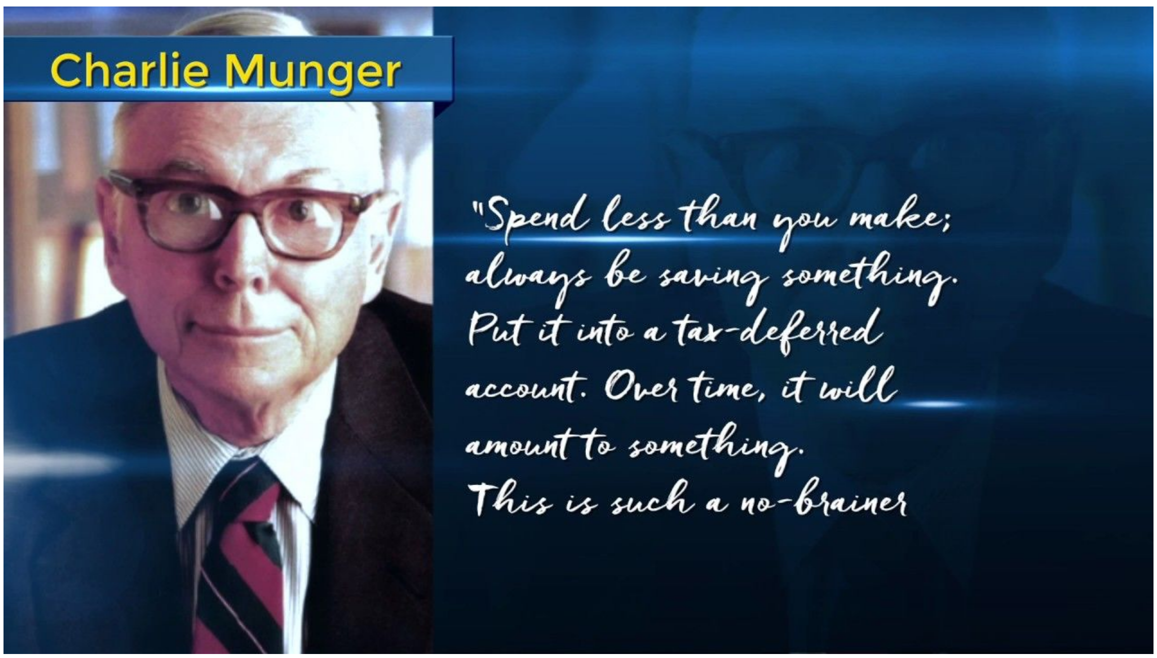
Three bucket framework to Investing

For Value Investing Almanack, Anshul Khare asked me the following question: *"Being in value investing disciple and also working in a company which is at the bleeding edge of technological disruption, how has your investing style evolved in last five years?"* My response (slightly edited) to Anshul question is below.

I have this three-bucket framework for approaching investing. The first bucket is the core which is the indexing bucket. The second bucket is symbiosis. The third bucket is picking individual stocks. I'll talk about each of them in detail.

Bucket 1: Indexing



The first bucket is to index in the US market. Indexing in the US is extremely simple and powerful. It is enduring. If you go back to 1940s and 1950s, S&P 500 was there. In the 1970s, it was there. In 2000, it was there. Even today it's there, and it's going to be there for next 30 - 50 years. Survivorship is the most important thing for any investor. End of the day, in investing we're playing the compounding game. In compounding, the magic happens when either I can compound at a very high rate (R) or I compound at reasonable rates for a very long time (N).

What indexing allows us to do is even though the R might be around 6-7 percent, but N is super long. Remember N is an exponent, and this makes the 8th wonder of the world happen. You can capture N only by surviving, and indexing gets that for you provided you can control your emotions.

The next important thing is indexing holds on to the winners and let's go off the losers. Just by the nature of indexing, losing company will be no longer in the index and index will hold on to the winners. Now if you take survivorship and winners together, it is magical. And the way I think about investing is I don't think about in 5 or 10 years period. I think about it as a fifty-year game.

What is going to happen, the luck must help, is that all of us are going to live longer. Because of the medical advancements, the longevity has gone up by leaps and bounds. I wouldn't be surprised if a lot of us live till 100 years. Even let's say you start at age 30, from 30 to 100 there are seventy long years. Now put that in the exponent in compounding equation. Even at 7 percent growth, we're going to double every ten years. And for 70 years we're going to get seven doubles. Your initial capital would have compounded by 128 times. People don't get it.

The earnings growth happens from real GDP growth plus inflation. And you're going to get the dividend growth, which let's take at 2 percent. If you add this all together, you're going to get this magical number of 6-7 percent. I am not even considering buybacks. Now, by dollar cost averaging, you're neutralizing the P/E multiple.

People think that if you had bought S&P 500 in 1999 and held onto it till 2009, you'd not have made a dime. But that's now how one approaches indexing. I would have bought some in 1999 in January, in February, in March, April, May and I am doing that even today. If you look at it through that lens, you're going to capture the magic of compounding through indexing.

Bucket 2: Symbiosis

My second bucket is symbiosis. I am not an expert in investing. Tom Gayner mentor once said, "*To be successful in investing, one has to survive for 30 years.*" I'm just a newbie from that time angle. I started picking individual stocks in 2012, slowly building my positions. So, what I did is I partnered with a few people who have been in this business for a long time. This is a symbiotic relationship, and we mutually benefit from each other. I refer to them as my partners. Here are a few things that I look in my partners.

1. Are they good human beings? Would I love to be associated with them irrespective of what their IRR is?

2. What percentage of their own money do they invest along with clients' portfolio? In Nassim Taleb vocabulary, *Do they have skin the game.*

3. Would their investing style connect with my core investing philosophy? I like owning long-term compounders with low-to-no churn and like to partner with able and ethical management.

Bucket 3: Pick my own stocks

My third bucket is to pick stocks on my own. The criteria that I apply is simple. One is that the management must be top notch. Some examples of companies with unquestionable integrity that I own are Berkshire Hathaway, Markel Corporation, and Piramal Enterprises. I have been holding these businesses for quite some time now. Top-notch management has been running these businesses for several decades.

Someone like Ajay Piramal has been compounding wealth at almost 30 percent for 30 years. He treats minority shareholders with great respect. There is a lot of intelligence embedded in time, and I partner with them even though these businesses have too many moving parts. I monitor the progress of these businesses through a few key variables.

The second kind of companies I own are businesses that are easy to understand, and I have been using their products and services. Some examples are Amazon, Facebook, Google, and Bajaj Finance. They have long runways with a lot of reinvestment opportunities.

These businesses have durable competitive advantages, which should help them to protect their high return on invested capital. Also, the founders are still overseeing the business. Let us look at Bajaj Finance as an example.

Bajaj Finance entered the consumer loan business in late 2007. It had a gross NPA of around 16 percent. It managed to survive without getting its head chopped. It cleaned up its books, invested in technology, strengthened the risk management process, and emerged as a market leader in retail loans. How did it do in the next crisis?

It entered construction and infrastructure finance. With 15 months of launching it saw issues with asset quality. It immediately stopped issuing new loans and shrunk its loan book. This experience taught Bajaj Finance to do sensitivity analysis during good and bad times.

Other players like Shriram Transport Finance took another 2 years to see the trouble and blew up badly. I like management learning from their past failures and making sure that they don't repeat it again in the future. Today Bajaj Finance is a leading diversified non-banking financial companies of India. What does diversified mean?

The loan book of Bajaj Finance is a grid of loan type and cities. It would have several dozen cells. Each cell will represent a single digit percentage of the entire loan book. Even a few bad cells would not affect the loan book.

	Delhi	Mumbai	Chennai	Indore	Ludhina	...
2-and-3 wheelers						
Durables						
Digital						
Lifestyle						
Personal loans cross sell						
Salaried personal loans						
Salaries home loans						
Business						
Professional						
Loan against property						
Home loan self employed						

During GST and Demonetization, it had issues with 2-and-3 wheeler loan book. Did anyone notice this issue? Of course not. During FY17 and FY18 it had a net NPA of 0.44% and 0.38%. This is the real meaning of diversified loan book. Bajaj Finance management is top notch and thinks about risk management. Partnering with them would let me sleep peacefully at night and build wealth at the same time.

My three bucket framework evolved over the last 12 years. I started with indexing in 2006. I came across Prof. Sanjay Bakshi's blog in 2011. Started picking individual stocks from 2012. Started my blog in 2013 and that created an opportunity to interact with smart value investors. I ended up partnering with them.

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