Rupal J. Bhansali from Ariel Investments

Rupal J. Bhansali recently released her first book called Non-Consensus Investing and we reached out to her to discuss the book and her investment philosophy.

1. Introduction to the book

InvestingByTheBooks: First let me say that in your acknowledgments, I loved and so did my wife, *"thank you for figuring out how to stand by me and still let me stand on my own"*. So beautiful and so true, it resonated a lot with us.

Second, I am embarrassed to say I have read hundreds of investment related books, of which less than 10 have been written by a woman and none of them have managed money. They write about men. So, to be a woman, with a great track record & writing a book about it, is clearly out of consensus.

Rupal J. Bhansali: Yes! There is a chapter at the end called "A Special Message from Me to You" which I wrote especially for women. As one of the few solo female portfolio managers to manage a mutual fund in the US, I wanted to share my journey of how I broke through the glass ceiling and how others can follow in my footsteps to achieve similar success.

I fervently hope it encourages women to become more financially savvy let alone literate and to think of money as a thought provoking instead of taboo topic. I would be thrilled to bits if this book motivates women to learn more about investing and consider a career in finance, as our gender is severely under-represented in the profession.

IBTB: Why should readers read your book "Non-Consensus Investing"?

Bhansali: According to many experts (and I concur with them), we are likely to encounter a decade or so of low, no or negative returns. The need for higher returns and lower risk has never been greater, yet few asset classes or investment strategies offer either let alone both. The solution is not to give up on these goals, but to change the means of achieving them. This book talks about those means - a game changing investment discipline which I have honed and practiced over a career spanning twenty-five years, managing multi-billion dollars of global equity portfolios, for sophisticated investors ranging from pension plans to university endowments.

IBTB: What is the core message of the book?

Bhansali: To achieve superior investment results versus peers & passive indices, one must think and act differently and correctly. The book reveals several counterintuitive precepts to succeed in the sport of investing - where the rules of the game are not only different, they are asymmetric! For example:
It is not enough to be correct one must also be non-consensus.
It is not enough to pick the winners one must also know how to avoid the losers.
It is not about finding the right answers but the right questions to ask.
It is not about winning the battle but about winning the war.
It is not about settling for the sub-optimal "Or" but insisting on "And".

IBTB: What is different about this book from other value investing books?

Bhansali: Most books on value investing focus overwhelmingly on what you pay viz. headline valuation multiples and past stock price action. I take a different approach and place primary emphasis on what you get – the future risk, returns and growth of the business, not just what you pay for it.

Also, value investing has degenerated into valuation investing, while my emphasis is on investing with a margin of safety to reduce downside risk. I demonstrate how avoiding losers and losses matters more to compounding capital than simply picking the winners.

Finally, this book is a practical handbook on how to conduct differentiated fundamental research to connect the dots that others have not and identify mispriced securities.

2. Books

IBTB: You write that you had a deep personal reason to write the book, that books have been among your finest teachers. Are there any teachers you would like to mention? Maybe you can add when you read them, for example what did you read before you went to the US, after and more recent? Books we all have read, some unknowns maybe and some not in the investing field that have inspired you? Please tell us your story of books, maybe a book or two that you reread? Where do you find inspiration when you are struggling and what to do when things are going according to plan? I know too many questions in one question, but just tried to inspire you.

Bhansali: While I have read the obvious classic investment books that everyone knows about, I will highlight those that are not talked about in the mainstream. In particular, I would call out books by Michael Mauboussin, who is an investment strategist by vocation and also teaches at the Columbia Business School. He is an outside the box thinker who provides frameworks, not formulaic approaches to making better investment decisions.

IBTB: How do you get through the inevitable periods of underperformance?

Bhansali: Few people realize that it is very common for top decile managers to have three straight years of underperformance. This is because in investing, winning the war (compounding capital) often means you must lose the battle (aka underperform in the short term). No matter whether I am out or under-performing, I don't alter my portfolio to suit the mood of the moment - I focus on getting my research right which eventually pays off over a full market cycle.

Over the years, I have learnt that it is not my discipline alone that matters – my clients' discipline is crucial too. So, I spend a great deal of time upfront, managing their expectations not just their money. When they understand the environments during which we are likely to underperform, it helps them stay the course when the strategy faces headwinds.

3. Non-consensus investing

IBTB: When I first read the title of your book, I thought it was a book about being a contrarian, and it is to some extent. (You explain more about this on your site https://nonconsensusinvesting.com/index.php/faqs/). And clearly, it's not cigar butt investing. I think it means opportune investing in good companies in stocks gone bad in the stock market, that is my interpretation of your quest, after reading your book. Correct?

Bhansali: Yes, it is about buying quality on sale, not junk at clearance prices.

IBTB: But when I read your 9 q to nirvana, many of them are related to price. I think many value investors rely too much on price and too little about the business of the company, like you focus on. Please elaborate further.

Bhansali: I am an intrinsic value investor – which means I care about what I get (the quality, growth, risk and return profile of the business) not just what I pay (the headline valuation multiple). It is fair to say that too many value investors have turned into valuation investors – they predominantly care about what they pay and overlook what they are getting in exchange. This is putting the cart before the horse.

IBTB: Personally, I appreciated Neglect, Secular growth hiding behind cyclical growth & finally the "and" propositions the most. Mostly as I think here there is more of a clear road out of the reasons why the stock is cheap? Do you agree? Does it matter if your business research shows, let's say, a near term (within a year or two) trigger/improvement?

As an investor I am usually drawn to *"Where failure is priced in, but success is not"*, but it's a more difficult concept than one might think, especially in a rising market. Do you have any investment horizon with these and others? I have been thinking of having "time-stops", in essence if it hasn't proven itself within a certain time period, move on. Your thought?

Bhansali: It is more important to figure out if an investment is undervalued rather than when it is likely to become fairly valued. Value is its own catalyst – markets are efficient in the long run – they ferret out value because everyone is looking for it. The trick is to uncover it first – before the consensus catches on.

The way to tell if one is merely early versus wrong, is to focus on the fundamentals of the business – not the stock price. If the business is doing what you expected, stick with it even if the stock is not doing what you expected. If the business is deteriorating relative to your thesis, then revisit and do a clean slate evaluation of whether to hold or fold.

4. Research the business. Period. Then the modelling, and then when/if buy. Patiently.

IBTB: It's very easy to do screens and focus on daily news and stock prices in themselves. Your book will help many with getting back on the right track. But after that it's time for some modelling. Any favorite metrics, be it what type of margin, what type of return? What type multiples do you look at, none just a DCF (discounted cash flow)? Is it more scenarios, or what is priced in today's price? What WACC do you use and how do you think about the DCF? What is a typical good risk/reward for you, when to buy?

Bhansali: It is important to not anchor on any one-point estimate or price target or valuation methodology. Triangulation is key – use a variety of different methodologies from DDM (dividend discount model) to DCF to FCF (free-cash flow) multiples to sum of the parts (SOTP). The goal is to identify why the different methods yield a different value and then figuring out the line of best fit. Keep in mind, valuations & values are an output. The inputs are far more important – so spend more time on stress testing worst to best case scenarios in the key line items being forecasted – revenues, earnings, cash-flows and balance sheet. Likewise, WACC is just one assumption among many that one makes. The WACC will vary according to the different risk premiums that are applicable for a given security. That said, as prudent investors, it is fairly typical for us to charge a higher WACC than the sell-side.

I don't establish a target risk reward because research should be conducted without an agenda – it is a quest for truth – one must let the chips fall where they may. If you set a preset target, human tendency is to back fill it. Investing should always be based on principles, not rules. It takes judgment and fortitude to make qualitative assessments – formulaic approaches don't square well with fundamental investing.

5. When to sell

IBTB: You talk about setting up certain qualitative & quantitative goals to keep a stock, and if the company fails them, then you are out regardless of price & it also means that if the company is doing well, but price not, you buy more. If stock is doing fine and they perform inline, but the stock gets ahead of itself, time to sell? Seems you are holding Microsoft, but it's not out of consensus anymore, nor cheap? Or if you for example suddenly have many more new ideas, so you need to reduce current holding because of that. Historically when you do sell, what have been the main reasons?

Bhansali: My sell discipline is straight-forward: if the thesis is undermined or busted or if there are better opportunities to deploy cash elsewhere. Selling to take profits is fine, but one should be mindful of the ability (or lack thereof) to redeploy the proceeds in more compelling opportunities or the opportunity cost of holding cash

6. Risk

IBTB: I think you address in a very good & practical way. Risk measurement is not risk management. But you take it even further with stating *"Risk management not just about risk reduction, it's also return enhancement"*. Here you also bring in the concept of margin of safety in a very good way.

Bhansali: Many places in the book is about avoiding big mistakes, do you see that has the biggest risk reducer, avoiding the biggest potential losers? Is it even more important than picking winners? Yes, absolutely. Avoiding losers is as important as picking the winners because you always lose money from a bigger number and make money off a smaller number.

IBTB: You touch upon the use of preset stop loss levels. You don't sound that negative on that, which surprised me a bit. (Absolute or relative the market?)

Bhansali: I am against the ideas of using preset rules – I prefer to rely on judgment. As a portfolio manager who is invested alongside my clients, my interests are aligned - I am not looking to preserve my face, I am looking to preserve my capital. Preset rules can become a copout – I prefer to think through and defend every decision rather than point to a formulaic rule book.

7. Risk can be measured? Base rates

IBTB: One book you mentioned, is a book from 1921, by Frank Knight. *"Risk is when we can measure the odds, uncertainty we can't"*. Is that how you see it as well. Do you try and estimate probabilities, when you do scenarios? Do you use the concept of base rates? See for example this great report.

https://research-doc.credit-suisse.com/docView?language=ENG&format=PDF&source_id=csplusresearchcp&document_id=1065113751&serialid=Z1zrAAt3OJhElh4iwIYc9JHmliTCIARGu75f0b5s4bc%3D

I think you used that concept brilliantly when you looked at the history of PPP:s.

Bhansali: Handicapping risk means stress testing a range of best case to worst case scenarios. To avoid bias, it is about testing for the upside risk (what can go right) just as much as much as one weigh downside risk (what can go wrong). Most investors focus on upside risk and ignore downside. It is important to go in eyes wide open and insisting on a margin of safety – which is the definition of value investing.

8. Skill or Luck? In what sectors should we invest?

IBTB: If we continue to the last question, do you evaluate your decisions into luck or skill, based on probabilities, scenarios, for example on an annual basis? And do you adjust probabilities as times pass, as the initial thesis get stronger or weaker?

Further on I appreciated your many examples in the book on the importance to make a difference between luck and skill, for instance in the tailwind basic resources stocks had in 2003-2007. In general, do you avoid sectors that are so dependent on one factor, a price of a commodity or the like, just because its more luck than skill, to get the commodity price right? Or because that it's just a capacity game, that will always be solved with modest returns? I guess the bigger question is in what sector is it about skill?

Bhansali: Skill matters in all sectors because risk is endemic to every business. The risks may not be as obvious as those that exist in commodities, which is why you and the market is mindful of them. In fact, it is where the risks exist but are being ignored that one should be most vigilant. Take the consumer staples sector – it is viewed as the opposite of commodities – having pricing power on the back of brand strength, marketing prowess and distribution clout. All these positive attributes are being chipped away in a digital, direct to consumer world, yet Wall Street is ignoring them. When stocks price in success and if failure occurs unexpectedly, there is a blow up at hand, as we just witnessed with Kraft Foods.

IBTB: To keep on this, rates have been coming down a lot for a much longer time, than most, myself included could have dreamt of, which has meant that staples (and defensives) & rate sensitive and many more have been bid up just because of that. To what extent is that like basic resources stocks, when it comes to risks?

Bhansali: Risk is an exposure, not an experience. If one believes that high growth companies are also low risk, one can justify a very high multiple on it as discounting rates are low. But one must question that premise. Is Netflix really low risk and high growth or high risk and low growth? It is about to face stiff competition from 4 stalwart competitors – Disney Plus, Amazon Prime, AT&T, Comcast and now Apple – all of whom want a piece of the streaming business. I would argue that extrapolating the growth rate of heady growth companies is a perennial mistake made by investors. The low interest rates amplify their mistakes as they justify overpaying even more for a rosy future that may not materialize.

9. Climate change. Impact on your investment strategy

IBTB: I think it's for real, and facts suggest that the world need to do much, much more than we do currently. Some companies are taking the lead, for example Amazons climate pledge in September. You see any opportunities or some to avoid here? Maybe it's more of risks than opportunities for investors. In any case, I think this is an environment where you could thrive, since not everyone is looking at it? What are your thoughts on the investable universe in for example solar and wind? Or other sectors, bullish or bearish?

Bhansali: As a risk aware investor, I consider ESG (and within that climate change) as one risk factor of many to weigh. I think many solar and wind stocks have been bid up not due to their fundamental business outlook but because of their headline appeal to ESG driven investors. We prefer to own companies that are bid down, not up – so owning companies based on scarcity premiums does not strike as a compelling investment opportunity to us.

10. Finally – when you have been out of favor - what to do?

IBTB: You kindly share multiple stories of when you have been wrong, both in terms of sectors, countries and stocks. Some of the times have been harder than others for you (and I hope you got a lot of brownies those times 😉). I found the story of Jean-Marie Eveillard in late nineties you provided very insightful, and that is the right way to reason. Would you have anything more to add to this, sources for encouragement et cetera. that maybe helped you? Maybe re-read a book or two? Long walks? You indicate that you will use your site for this. Looking forward to that!

Personally, I found this encouraging, which now is on the wall next to my screen:

"The non-consensus investor treats markets as shopping mail, where things periodically go on sale, as opposed to an auction house, where you must bid the highest price to get what you want" Rupal Bhansali, my North Star, November 2019.

Finally, I wish you all the best for you, and a happy 2020 and beyond.

Bhansali: Thank you for your interest in my life's work. I shared my journey and experiences to help others navigate a tough and hostile world for active, let alone value investors. I offer suggestions in Chapter 9 of how to become victor instead of victim to what is going on around you. I hope your readers can borrow a leaf from that and other chapters, to get through this very challenging time for our stock picking craft and value mindset.

If you want to know more about Rupal and Ariel, here are some great links.

https://nonconsensusinvesting.com/ & https://arielinvestments.com

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