PPFAS
There's only one right way©

April 13, 2009

The Week Gone By

Weekly Newsletter

Perception of Misperception

Contributor: Arpit Ranka | arpit@ppfas.com

As an investor, each one of us is trying to buy low and sell high. In the process, we, more or less, have the same set of information to help us decide. But for every trade done on the stock exchange, there is always that other guy who disagrees with you and only one of us ends up as right. What one gains is somebody else's loss. This not only highlights one of the important aspects of investing, that is, that it's a zero sum game but also highlights the fact that the people reach diverse set of opinions based on the differential in the way they *construct* reality. Excluding the element of luck, over the long run, the one, who is better at constructing reality or making sense out of the surrounding, is the one who will end up one amongst the winner. Thus, I think, it will be a good exercise to understand what leads to the perceptual contrast amongst people.

Bounded Rationality:

Herbert Simon, the person who propounded this theory, says that as human beings, we are not blessed with unlimited circuitry to make sense out of the complexity of the world in its entirety. To cope up with this limitation, he argues that we rely on simplistic models of reality, which helps us get through most of the things happening around us decently well, but in a complex situation this limited circuitry might fail us, leading to sub-optimal decision making. In the context of investing, each one of us has our own philosophy, which helps us decide which opportunity is suitable to deserve our attention and our capital, eventually. The more potent our philosophy is at replicating the underlying reality the better would be our results.

No matter how hard one tries, our mind-set (philosophy, in the context of investing) has its limitations and understanding where and how it might fail us would be indispensable. The prime reason, which is inescapable, but mistake prone is Satisficing.

Satisficing:

Satisficing says that we start with a tentative hypothesis and start to look for evidence supporting the initial hypothesis. (Insiders are buying. Oh, the most probable reason has to be that the management feels that the business is undervalued by Mr. Market. Is it so, let me check it out?). In the process, the goal is to seek enough information, broadly speaking, to validate our hypothesis satisfactorily.

Even though, I don't think we can do away with rationality, which is bounded anatomically, and satisficing, which helps us reach decisions amidst uncertainty, I do think that by understanding as to how they can fail us under certain ways, we can improve our ability at constructing reality.

Pre-conceptions can lead to Concussions:

None of us can claim to analyze a problem being 'completely blank' to start with. The software (mind), which we develop in certain ways, but which is also pre-conditioned and shaped by surroundings, is different in each one of us. Moreover, no matter how hard we try, it is a mystery even to its possessor (remember, how often we end up over-estimating or under-estimating our ability at various activities). Given this understanding, it might not be wrong to assert that pre-conceptions/mind-set, when incomplete and unsuitable, can lead us to construct reality under false impression. Let me quickly add that I do not intend to say that we should do away with our pre-conceptions, which is impossible, but just that better understanding of the limitations of pre-conceptions can help us gain an edge over others*(remember, the guy at the opposite end of the trade. He might not be, manic depressive, Mr. Market but, say, the smartest investor out there!)*

When can pre-conceptions fail us? Mr. Munger answers it best - 'To a man with a hammer everything looks like a nail.' The best way to overcome is to gather multiple models and use mental tools like checklist, zoom-out, zoom-in, reductionism, backward thinking, and forward thinking. As each one of those will also help overcome the following limitation by developing multiple hypotheses...

Continued to Page 2...

Inside...

Selective Perception:

The cost one pays in starting with a single hypothesis and looking for evidence supporting his initial claim is that he overlooks the information, which is not related to the narrowed down scale of the problem at hand, but which might none the less be substantial when viewed from a different angle. And I think, the dissonance increases, in cases where the hypothesis cannot be supported. In such cases, we simply take a pass. But who knows, looked from a different angle, the investment opportunity might have been very attractive and a cinch. Let us look at a solution, which can help us overcome this limitation.

Decomposition:

It is nothing but breaking a complex problem into numerous simple problems. For example, this is what happens when we follow Mr. Buffett's method of asking ourselves 'whether keeping aside the element of price, would I like to own this business?' or 'would I approve if my daughter wants to marry the executive of the company' or 'Is this opportunity better than, say, most of the opportunities I can invest my capital in?'... This way, I think, it allows us to make better use of information available at hand and make a calculated guess, weighing the pros and cons more efficiently...

Conclusion:

As I sit down here reflecting on my answer to the problem of misperceiving reality, I wonder if I have done justice at perceiving the problem at hand. I shall continue to reflect if I have become a victim of selective perception, man with a hammer tendency, confirmation bias, and all those sort of stuff.

Having said that, I would like to add what Prof. Sanjay Bakshi once said–A tiny edge is all you need... (as compounding will magnify the impact of the edge as time goes by...)

Medical Insurance for the Elderly

Kavitha Menon | kavitha@ppfas.com

Senior Citizens who have not had any medical insurance cover till 60 , or were covered by their employers and on retirement suddenly find themselves without a medical insurance net have the going tough for them, simply because many insurance companies do not take new policies after age 55 although they may renew policies till 75 years or even 80 years in many products. Also there is a myth that pre existing illness may not permit them to be covered.

We have tried to study the market for products that are available to senior citizens. There may be very few options but they are sufficient to provide a decent cover to those looking for medical insurance after 60 years of age. Some of the products we found are as follows –

1) The National Insurance Company offers the Varistha Mediclaim Policy upto 1 lakh only. Any person from above age 60 can avail of this policy .The premium of a 60 year old is about Rs.4180 which is expensive. A Critical Illness rider up to 2 lakhs is also available at extra premium

2) Oriental Insurance Company has a policy called HOPE – for Senior citizens. However there are too many exclusions and it covers only specified illnesses.

3) Star Insurance: This Company has two products

a. Regular Medicare the Regular product allows entry till age 65 subject to medical check up and allows renewals till 70 years . Cover upto 5 lakhs is possible

b. Senior Citizen Red Carpet - This product allows entry right upto age 69 and allows renewals till 80 years. However the Red carpet product allows a cover uptoRs.200000 only.

4) ICICI Prudential Medicare: A plain vanilla Mediclaim policy that allows entry till 65 and assures cover till 75 years. One can take a cover for upto 10 lakhs

5) Bajaj Allaince Silver Health – This is similar to the PRU ICICI product .Maximum cover is Rs.5 lakhs.

A policy cover of Rs. 4 lakhs will cost about Rs.12000 for a person of 60 years .Medical check up is a must except for the red carpet product offered by Star.Pre existing illness like Diabetes, Blood Pressure etc are covered after a certain number of years in all policies except that offered by Oriental.

Premium wise all policies offered by the private insurers seem to be on an equal footing. But look out of policy wordings for full list of exclusions and waiting period before inclusion of pre exiting illnesses so that you choose a product most suitable to you. You must take a look at the list of network hospitals should you have any preferred hospital for treatment

You can also look at buying these policies for your parents if they have crossed the threshold limit of 55 years for new policies. Payment of insurance premium on behalf of parent entitles you for deduction upto Rs.20000 under section 80 D. This is over and above Rs.15000 for self .

Investment Case on Broking Firms

Jigar Valia | jigar@ppfas.com

We observe that over the past few quarters, most participants have got conservative / defensive in the way they use equities as an investment tool. Since we are discussing an investment case for Broking Firms, it is important that we share some perspective on our outlook for equities in the current scenario. Gold has already handsomely rewarded investors in the recent past and has truly been exceptional. Also, many investors have chose to switch to bank & corporate deposits, more especially now, since the expectations for rate cuts.

However if we look at the regulatory measures being implemented, an interesting & critical scenario emerges.
As Buffett said, medicines are given in buckets and not spoons in various forms :

- Government infusing capital,
- Restructuring of loans & reduction in EMIs,
- Cut in taxes,
- Other fiscal stimulus & government spending,
- Pay unemployment benefits,
- Banks forced to increase lending to both companies & consumers;

- The side effects of which will soon be witnessed in the form of high inflation / hyperinflation.

Well a natural consequence in such high inflation scenario would be the shift in importance from money itself to the buying power of money. Thinking of asset classes that can beat inflation, gold at best matches inflation on average in the long run.

Historical data suggests that gold maintains in $ relative log valuation, though it may move higher during interim short durations. Anyone looking at fresh investments into gold should realize that at the moment, gold is valued at higher than average of its $ relative log valuation & should be cognizant of this underlying relative valuation risks.

While initially we saw some desperate fund raising at high interest rates, globally we are seeing a continual decline in the interest rate regime. This brings to the fore a dual risk of lower absolute returns and a further downside valuation risk incase of an increase in interest rates. As we start feeling the symptoms of the side effects of the stimulus overdose, it would be only natural to expect the government to suck out the liquidity from the system through higher interest rate borrowings. This higher interest rate & some slowdown will be the price to pay to avert going back to the barter system days.

Equity remains a key asset-class to beat inflationary risks with liquidity & regular cash flows. However its carefully selected Equities that would beat inflationary risks with liquidity & regular cash flows. But one would agree that this isn't an easy process. Take a try responding to some to the underlying thoughts ...

– How will the $ move & impact the IT sector in 2009 & 2010?
– Would FMCG & Pharma continue to outperform? Or/and
– Is the time apt to play blackjacks? Or/and
– Go the Graham way & storm the discount store?

It is here that Broking Firms become an interesting proposition.

Best proxy for equity cycles
For once when we are reasonably sure of investments into equities to ramp up, but most convinced on a specific strategy/industry, broking firms as indirect substitutes are the best proxy for equity cycles. The business of a broking outfit is directly correlated to the trading & investment volumes on the markets.

Business Model – lower downside risks
While the revenue in terms of bps has come down significantly over the past decade, there has also been a significant reduction in the risks as well. Most of the benefits have been an outcome of improving business practices, efficient

exchange systems and regulatory checks & procedures. In terms of business segments, while the institutional segment does not have any credit risk, the credit risk for the retail business has significantly come down with the reduction in settlement time and off course the available security collateral. The online business model has been bringing in scalability coupled with cost savings and better management & control. With Direct Market Access (DMA) coming into effect, the execution risk too shifts on the client's end. On the flipside, increasing competition & increasing need to provide value added services like research have gathered importance to maintain market share.

Get on this Ferris wheel - Shortening (fastest adjusting) Business Cycles

The key bet for investment into broking firms would be on the cyclical aspect of the business. Most cyclical businesses have a certain gestation period in terms of building up capacities & then effecting consumption, there is a certain minimal timeline for a business cycle to complete. However, what we have been witnessing for financial cyclicals is that the business cycles have been steadily shortening. The pace at which changes have been brought about at government & central banks levels, the movements on the bourses are displaying shorter cycles & sharper price movements.

Snapshot on some listed stock broking companies

Particulars	Motilal Oswal	JM Financial	Edelweiss Capital	Religare	India Infoline	Geojit
52 W High	177.00	79.00	905.00	433.00	213.00	67.70
52 W Low	44.00	16.50	218.00	275.00	34.00	16.50
CMP (Rs.)	80.55	24.40	293.80	324.50	72.30	25.50
Equity Cap (Rs. Mn.)	142.00	750.00	374.70	762.74	571.92	209.50
FV (Rs.)	1.00	1.00	5.00	10.00	2.00	1.00
M Cap (Rs. Mn.)	11,438.10	18,300.00	22,017.37	24,750.75	20,674.91	5,342.25
FY08 Networth (Rs. Mn.)	7,090.27	18,702.70	18,470.00	5,825.40	17,709.01	2,524.90
9M FY09 Profits (Rs. Mn.)	737.70	623.09	1,455.10	(3.32)	1,195.34	118.60
9M FY09 Annualized (Rs. Mn.)	983.60	830.79	1,940.13	(4.43)	1,593.79	158.13
FY09E Networth (Rs. Mn.)	8,073.87	19,533.49	20,410.13	5,820.97	19,302.80	2,683.03
P/E	11.63	22.03	11.35	(5,584.56)	12.97	33.78
P/BV	1.42	0.94	1.08	4.25	1.07	1.99
Debt/ Equity (FY08)	20.45%	54.71%	84.98%	525.63%	38.87%	6.35%
Key Business Segments	Brokerage (57%) & Financing (43%)	Brokerage (72%) & Financing (28%)	Brokerage (50%) & Arbitrage (50%)	Brokerage (68%) & Invt/Fin (28%)	Brokerage (54%)& Financing (31%)	Brokerage (72%)

Opinion

Basically, our view is that equity is certainly the best asset class available, broking firms offer a dependable proxy for equities and amongst the cyclicals, it appears as the early ones to revive. In comparison with broking firms, we have other financial services investment opportunities like Rating Agencies (Crisil & ICRA) and Investment Firms (IL&FS Investment Managers) with much better business model, visibility & valuations. Also when looking at the current multiples, one should factor that much of the profits are generated in the first two quarters and the recent performance has been fairly dull. While valuations may not be very great, but then cyclicals are meant to be bought at high P/E multiples & sold at low P/Es. However, there are some other perspectives that need to be considered. Apart from pure broking, most firma have other ancillary revenue streams like PMS, Arbitrage, Margin Funding, Distribution, etc. We see that an increasing percentage of the overall business is coming in from financing related activities for most firms, which include margin funding and also other NBFC related endeavours. But this a relatively capital intensive and different business model as compared to broking per se. The segmental information are available largely at revenue levels only, and individual subsidiary wise financials are not generally shared voluntarily. Overall we find India Infoline & Motilal Oswal, which are trading at reasonable valuations with moderate debt on books and a slightly capital efficient business model. Also the track record over the past years has been heartening. But the key broking business has become mature in its growth cycle and the growth rates may not be replicated in the coming times. The growth would mainly come from new businesses where the capabilities will have to be proven. Still, as a pure bet on cyclicality, some of these better firms may be good investment perspectives, given below book valuations.

Due to some technical difficulties
we are unable to provide with Market Statistics.

130/132,Great Western Building,1st Floor,S.B.Marg,Near Lion Gate,Fort,Mumbai-400 023. Tel : 91-22-2284 6555 Fax : 91-22-2284 6553,e-mail : researchcall@ppfas.com