

April 2010 CGI Value Voices: Interview with Ragu Chandrasekaran

Dear Member:

Our second installment of the **Value Voice Interview Series** features CGI veteran Ragu Chandrasekaran. We hope you'll enjoy Ragu's reflections.

Thanks for being a Value Focus Member.

Best wishes,
Ragu and Jeff

Background

Jeff Anello: To start, tell me a little bit about your background. What were you doing before you got into investing?

Ragu Chandrasekaran: Working in software, and realizing fairly early on that it wasn't what I truly wanted to do. After working for a series of startups, with the most successful one resulting in a botched acquisition, I concluded that the 95% failure rate for all business startups was an optimistic estimate.

JA: Did you ever attempt to work for a more mature software company?

RC: Not really. However, I suspect that working for a mature software company would've only helped delay the inevitable foray out of software.

JA: How did you become interested in investing?

RC: My initial interest was sparked by disenchantment with my software job, and the realization that understanding how to invest my money was the only path to independence from the job that I currently had, but no longer wanted.

JA: How did you go about learning the craft of investing? What books, resources, or people were your earliest influences?

RC: I essentially muddled around for a few years reading seminal investing masterpieces such as *Rich Dad, Poor Dad*, by Robert Kiyosaki. A friend then recommended *The Intelligent Investor*, by Benjamin Graham. The book just made so much sense. As a bonus, I discovered Warren Buffett from the foreword. This book was the one that essentially helped me understand what I really wanted to do for a living, i.e. value investing.

JA: Let's expand on that a bit. As you taught yourself investing, what did you struggle with the most? Or did it all just "click" for you?

RC: Nope, it didn't all just "click." I wasn't wired at birth to do this. You can learn a lot from reading Buffett, Charlie Munger, Seth Klarman, Joel Greenblatt, etc, and I did. Ultimately, though, it's up to the individual to piece things together. This can take a fair while. For someone with no background in finance, I found accounting the most challenging. The couple of levels of the CFA helped with that, although there's still much to learn.

JA: Tell me about an early investment you made.

How did it go?

RC: My first investment was **Berkshire Hathaway (BRK)**. I was even more naïve about Berkshire at that time than I am today. Back then, Berkshire was down a bit because of the GenRe investigations and the impact of Hurricane Katrina.

Here's how things stood at the end of 2005, based on figures from Buffett's 2005 shareholder letter:

- Cash and investments per 'A' share: \$74,129
- Non-insurance pre-tax earnings per 'A' share: \$2,441

The 'A' shares were selling for around \$89,000 at the time, implying a multiple of 6.1 on those non-insurance pre-tax earnings. For the quality of Berkshire's non-insurance subsidiaries, I felt the multiple was really cheap. Plus, there was the \$40 billion cash hoard, about a third of Berkshire's market cap at the time.

With the markets advancing, and Buffett and Munger complaining about the lack of opportunities, I knew enough to know who was going to be proven right eventually. I figured that a fairly valuable option that was attached to that huge cash hoard was being thrown in for free at the prices at which I was buying.

As for how it went, the 'B' shares went from around \$3K in mid 2006 to \$5K in late 2007, and then all the way down to around \$2.3K in March 2009. I did nothing in between. I'd say the overall results have been commensurate with my process.

JA: Can you explain that last statement a little?

At the time that I bought Berkshire, I didn't *think* enough about the implications of the two-column approach to Berkshire's valuation that Buffett seems to endorse in his annual letters. What are the assumptions behind the approach? What are the limitations? When is it likely that the approach will overvalue Berkshire? When is it likely that it will undervalue Berkshire?

The fat lady hasn't sung yet as far as this investment is concerned, but an overall 36% gain on cost over what's approaching a four-year holding period seems about right in light of the above.

JA: How have you improved as an investor over time?

RC: My decisions take a lot longer than they used to. As I continue to learn, my criteria for investment selection have become more stringent than before. I've also learned to distinguish the opportunity cost of investing my first dollar of cash versus the last. Since the non-availability of cash can severely crimp an investor's ability to take advantage of panic, I believe one should demand progressively attractive values as cash is invested, and perhaps extraordinary values as one reaches the point of being fully invested.

JA: How did you get into writing online?

RC: My colleagues at my last job in the U.S. figured that I might be more interested in investing than software. Seeing as I was leaving, they encouraged me to write an investing blog as a means of staying in touch. About six months later, and with some inspiration from this [blog](#), I decided it was time. Primarily though, [my blog's](#) intended purpose was to encourage interest and comment from like-minded investors.

JA: Do you like to read books? What are your favorites?

RC: I used to like reading books, but that habit fell by the wayside when I went to graduate school in the U.S. I never really picked it up again until I began to be attracted to value investing. Since then, it's been mostly value investing literature.

The following are my top three recommended books in addition to *The Intelligent Investor*:

(1) *The Essays of Warren Buffett: Lessons for Corporate America*, by Lawrence Cunningham. (It's too bad that those lessons haven't been learned and continue to be even more important today than at the time that Buffett started giving them.)

(2) *Margin of Safety*, by Seth Klarman.

(3) *You Can Be A Stock Market Genius*, by Joel Greenblatt (This is, perhaps, the most underrated value investing book ever.)

JA: What are your professional goals? Would you manage other people's money professionally if offered the chance?

RC: I believe that it's easier to manage your own money than it is to manage someone else's. However, if offered the chance, I think that managing other people's money professionally would be interesting. Of course, I'd need to feel ready to do it, and the people giving me the money need to be aligned with my investment philosophy at that time. This is more important than it may sound.

Two identically talented investors – cloned if you will – with an emphasis on the long-term will produce wildly differing long-term investment results depending on their clients, especially if one is skittish and short-term, and one is patient

and long-term. In fact, if you're looking at a successful value-oriented money manager, I'd suggest that his skill at picking clients might well be superior to his considerable skill at picking undervalued investments. Seth Klarman comes to mind in this regard. My thinking today is that I'd also require a long-term lockup of the money for, ideally, five years, and a minimum of three, with the understanding that this is going to severely inhibit the raising of capital.

JA: What, in your mind, are the main differences to managing other people's money versus your own?

RC: The first main difference is the degree of concentration. Buffett and Munger have been on record as saying that there have been points in their lives when they have placed close to 100% of their net worth on a single idea. If I found a very attractive idea with a tremendous margin of safety, I might be inclined to put a high portion of my net worth into it. Not so if I were managing other people's money. I might still put a high portion of the managed funds into the same attractive idea, but the degree of concentration would still be miles apart.

The second main difference is that when managing other people's money, you have to manage their emotions when things don't go well – and it's a *certainty* that those periods will exist, especially if you're running a value-oriented concentrated portfolio. So, you're effectively *managing people and their money*, at a time when your focus should solely be on finding attractive stock market values.

A fund manager I know lamented about this situation in late 2008. He said that he was forced to spend most of his time convincing clients not to withdraw their money instead of focusing on his real job of finding attractive investments.

That's the biggest danger when it comes to managing other people's investments: you may not get to play out your hand, however attractive it may be. It's the ultimate margin call, if you will.

The third difference, and quite possibly the most important, is dealing with the psychological

impact of quotational losses. In late 2008 and early 2009, I was able to deal reasonably okay -- not great, but okay -- with the high quotational losses in my personal portfolio. I don't know that my reaction to them would have been the same if other people's money had been involved.

Philosophy & Process

JA: Let's talk about your investment philosophy as it stands today. What are your main tenets? What do you look for in any investment?

RC: Like everyone else, I have a preference for simple businesses with good economics that even I can understand -- although I'm sometimes tempted to stray away from this tenet. I also like to understand the reason for the mis-pricing that I perceive exists. In the absence of a complete market meltdown, if I can't explain what the problem is that's causing the mis-pricing, then it's reasonable to assume that I don't have a good understanding of the investment.

For long-term holdings, my first and foremost requirement is management integrity, followed closely by ability. This is necessarily subjective, especially if management doesn't have a long-term track record. Evaluation of management integrity is very important, nonetheless, even if it's more art than science.

I also demand significant management skin in the game via stock, not options. Growth prospects are very important, too, either via expansion in the original business or by investments in outside businesses. In my view, the very best value investments are the ones that have high-probability prospects for value-enhancing growth.

Shareholder communication is also very important. I look for CEOs who are forthright, and highlight their mistakes more than they trumpet their successes. A well-written annual letter by the CEO, not by the company's PR department, is often the very best filter in the search for truly long-term buy and holds. Not only does a letter from the CEO demonstrate that he cares about communicating business information to his partners, it can often showcase his thought processes. A CEO who espouses rational thoughts in an annual letter is likely to be rational in business decisions, too.

I look for CEOs who understand the importance of capital allocation. In my mind, a truly great CEO is one who has the ability to take the cash from business operations and deploy it appropriately, within the business or otherwise.

There are CEOs who accidentally find themselves in businesses with attractive economics, and there are CEOs who are in such businesses rather deliberately. It's best to partner with the latter type of CEO, like Ken Peak of **Contango Oil and Gas** (MCF). It's a sad indictment of corporate America that the latter group of CEOs is by far the lonelier group as compared to the former.

I also pay attention to compensation structure. The total amount of compensation doesn't

interest me as much as *how that compensation was arrived at*. Incentive alignment is incredibly important, so I'm excited when I see one that makes good sense.

Companies that employ conservative accounting techniques are worth their weight in gold – or any other commodity you'd prefer – and more.

And last, but certainly not least, is earnings guidance. If there's a Wall Street satisfying practice that I abhor more, I don't know about it. I regard the incentives that long-term, fixed-price options provide as superior to the incentives that the practice of earnings guidance provides. And I consider that long-term, fixed-price options provide a terrible incentive.

The SEC should ban the practice of earnings guidance, seeing the perverse incentive it provides management to fudge numbers. It also provides opportunity to people with inside knowledge to exchange earnings information for money, not to mention the unnecessary short-term spotlight it shines on quarterly earnings reports. A management that provides no earnings guidance as a matter of principle is automatically one worth exploring.

As you can see, I emphasize management quality to a huge degree when evaluating potential long-term holdings. The greater the odds that management is likely to resist the institutional imperative in my estimation, the more interested I get.

For companies that I don't expect to hold long-term, cheapness relative to realizable asset value or normalized earnings is what I focus on.

JA: Of the prominent investors we all follow, whose investment style is yours the most closely aligned with?

RC: I don't know that I'm aligned with any one of them in particular, really. If I can understand what they're saying, and I find myself nodding my head in agreement, I tend to incorporate those ideas in my investments. Needless to say, my most vigorous head nodding is reserved for Buffett and Sardar Biglari.

JA: How do you think about portfolio management? Do you consider yourself a concentrated or more diversified investor?

RC: I disagree enough with Modern Portfolio Theory that I decided to not write the Level 3 exam of the CFA, which is heavily weighted toward portfolio management. Not surprisingly, I didn't get a passing grade in portfolio management in either the Level 1 or Level 2 exams. Some might consider that a good thing.

As for concentrated versus diversified, I'd definitely qualify as concentrated. As to why, it's the standard reason: Truly good investment ideas are rare, so when you find one, you should bet an amount that will make a difference to your portfolio.

JA: Considering that you buy both long-term holdings and shorter-term cigar butts, how do you go about sizing a position? Do you take smaller positions in riskier companies and vice versa?

RC: That's what I would like to do, although it certainly hasn't always worked out that way because I was wrong about a couple of situations that I didn't assess initially as having a lot of risk.

For short-term holdings, position sizing is also dictated by the imminence of a catalyst that will cause the gap between price and value to close. The closer a likely catalyst, the more willing I'd be to allocate a higher portion to that idea than I'd otherwise normally do.

JA: Besides long equities, what else do you put in your portfolio? Do you ever short stocks or buy bonds, mutual funds, or derivative instruments like options?

RC: Nothing else. Actually, that's not completely true. I had a position in an Indian mutual fund. The position in that fund was an admission of my ignorance about investing in Indian equities. I no longer hold that position, although I still have a long way to go when it comes to investing in India.

JA: Is this more a function of your knowledge right now or an actual decision to stay out of other areas?

RC: Probably a bit of both and a desire to see how well I'd do if I just bought long stock positions. Shorting stock and buying call options both necessitate getting the timing right. That makes me uncomfortable enough to stay away. However, I've been thinking a bit about options recently. They look like an interesting option – pun unintended – when a binary outcome is likely.

JA: How do you find investment ideas?

RC: Reading. Often, I'll just look at a particular group and see if I can find anything that stands out in a particular company within that group. I use screens, but the truly great investment opportunities rarely come from them. I also track insider buys, especially older ones where the stock in question hasn't moved much since the insider purchase. Another source of investment ideas is a situation where an activist shareholder

is involved. I also look up investment write-ups on VIC.

JA: Okay, so you've found an idea. Bring us through your process of investigating the opportunity and deciding "Yes, I'll buy it," or "No, this is not a good investment."

RC: If the stock looks cheap on quantitative metrics, I need to answer the question of why. Most likely, there's a visible reason for the cheapness. The question then becomes one of evaluating whether today's price overstates the troubles facing the business. Sometimes, it's fundamentally declining business prospects, or blatantly self-serving/incompetent management, and sometimes you don't know enough to know. In those cases, I move on.

Otherwise, I continue to look at the idea. The question of whether this is a potential long-term holding or not is dictated by the evaluation I described before. I'd much rather buy something for the long-term, but cigar butts aren't too bad. Cheapness relative to net realizable asset values is easier to evaluate than cheapness relative to normalized earnings power.

With respect to assets, I prefer real estate purchased way back that has been recorded at cost on the books, thereby providing a margin of safety, as in **Steak 'N Shake** (SNS), or unique assets that a buyer might well pay up for, as in **Premier Exhibitions** (PRXI). In both these cases, I'd like to see management – or someone who's in an activist role and has both the intent and the capability – take the steps to preserve, at worst, or unlock, at best, the value in the assets. More often than not, I can't develop enough conviction in management's intent to do the right thing, so I move along. In far too many cases, cheap is cheap for a very good reason.

JA: What sources do you spend the most time reading?

RC: Annual letters, company presentations, 10Ks and 10Qs, blogs of folks whose thought processes I admire.

JA: What role does “scuttlebutt” play in your investment process?

RC: Not much – up until now, at least.

JA: Is this something you’d like to do more of? Do you think it would improve your process?

RC: Absolutely. I think it would improve my process, especially when dealing with small companies. Feedback from customers, suppliers,

etc. is likely to be very helpful in the assessment of the company’s culture. It’s also likely that you’ll pick up on any sources of competitive advantages during this process.

JA: Where do you need to improve as an investor?

RC: (1) Expanding my circle of competence, both in terms of the variety of businesses I understand and in terms of investment strategies.

(2) Designing an effective search strategy to find investment ideas.

(3) Being more decisive, especially when I have a high degree of conviction.

Investments and Businesses

JA: What would you consider to be your most successful investment to date, and why?

RC: My most successful investment to date has been SNS. However, I still consider the original investment a mistake, simply because I underestimated the enormity of the problems that eventually happened there. Always beware of a management team with its back to the wall against an activist investor.

JA: The least? Why?

RC: The award here easily goes to PRXI. I overestimated the amount of influence that Mark Sellers would have on management once he got on the board. Missing both the aggressive front-loading of revenues and the blatant misclassification of asset sales as operational cash flows was especially bad, because both those accounting issues were well within my circle of competence. If I’d picked up on either one of these two issues, I would have held off on purchasing PRXI.

JA: That makes two of us. I see that both your best and worst investments involved analytical mistakes surrounding management. Is this why you put such heavy emphasis on management quality today?

RC: Interesting that you put it that way. However, I wouldn’t say that I put such a heavy emphasis on management quality because of what happened with my best and worst investments so far. I always have, especially for long-term holdings. In my mind, managements are stewards of shareholders’ capital, and I want to be associated with managements that are capable and whose actions reflect a similar fiduciary responsibility.

With regard to SNS and PRXI, I’d say that my chances of being invested in these positions without the likelihood of Biglari and Sellers getting on the board would range somewhere between zero and none.

JA: Where do you typically make your mistakes?

RC: Being overly sanguine about the prospects of a turnaround and not judging the severity of deteriorating business prospects. Also, anchoring to the original purchase price when improving fundamentals call for a clearly higher valuation.

JA: Assuming you were offered a fair price, if you had to choose one stock to buy for the next 30 years, which business would it be, and why?

RC: I don't think I'd be comfortable buying anything at this point in my investing life that I'd designate as a 30-year holding at the time of purchase.

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Thanks to Ragu for sharing his insights with us. We hope that you enjoyed the interview. Remember, if you have any questions, join us on the Member [Forum](#) and thank you for being a *Value Focus* member.

Best wishes,
The CGI Gang

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