InvestorInsights: Jaideep Merchant

Jaideep has been part of the Indian equity markets for more than two decades. He has worked in Fund Management, Equity Research, and Dealing. He is managing portfolios at Janak Merchant Securities Pvt. Ltd., a company promoted by his family, for the past 14 years. Jaideep is a member of the Institute of Chartered Accountants of India and is also a CFA Charter holder.

Disclaimer: *Stocks/Examples quoted below should not be construed as recommendations*

Safal Niveshak (SN): What are the key factors that shaped your life as an investor and money manager? What inspired you in your early career and how have you evolved over the years?

Jaideep Merchant (JM): The equity markets have been a part of our family. In the late seventies, my father Janak Merchant set up a Stock Broking business in Pune. His disciplined work ethic and ability to identify risks while making investments molded my investing behaviour. Time after school and most holidays were spent in the office selling Public Issues, Company Fixed Deposits and filling share transfer forms.

He kindled my interest in investing and taught me the ropes of how to pick good stocks. I was tasked to go through the Capital Market magazine scoreboard and mark companies that met certain criterion. It did not seem like a job but something that I enjoyed doing.

I successfully cleared my Chartered Accountancy exam in 1999 and joined the business just as the tech boom was reaching its peak. The destruction of investor wealth in those sectors was staggering. I realized that a transaction-oriented business model had inherent conflicts of interest and was against the interest of clients. The longevity of a business is more important than near term profitability, hence the journey to try and manage money began from then on.

In order to get a better perspective of global linkages in our financial markets, I got my CFA Charter in 2006.

SN: How do you find your ideas? What are the necessary conditions that you would look at before you invest in a company and the additional conditions that that will just go about reinforcing your confidence in the company?

JM: Stock picking for me has always been thinking top-down about a macro trend or a sector that is currently mispriced by the market. I prefer Mid and Small-Cap companies.

Market capitalization of the company versus the opportunity size, relatively low sales to market capitalization or high operating cash flow to market capitalization are some of the criteria that interest me. Recent changes in top management, positive disruptive regulatory changes in the business environment and cyclicality in earnings also interest me.

The next stage in trying to validate my thesis is to do a comprehensive review of financials especially the cash flow statement, accounting policies, related party transactions and peer group comparison. I stay clear of companies with relatively high debt and managements that have had a checkered corporate governance record.

I tend to avoid crowded trades and prefer under-invested themes. Lastly, it boils to what price you are paying and how much can you lose if you are wrong.

SN: Compared to when you started investing, the sheer amount of irrelevant information faced by investors is truly staggering today. Today we find ourselves captives of the information age. Anything you could possibly need to know seems to appear at the touch of the keypad. However, rarely, if ever, do we stop and ask ourselves exactly what we need to know in order to make a good decision.

How can investors trapped by irrelevant information make independent investment decisions? What are the few factors investors can use to improve the quality of their decision making?

JM: It is helpful to build a level of familiarity with few industries or investment situations. Given that equity markets are volatile it is safe to assume that over a relatively long period of time you are likely to find yourself in a place that you have already been before.

Documenting these is likely to improve the outcome of your future investment decisions. Over a reasonable time period, this will give you enough data points that are relevant. It helps to have an elephant's memory in the markets. Having a peer group of few investment friends where you can bounce your ideas helps as it normally brings out disconfirming evidence.

A thorough reading of past years annual reports and a visit to the AGM are a must.

SN: A lot of long-time investors have said that they took concentrated bets during the initial phase of their investing life, and later they diversified. How has your journey been on this front? What are your thoughts on concentration vs diversification?

JM: Having a conservative bent of mind I have yet to hit the jackpot with a large concentrated bet. This involves a larger amount of luck than skill. In concentrated bets instead of the investor owning the stock, the stock ends up owning the investor, a situation I would not like to be in.

I have had good success in taking concentrated bets on investment themes or sectors such as PSU companies post the technology boom and Non-Banking Finance companies post 2009. Another strategy that has worked for me is to eliminate weightage in sectors or themes that are extremely overvalued and over-owned by investors such as technology and media in 2000, infrastructure and real estate in 2008 and Non-Banking finance companies in 2017.

Over the last few years, I have started having concentrated portfolios with 10-12 stocks and giving position sizing much more thought than I used to.

SN: Given your long career in the stock market, you have gone through several periods of uncertainties and turmoil. How have you learned to deal with such situations?

JM: Investing is very frustrating at times, especially if you are positioned differently from the flavor of the current cycle. I do not use leverage while managing my own money. Most leveraged investors are unlikely to act rationally as the pressure of margins will make you sell your winners and keep your losers.

While managing other people's money we make sure that clients understand our investment style and we understand client expectations before signing up to manage their monies.

Building a high level of conviction in your investment strategy and keeping that conviction by constantly evaluating your investment rationale helps to deal with such situations. I have kept an eye on my asset allocation between equities and fixed income. A large fixed income or cash allocation helps to capture opportunities at the right time.

SN: What are your thoughts on investment cycles?

JM: Identifying the investment cycle is perhaps the most important step in an investment strategy. Given that India has always been a country that has run a budget deficit and capital account deficit, it is imperative to keep tabs on capital flows that are dependent on what happens globally. A better understanding of this will assist in decision making.

Every few years you see a sector or theme capture the imagination of investors. After a while, this sector or theme becomes a very large part of the indices and portfolios. This sort of consensus investing leads to premium valuations in the sector that is in vogue as more capital chases it.

At the same time, the out of favour parts of the market see liquidity drained out from them are available at relatively low valuations. These cycles are relatively easy to identify with frenzied fundraising and insider selling in a hot sector. The challenge with positioning oneself against this cycle is that you don't know how long it will take to reverse.

If an investment strategy or theme has worked successfully for an extended period, it may be time to look at whether it needs to be changed.

SN: How do you think about valuations? Are there specific valuation models you prefer over others? If yes, which ones and why?

JM: I use conventional valuation parameters such as operating cash flow to market capitalization and P/E multiples. The primary focus is on identifying the levers that will move profitability over the next 2-3 year such as operating or financial leverage, operating margin trajectory and improvement in the macro-economic environment.

Complex financial modeling is not my cup of tea. It is difficult to predict the pace or extent at which change will occur over the medium to long term. It's easier to get the direction of change right.

I lay more emphasis on identifying structural drivers of profitability in a company's business model. For e.g. the regulatory arbitrage in running an NBFC leads to higher ROE as NBFCs don't have to play by the same rules as banks have to. Their profits can disappear if regulations are tightened.

Another example is the fertilizer industry. These companies are the largest brands in rural India. They have poor ROCE as most of their money is stuck in receivables and inventory, and rightfully suffer from poor valuations. The emerging regulatory framework in the sector may delink the fortunes of these companies from the government and lead to lower working capital, improved profitability, and a sharp increase in their valuations.

Lastly, if one were to look at the organized jewellery industry, the gold loan scheme gives them raw material at close to 3% per annum. This means a jeweler with a decent balance sheet can go to a bank to borrow raw material and his inventory.

SN: What are your thoughts on selling stocks? How does one get discipline into the selling process because there are more biases at work here than when one is buying? What selling rules do you follow?

JM: An investor will sell stocks in the following cases –

- **When the investment rationale has not gone as per their expectations –** This one is simple; you exit the stock when you realize that the rationale with which you bought the stock no longer exists.

- **Sell to raise cash as you think markets are overvalued –** You sell part of your portfolio across the board and keep cash.
- **Profit booking in a stock that you think has become overvalued –** This one is the trickiest. Companies that are growing their earnings consistently will become larger and attract more institutional investors. If you are an early investor in such companies, valuations would have been much lower when you bought them. As a company's profits grow from say Rs 50 crore to Rs 500 crore, the market gives it higher valuations as it attracts more institutional money. Given the large size now the company may be growing at a slower pace than in the past. We used to look at absolute valuations versus growth rates and sell a stock when it was expensive. Whereas, it was time to ride the deluge of institutional money that was making its way into the stock. It is prudent to sell gradually as the market piles into the stock.
- **Sell a stock when the management takes an audacious capital allocation decision.**

SN: When you look back at your investment mistakes, were there any common elements of themes? What investment process/philosophy you have changed/updated based on your past mistakes? Real-life examples would be helpful.

JM: Most of my investment mistakes have been selling a stock early.

We bought Eicher Motors for the CV business and cash on the books and did not anticipate the growth in Royal Enfield. After we sold, the stock was up 10X in a short period. Another example was Honeywell Automation which was a large position in 2007. We sold when valuations turned expensive ignoring the potential growth in the services business that Honeywell was undergoing.

You need to let your profits ride in a company after its profits have crossed a threshold that makes it investible to larger investors.

A recent learning from the sharp fall in mid and small-cap stocks since January 2018 was that there are very few places to hide in case liquidity goes out of the market. We did not own any of the bubble sectors or expensive stocks. But the relatively undervalued stocks we owned became more undervalued. This should have been learning from the 2008 market crisis. The macroeconomic environment was nowhere as bad as 2008 but the small-cap indices lost close to 40% from their highs.

In case liquidity dries up you need to have cash in your portfolio.

SN: What are your thoughts on disruption and its impact on businesses and industries? How do you think about investment risk in a world that's highly disruptive?

JM: Disruption is commonly understood as technological, however, regulatory disruption is more common.
A classic example was the NBFC business in the mid-nineties. With one stroke, the RBI bought in capital adequacy requirements for NBFCs that were accepting public deposits. Overnight, thousands of NBFCs closed shop and left depositors in a lurch. What survived was a handful. This was my first taste of what can happen when regulation is tightened.

Let's look at the evolution of the Indian equity markets post-Harshad Mehta.

SEBI was formed, the monopoly of the BSE was broken, NSE introduced screen-based trading, Badla was banned, UTI 64 went under, settlement of trades in demat was implemented gradually for all stocks, regional stock exchanges collapsed, settlement of trades moved to T+2 basis, futures & options trading is now available in stocks, interest rates, and foreign exchange.

All these regulatory changes led to lower transactions costs for investors. Electronic trading and settlement systems that removed counterparty risk and brought in transparency. More importantly, it disrupted the business of a few lakh stockbrokers in India as the profits from the inefficiencies in the system disappeared.

In case the profitability of a business comes from a regulatory arbitrage of some sort, an investor must constantly evaluate the longevity of such an arbitrage. The business fundamentals are likely to change for the sector as regulation changes. Most regulatory changes reduce profit margins and capital return ratios to start with, after which the consolidation wave results in higher profits for the remaining companies.

Given the way regulatory framework in our country is tightening, it will be challenging for the economic rent-seekers to earn high profits in the new normal. Investors must incorporate this change in the environment in their investment strategy.

SN: What are your thoughts on the issue of corporate governance in India? How does a minority investor assess governance that is such a tricky subject? Are there are thumb rules you follow to test governance levels?

JM: Corporate governance standards in India in the past have been poor. Historical actions of the management are a good yardstick to judge corporate governance.
Some of the red flags are –

- Merger between group companies where the ratio favors the company where the promoter has a higher stake in name of synergies and cost-saving
- Large related party transactions
- Undertaking a large capital expenditure in an unrelated business using the listed company balance sheet and then demerging that business and taking it

private after it has started doing well in the name of FOCUS
- Squeezing out minority shareholders from a listed entity in your previous avatar and then relaunching yourself in public markets
- Frequent changes in auditors, CFO

This list is endless; however, each case is unique. The next generation of promoters may be different from their previous generation. Recent changes in company law where promoters are not allowed to vote on certain resolutions and tightening accounting standards reduced the opportunities to short change minority shareholders.

SN: Which are some the books on investing, behaviour, and multidisciplinary thinking that have inspired you the most over the years? If you were to give away all your books but one, which one would it be and why?

JM: I prefer to read on Indian mythology, Yoga and Indian History. The Tree of Yoga by BKS Iyengar is an excellent read for a layman who is trying to understand the philosophy behind Yoga.

SN: Who are some of the people – inside or outside the value investing circles – who have inspired you the most over the years, and why?

JM: My father, given his determination to set up an investment business away from Mumbai when he came from a background that had nothing to do with the equity markets.

My mother, who tirelessly encouraged me to complete my CA, and my wife who left her plum job at a big four accounting firm a decade ago when her career there had taken wings to bolster the management team at our newly set up portfolio management business.

Kuntal Shah who encouraged me to attend the Flame Investment Lab in 2013 where I got a perspective of how other professional investors think and met many likeminded people.

SN: Hypothetical question: Let's say that you knew you were going to lose all your memory the next morning. Briefly, what would you write in a letter to yourself, so that you could begin relearning everything starting the next day?

JM: Some key things to remember: Build conviction in whatever you do, moral compass in place, three types of accounts and their rules for debit and credit and think long term are some that I can think off.

SN: What other things do you do apart from investing? What's your daily routine?

JM: I am an early riser and reach office by 7.30 am after dropping both my kids to school. Try and be home by early evening to spend time with family. Most of my time in office is spent reading or meeting clients. Am an avid yoga practitioner and aspire to teach yoga soon and try and do a trip each year to a forest reserve.