DSP Transcript

Foundations Edition II: Valuations Matter

March-2025

Nearly every issue might conceivably be cheap in one price range and dear in another.

Benjamin Graham and David Dodd, Security Analysis (1934)

Valuations Matter

(~~Almost~~ Always)

Galbraith observed that financial markets have a memory of about 20 years. Yet, every year, excesses emerge somewhere—some sector, theme, or asset class repeats the mistakes of two decades ago. Time and again, investors forget a fundamental principle of investing: to make money consistently—without being lucky—you must buy an asset for less than its intrinsic worth.

In this Foundations Edition, *Valuations Matter*, we explore these recurring cycles of excess and forgetfulness. Our first Foundations Edition, "*Narratives Follow Prices*," covered a related theme. A lot of this is self-talk. Knowing isn't enough. At the height of your certainty, the market whispers its most dangerous lies. The devil comes for you when you are feeling invincible. You must keep reminding yourself, reinforcing the same lessons again and again.

Tulipomania: Flowers Stayed Put. Madness Took Flight.

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In the 17th-century Dutch tulip mania, the most sought-after tulip, Semper Augustus, displayed striking streaks and patterns on their petals. At the time, the cause of these unique appearances was unknown, leading to widespread speculation. Many believed that specific soil conditions, moisture levels, or fertilizers could produce these desirable traits. This uncertainty gave rise to numerous "experts" who offered advice on cultivating such tulips, often suggesting various soil treatments and planting techniques.

In reality, these prized tulips were not the result of expert cultivation but of a virus—Tulip Breaking Virus (TBV)—which disrupted pigment formation in the petals. This virus was only identified nearly 300 years later. The irony was that while TBV created the stunning streaks people paid fortunes for, it also weakened the bulbs over time, making them harder to propagate. Yet, at the height of the mania, no one knew this. Tulip bulbs were sold and resold while still in the ground, with prices climbing to absurd levels based purely on speculation. Merchants, artisans, and even laborers gambled on future blooms, convinced that the right techniques—or sheer luck—would make them rich.

The frenzy collapsed when buyers vanished, and prices plunged. Many were left with worthless contracts for bulbs they never even saw. The Dutch government tried to mediate, but the damage was done—fortunes disappeared overnight. Over time, cultivation stabilized, and tulips became valued once again for their beauty rather than speculation.

Bulls don't read. Bears read financial history.

James Buchan

Tulipomania: Flowers Stayed Put. Madness Took Flight.

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In the 1630s in Amsterdam, the price of a single bulb of Semper Augustus—the most prized tulip—was enough to buy:

27 tons of wheat +

50 tons of rye +

4 fat oxen + 8 fat pigs +

12 fat sheep +

2 hogshead of wine +

4 turns of beer +

2 tons of butter +

3 tons of cheese +

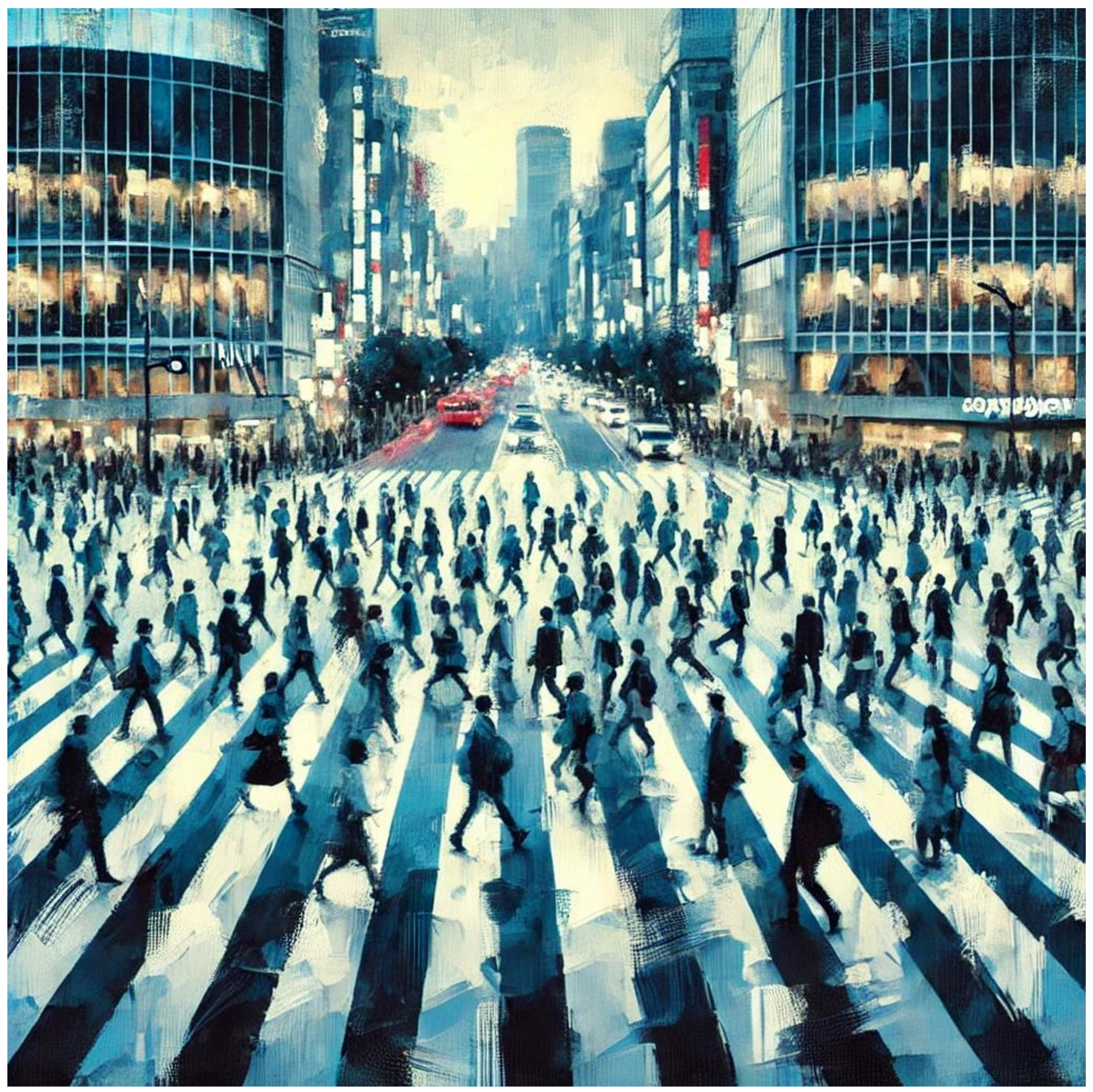
a bed with linen +

a wardrobe of clothes +

a silver beaker.

Source: Devil Take The Hindmost, Edward Chancellor

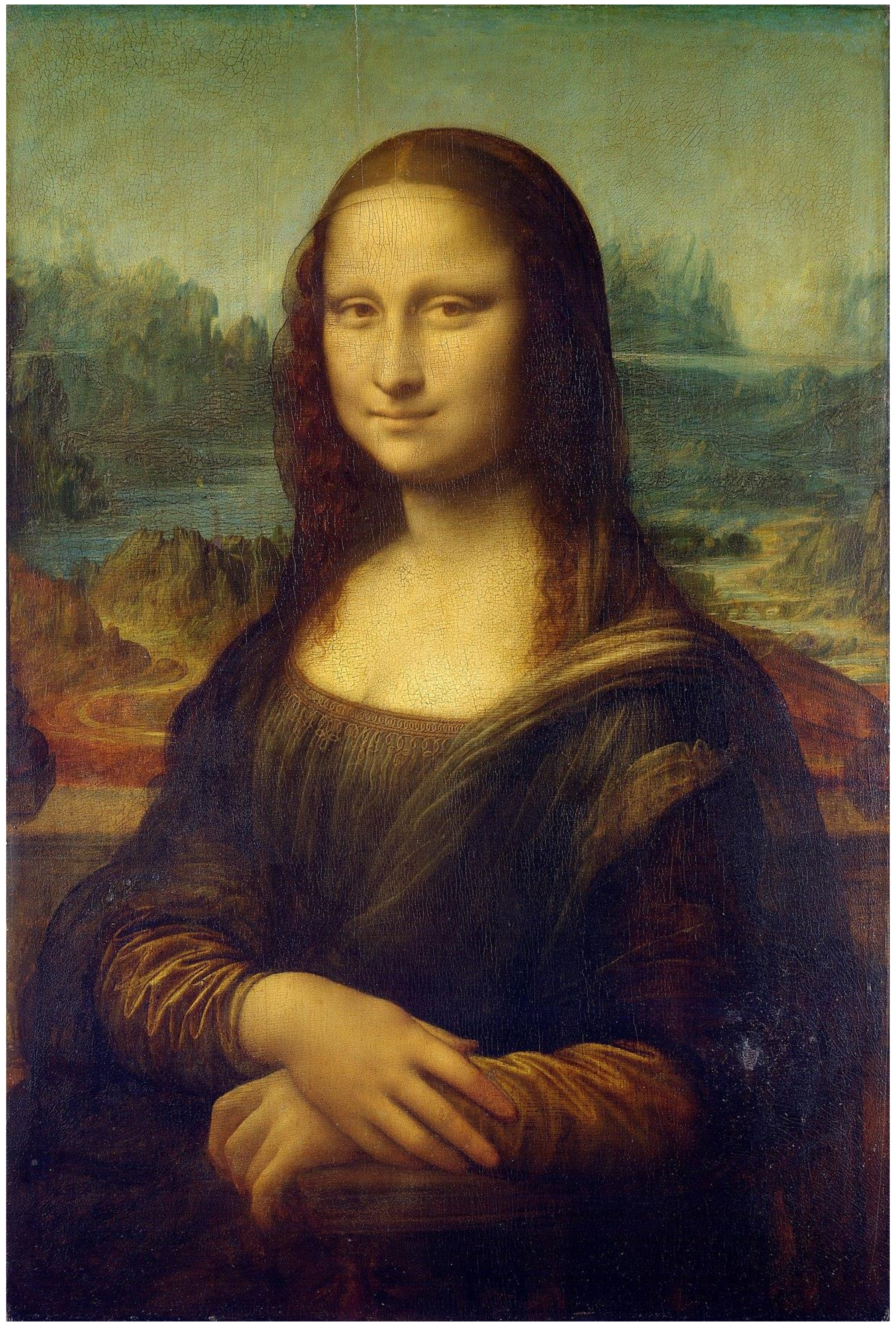
The slope of the world always tries to push you towards irrationality. No matter how cynical you get, it becomes difficult to keep up. You feel the pull to abandon what once made sense. Question yourself, but don't engage in self deceit. Resist.



If everyone crosses the signal together, there is no danger.

A saying among Japanese investors during the 1980s mania.

Value Vs. Price: Quadrillion Dollar Smile



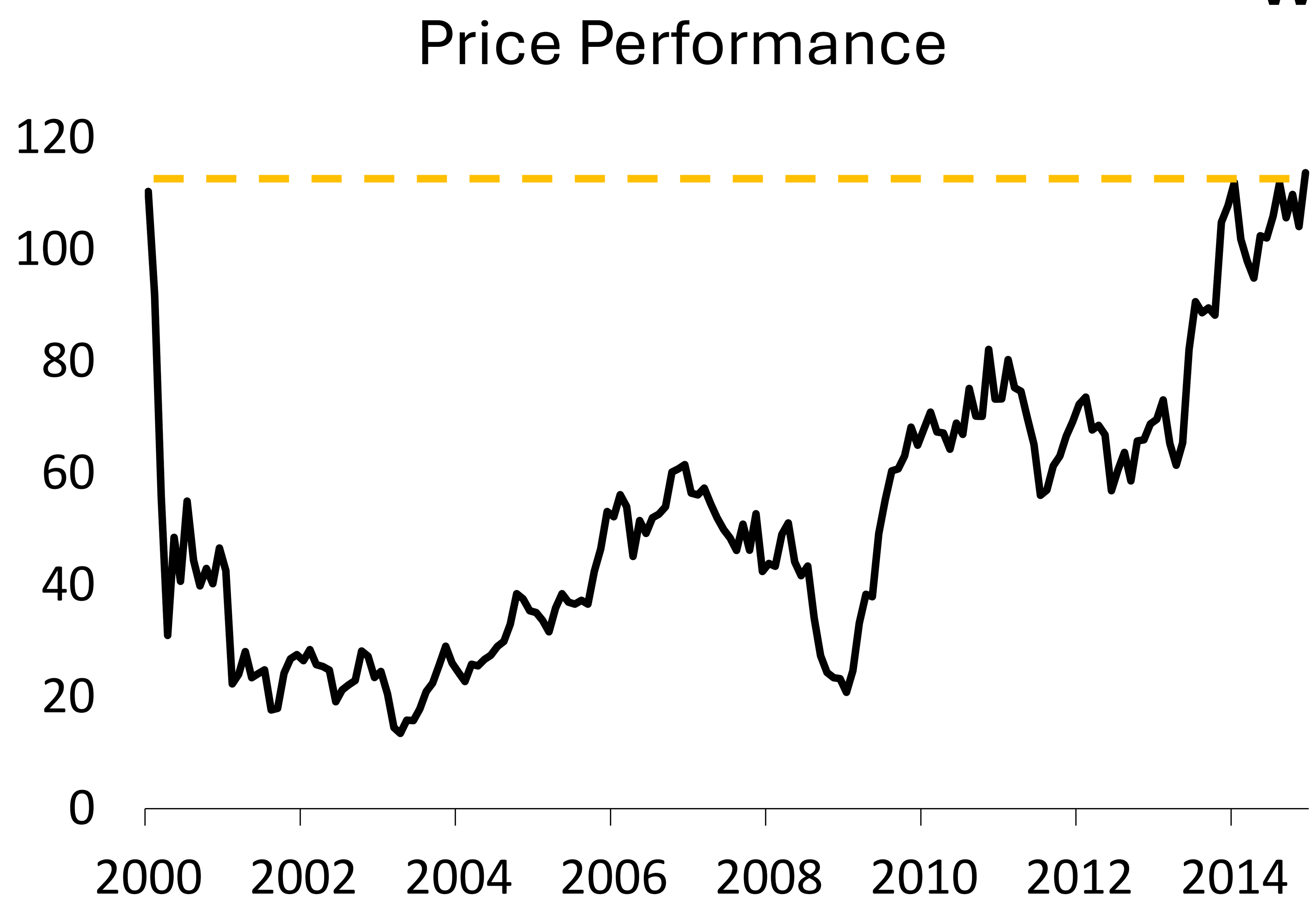
Francis I of France paid $20K (equivalent) in 1540 for Vinci's Mona Lisa. That amount compounded at 6% after-tax now would be worth $1 quadrillion. I trust this will end all discussion in our household about any purchases of paintings qualifying as an investment.

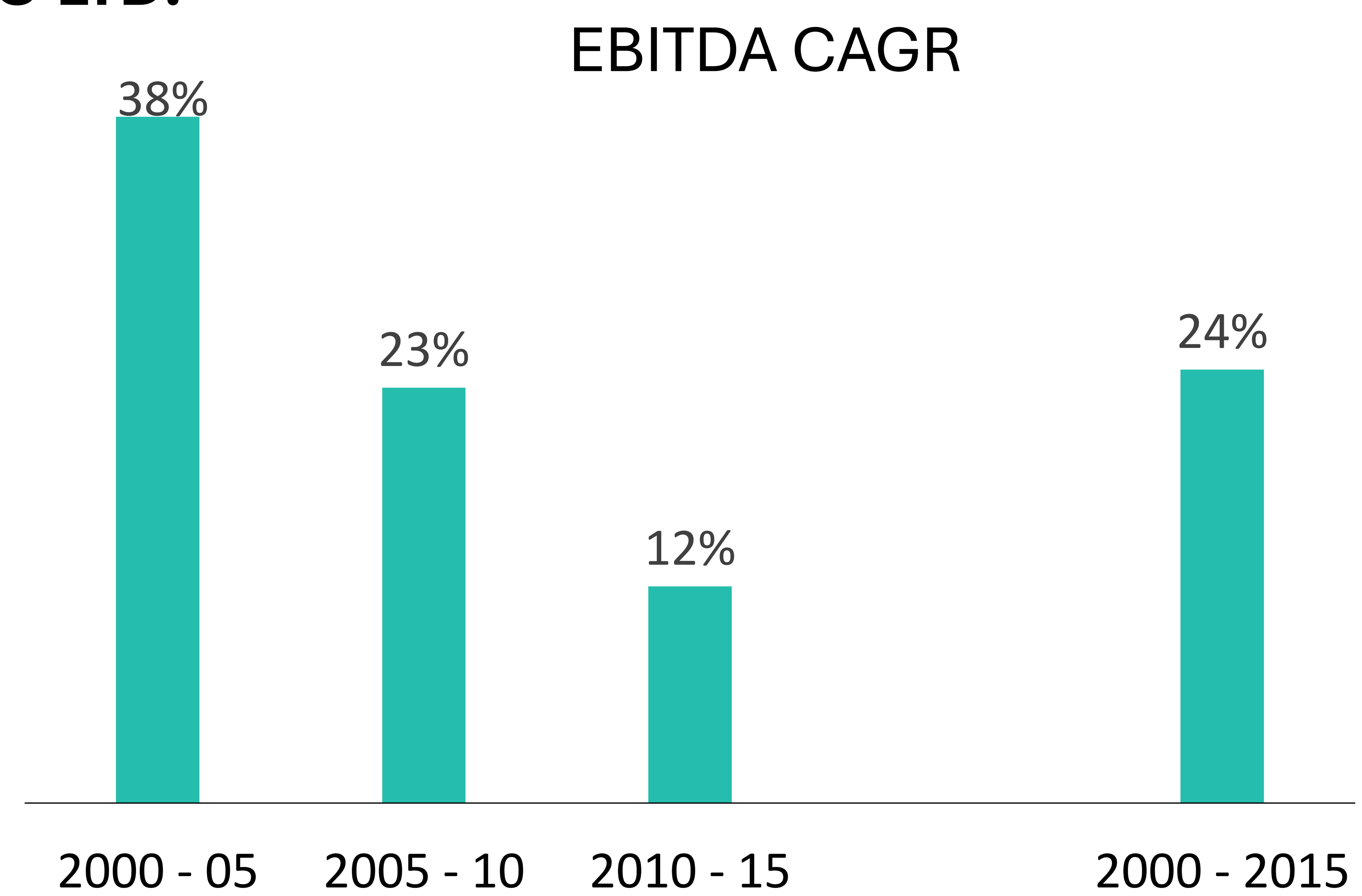
- Warren Buffett, 1964

Even if you consider a lower rate of return there was a price at which this *invaluable* painting should have been sold. Interestingly, the Mona Lisa wasn't even ranked among the most famous paintings before 1911. Its theft that year significantly boosted its popularity, and it only became a global phenomenon in the latter half of the 20th century.

Value Vs. Price: Business Was Right. Price Was Wrong.

WIPRO LTD.





Source: Bloomberg

IT companies delivered phenomenal results on every metric in the 10–15 years after 2000. But if you overpaid, none of that mattered—you had to wait over a decade in some cases to break even. A similar story played out in the U.S. with the Nifty Fifty, a group of high-quality franchises bid to extreme valuations. The basket took five decades to catch up with the S&P 500, and missing just one of its biggest winners meant never catching up at all.

No asset is so good that it can't be overpriced, and few assets are so bad that they can't be underpriced (Howard Marks). Value is different from Price. Differentiate.

Argentina: Gone With The Yield

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1827

1890

1951

1956

1982

1989

2001

2014

Defaults

2017 100-year bond issued at 7.9%

2020 ...Again

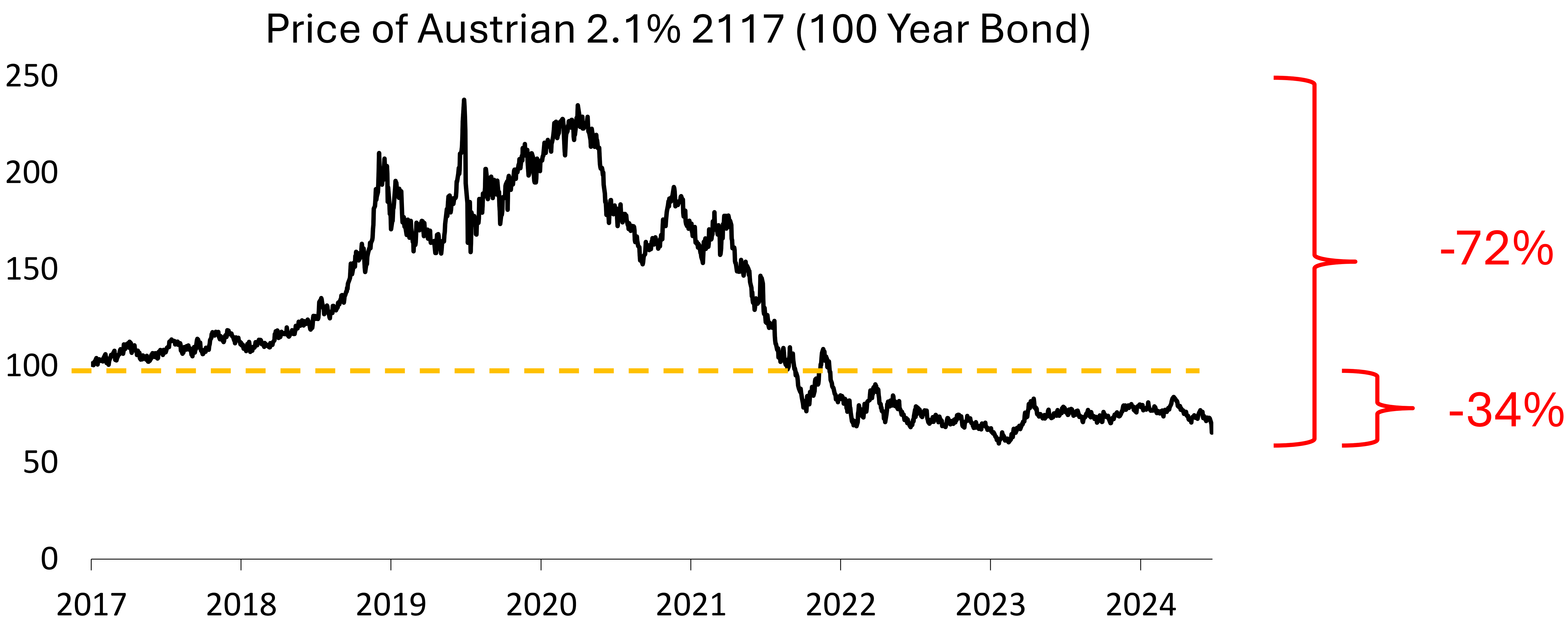
In 2017 Argentina issued a 100-year bond at an effective yield of 7.9%. The county had defaulted twice in the last 20 years and 8 times since its independence in 1816. This included largest sovereign default in history in 2001. The bond was restructured in 2020. If you bought at issuance and reinvested the coupons, you'd have lost about 30% before restructuring and roughly 53% after[1]. If you held the restructured bonds maturing in 2046 and reinvested the new coupon payments, your loss would be approximately 63.7% by Oct 2023. In a world of 0% German Bunds and 2% U.S. Treasuries, the 7.9% yield—equivalent to BBB corporates—seduced investors into underestimating tail risks on a bond that officially had a "junk bond" status.

[1]https://www.ft.com/content/1893d2e9-9548-4e47-92e7-ea3ceb873f9c

John Bull can stand a great deal but he can't stand 2%. Instead of that dreadful event he will invest his savings in something impossible.

The Economist, 1852

Austria: Gone With The Yield



Source: Bloomberg, As on 6th March 2025

Austria's 100-year bond is a lesson in yield desperation. Issued in 2017 at 2.1%, it already carried huge duration risk. But in 2020, a new tranche was reissued at 0.88%, as investors chased every last basis point in a "zero for longer" frenzy. Pension funds and insurers, supposedly cautious, piled in—some for duration, others because it became a trophy asset, a way to signal belief in ultra-low rates. When yields reversed, those who bought at the peak saw 70%+ losses on a bond. **100 years is a plenty of time for the unexpected**. But who cares when the real game was beating the next guy this year.

At extremes that are created by what *most people* believe – *most people* are wrong (Howard Marks). Defy.

In a rising market, everyone makes money and a value philosophy is unnecessary. But because there is no certain way to predict what the market will do, one must follow a value philosophy at all times. By controlling risk and limiting loss through extensive fundamental analysis, strict discipline, and endless patience, value investors can expect good results with limited downside. You may not get rich quick, but you will keep what you have, and if the future of value investing resembles its past, you are likely to get rich slowly. As investment strategies go, this is the most that any reasonable investor can hope for.

Seth Klarman, Preface, Security Analysis, 6th Edition

Covid: The Unbearable Simplicity Of Valuations

1	352%
2	410%
3	216%
4	283%
5	185%
6	285%
7	147%
8	106%
9	135%
10	137%

Source: Internal, ARQ

On March 31, 2020, at the peak of the Covid crisis, imagine, each stock in the BSE 100 Index was evaluated against its own 10-year valuation history (using relevant metrics: P/E, P/B, EV/EBITDA). Stocks were then grouped into deciles based on how their valuation on that date compared to their own historical levels. Decile 1 contained stocks trading at valuations cheaper than 90% of their own 10-year history. This included sectors like utilities, public sector banks, commodities, and autos—sectors that seemed highly uncertain at that time. Deciles 9 and 10 included stocks trading close to their historical peaks (more expensive compared to their own history). These were sectors perceived as safe and stable, such as consumer staples. While one interpretation is that high valuations reflected confidence in stability during prolonged uncertainty, an investor believing that the crisis would eventually pass had a clear path. Valuations served as a simple, guiding force.

'Wall street is a place, where investors shun a bargain'.

Covid: The Unbearable Simplicity Of Valuations

As on 31st March 2020

Company	Market Cap (Cr.)		Company	Market Cap (Cr.)
Sun Pharmaceuticals Industries Ltd	84529		Hindustan Unilever Ltd	497579
Divis Laboratories Ltd	52803			
Dr Reddys Laboratories Ltd	51858			
Cipla Ltd	34092			
Torrent Pharmaceuticals Ltd	33367			
Abbott India Ltd	32834			
Biocon Ltd	32466			
Alkem Laboratories Ltd	27809			
Zydus Lifesciences Ltd	27360			
Lupin Ltd	26711			
Aurobindo Pharma Ltd	24208			
Glaxosmithkline Pharmaceuticals Ltd	21301			
Pfizer Ltd	18404			
Ipca Laboratories Ltd	17591			
Apollo Hospitals Enterprise Ltd	15846			
Total	**501179**			**497579**

Source: Internal, ARQ

This was a period marked by deep uncertainty, so investor caution was understandable. Yet, it seems almost absurd that at the peak of a global healthcare crisis, the combined market value of India's top 15 healthcare companies—spanning Pharma, Hospitals, and Diagnostics, and at the forefront of combating this crisis, representing 80% of the country's listed healthcare sector—was equivalent to just one consumer staples company: Hindustan Unilever.

Discipline at peaks demands courage. Courage during complacency leads to clarity in crisis. And then when crisis strikes - Act.

Innovation: Priced For 'Nothing Can Go Wrong'

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Peak EV To Sales Post Covid (2020-2022)

Zoom	54
Shopify	47
Robinhood	29
Twilio	27
Roblox	24
Roku	23
Teladoc	21
Sea	17
Coinbase	15
Block	11
Peloton	10
Uber	7

Within 6-12 years, breakthroughs in AGI could a accelerate growth in GDP from 3-5% per year to **30-50% per year.** New DNA will win!

Cathie Wood, May 22, 2022

Source: X.Com, BusinessInsider.com, Bloomberg

The world has always faced disruption, even since the Stone Age. Yet historically, investors as a group haven't done well in the early stages of innovation—be it cars, phones, bicycles, radio, television, computers, the internet, or social media. The benefits of breakthrough technologies usually flow first to consumers, not investors. A low price-to-sales ratio doesn't always indicate a business is undervalued, but a high EV-to-sales ratio almost always demands caution. When extraordinary growth is already priced in, even minor disappointments can trigger severe penalties, as seen repeatedly with disruptive innovation stocks.

When you witness sweeping changes right before your eyes, it's easy to convince yourself the outlook could be fantastic—but history shows optimism alone rarely pays off.

Financial genius is a rising market. Innovation becomes dangerous precisely because its proponents believe so deeply that 'this time it's different (J.K. Galbraith). If you are a conservative investor delay participating in innovation. Instead, beware of what is being disrupted - that's easier. Wait.

A farmer was bragging to his friend about his prized pig, claiming it was worth a million dollars.

"How do you know that?" his friend asked, skeptical.

"Easy," the farmer replied with a grin. "I traded it for two chickens worth $500,000 each."

Be careful while using Relative Valuations.

LTCM: Formula Bearing Geeks

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1 in 10^{23}

The probability of loss estimated by insiders at Long Term Capital Management. Put another way this is once in the lifetime of the universe.

Source: When Genius Failed, Roger Lowenstein

We must watch for cases where people misapply simplifying assumptions to a complex world. Numbers can give undue credibility to statements that warrant skepticism, creating real risks.

Wittgenstein's ruler: was it really a "10 sigma event"?

In 1998, the hedge fund called "Long Term Capital Management" (LTCM) had a very short life; it went bust from some deviations in the markets –those "of an unexpected nature". The loss was a *yuuuge deal* because two of the partners received the Swedish Riksbank Prize, marketed as the "Nobel" in economics. More significantly, the fund harbored a large number of finance professors; LTCM had imitators among professors (at least sixty finance PhDs blew up during that period from trades similar to LTCM's, and owing to risk management methods that were identical). At least two of the partners made the statement that it was a "10 sigma" event (10 standard deviations), hence they should be absolved of all accusations of incompetence (I was first hand witness of two such statements).

Let us apply what the author calls "Wittgenstein's ruler": are you using the ruler to measure the table or using the table to measure the ruler?

Let us assume to simplify there are only two alternatives: a Gaussian distribution and a Power Law one. For the Gaussian, the "event" we define as the survival function of 10 standard deviations is 1.31×10^{23}. For the Power law of the same scale, a student T distribution with tail exponent 2, the survival function is $\frac{1}{203}$.

What is the probability of the data being Gaussian conditional on a 10 sigma event, compared to that alternative?

We start with Bayes' rule. $P(A|B) = \frac{P(A)P(B|A)}{P(B)}$. Replace $P(B) = P(A)P(B|A) + P(\overline{A})P(B|\overline{A})$ and apply to our case.

$$P(\text{Gaussian}|\text{Event}) = \frac{P(\text{Gaussian})(P(\text{Event}|\text{Gaussian}))}{(1 - P(\text{Gaussian})(P(\text{Event}|\text{NonGaussian})) + P(\text{Gaussian})P(\text{Event}|\text{Gaussian})}$$

P(Gaussian)	P(Gaussian|Event)
0.5	2×10^{-21}
0.999	2×10^{-18}
0.9999	2×10^{-17}
0.99999	2×10^{-16}
0.999999	2×10^{-15}
1	1

Moral: If there is a tiny probability, $< 10^{-10}$ that the data might not be Gaussian, one can firmly reject Gaussianity in favor of the fat tailed distribution.

Source: @nntaleb, X.com

Just because you use algebra doesn't mean you're rational. Things should be as objective & quantitative as possible—but no more. **Approximate.**

What Broadly Works

Reality

1. Life & markets are uncertain. Future is unpredictable.
2. When everything looks great, outlook seems fantastic, and investor confidence is high—that's often when the risks are highest.
3. Ever so often you will be sold a revolutionary idea that's going to change the world. And the arguments will be convincing. If they're not, they can always be made convincing—with layers of intractable math and complexity.

Action Plan

1. Buy when implied expectations are low. Sell when they are high.
2. If you can't figure it out, avoid.
3. Accept, you can be late to many life-changing ideas and still make satisfactory—even life-changing—returns.
4. Resilience beats optimization.
5. Avoiding stupidity is the most profitable strategy. How do you identify stupidity? It's often obvious if you don't engage in self-deceit.

Read, Read, Read

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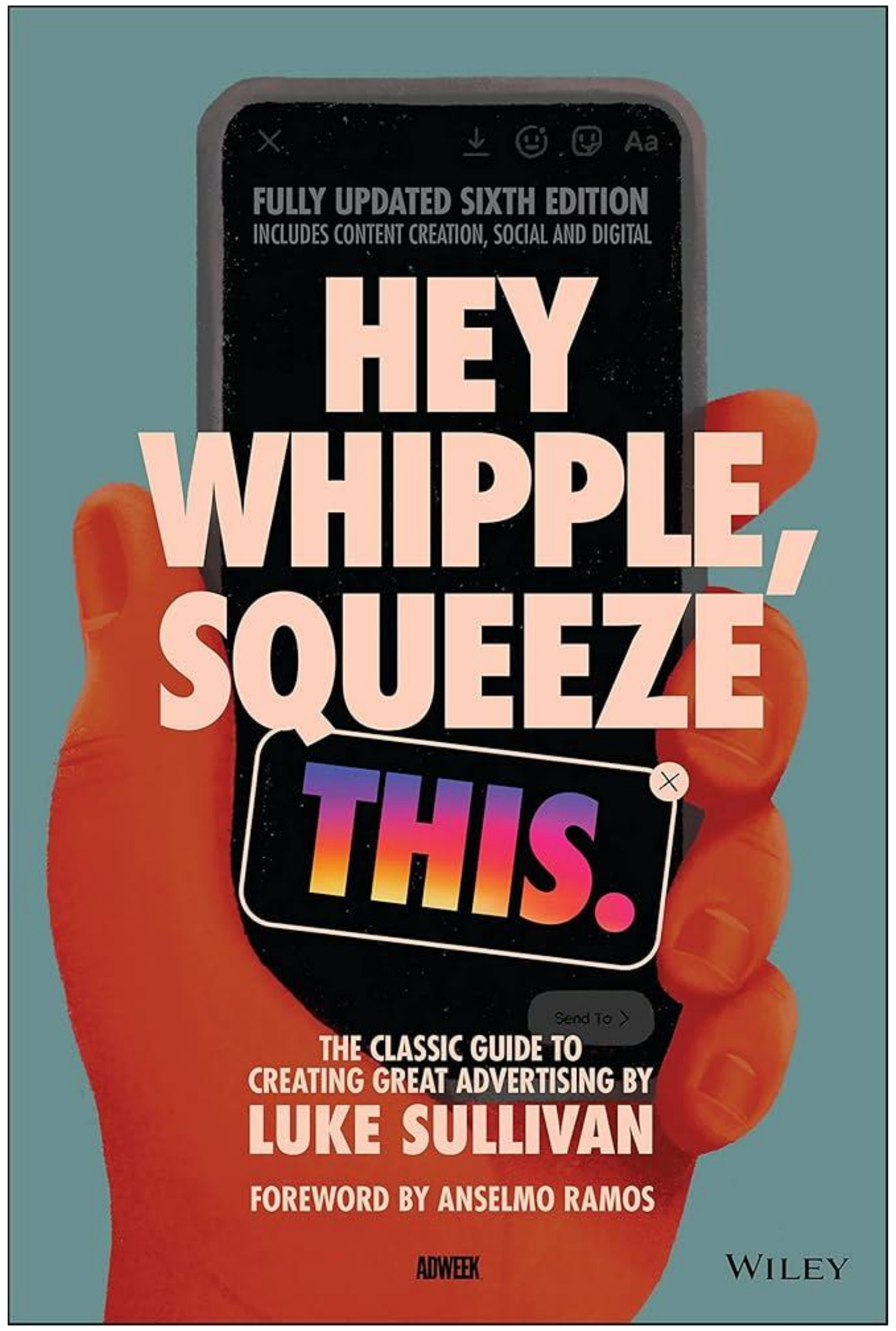

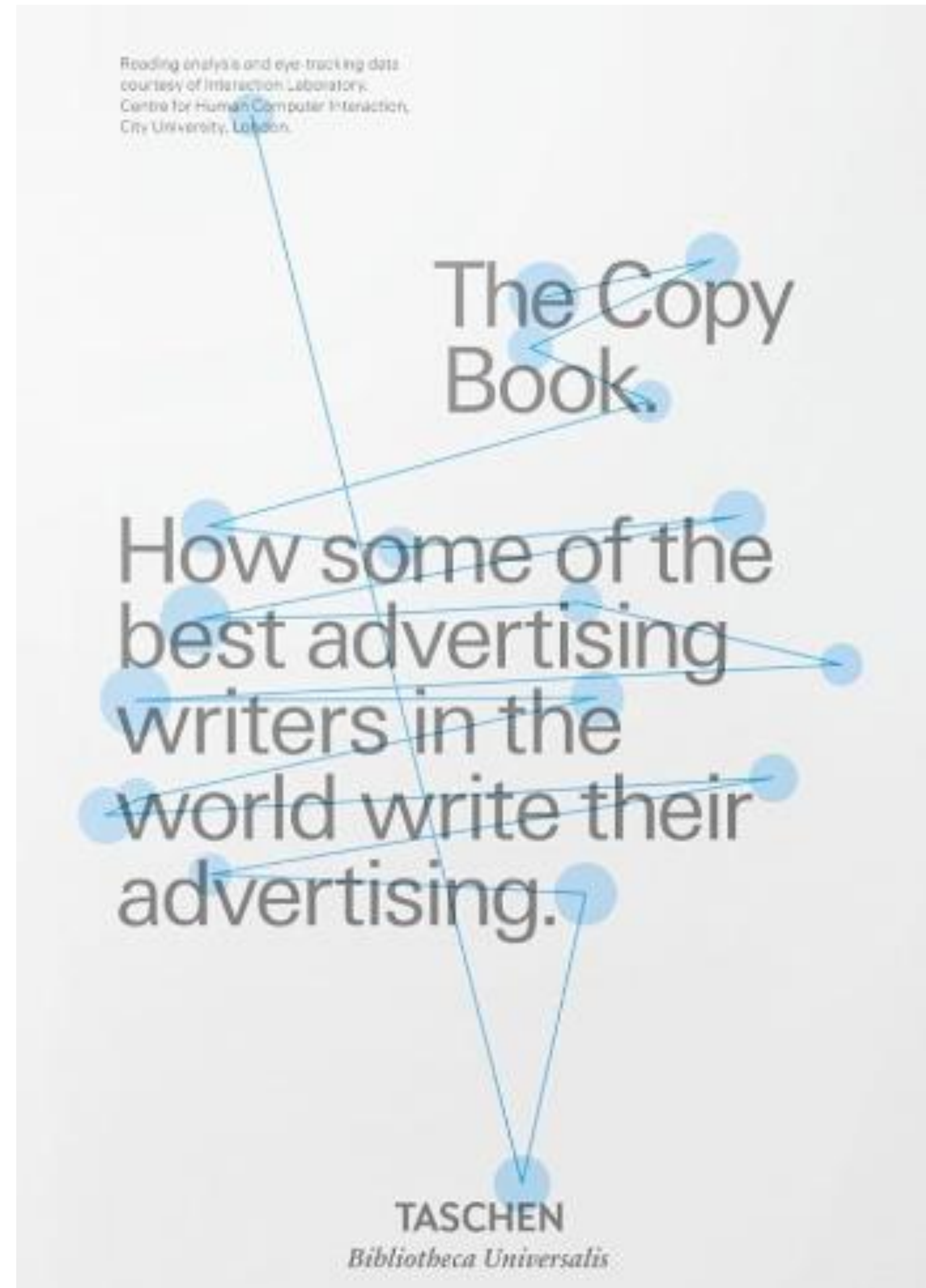

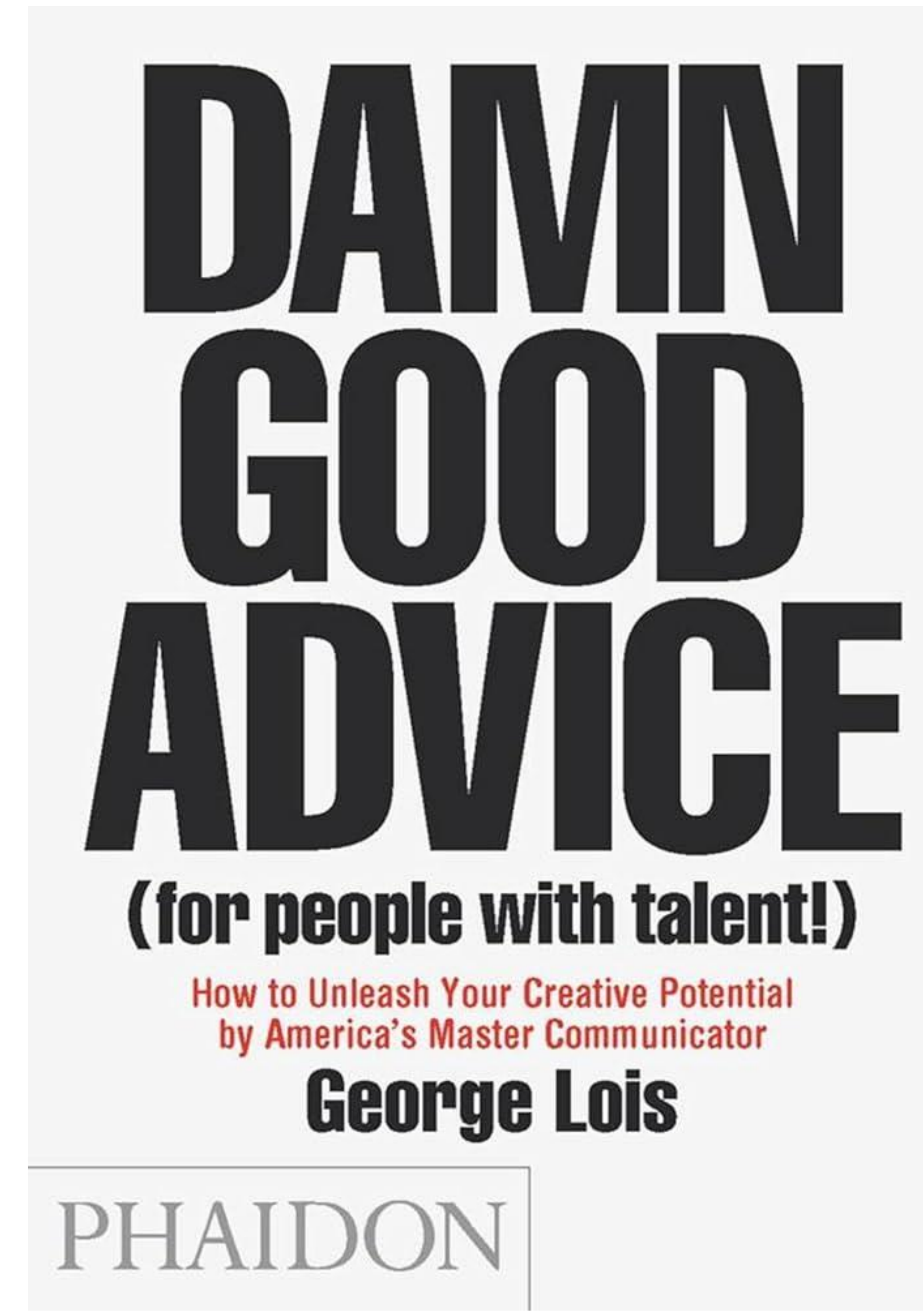

I have a great gimmick. **Let's tell the truth.**

Vague strategies inhibit. Precise strategies liberate.

People are indifferent to advertising or downright hostile. You have seconds to make an impact, and every extra word is a risk. That's why advertising is a great way to sharpen your communication. Clear and sharp messaging opens doors.

First book is packed with creative insights, the second is like a coffee table book—easy to flip through and third you can finish in an hour or two with a few great life lessons.

All are fun to read.

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Nobel For Lobotomy

António Egas Moniz was awarded the Nobel Prize in 1949 for developing the procedure. At the time, it was hailed as revolutionary for treating severe mental illnesses. It initially seemed promising as it reduced aggressive behaviors but later was condemned for causing irreversible brain damage and loss of personality.

The Nobel Foundation on its website hosts an article defending the award:

https://www.nobelprize.org/prizes/medicine/1949/moniz/article/

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