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GF Chat

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# Mohnish Pabrai: Low-Risk, High-Uncertainty 100-Baggers

Using uncertainty to play to your advantage

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A few weeks ago, I covered a lecture Mohnish Pabrai gave at the Guanghua School of Management in what was the first value investing course ever to be held in China two years ago.

The talk focused on Pabrai's process for finding 100-baggers, stocks that have the potential to increase in value 100 times -- the rare birds of the investing world.

In the lecture, Pabrai outlined the five different types of stocks he believed were the best placed to achieve this goal. This list included:

1. Companies that can be run by idiots.
2. Companies that cannot be run by idiots.
3. High-uncertainty, low-risk opportunities.
4. Bankruptcy reorganizations.
5. Bubble stocks.



I've already covered these criteria briefly in my previous articles. Here I dig deeper into the third criterion, "High-uncertainty, low-risk opportunities."

I believe stocks falling into this bucket offer the most opportunity for value investors today. Since the investment world is increasingly dominated by computerized trading and passive investing, these (to borrow Dr. Michael Burry's term) "ick" stocks fly under the radar.

These opportunities only exist because the rest of the market cannot distinguish between risk and uncertainty, where risk is defined as the permanent impairment of capital. They exist because most

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## Performances of the stocks mentioned by Rupert Hargreaves

Symbol	Company	Current Price	Change (%)	Gain (%)
FCX	Freeport-McMoRan Inc	\$ 16.65	-0.64 (-3.70%)	22.61%
SYF	Synchrony Financial	\$ 32.23	-0.73 (-2.21%)	-4.84%
IEP	Icahn Enterprises LP	\$ 76.15	1.42 (1.90%)	49.52%
CHK	Chesapeake Energy Corp	\$ 5.21	0.09 (1.76%)	-5.1%
PYPL	PayPal Holdings Inc	\$ 87.70	-1.43 (-1.60%)	97.3%
VSAT	Viasat Inc	\$ 69.55	-0.88 (-1.25%)	5.89%
CAT	Caterpillar Inc	\$ 140.77	1.35 (0.97%)	48.98%
CW	Curtiss-Wright Corp	\$ 122.91	1.09 (0.89%)	31.33%
ARII	American Railcar Industries Inc	\$ 41.82	0.29 (0.70%)	-4.17%
XRX	Xerox Corp	\$ 25.33	0.17 (0.68%)	-11.56%
Summary			-0.19%	23.02%

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cyclical forces and is not a suitable long-term investment.

Pabrai said:

"For example, Frontline (NYSE:FRO) was a shipping company, and this company focused on transporting crude oil. They had something known as VLCCs, Very Large Crude Carriers that they owned. The VLCCs are chartered two different ways. Either they are time charters, or they're daily charters. The entire Frontline fleet of 70 ships was on daily charters. The daily charter rate for these ships can vary from \$5,000 a day to \$300,000 a day. It is a huge variance and at that time in 2002, once the rates went below \$12,000 or \$13,000 they were not making any money; they were losing money. Once the rates went over \$30,000 or \$40,000, they were super, super abnormal profits, exponential profits. I bought Frontline at a point when these prices were \$5,000 or \$10,000 a day, and the stock had collapsed, and it was trading at about \$6 a share. Then it went from \$6 to \$9 in a short time. I wanted just to capture that spread. It was above the liquidation value. I sold the company. Because of the very high uncertainty in rates, if I had held the stock, even with all the recent collapse in shipping, would've been a 30, 35 times investment, from \$6 to \$160."



These low-risk, high-uncertainty opportunities come around infrequently, but the risk-reward payoff is tremendous. You only need a few ideas a year to make exceptional returns on capital. Another example Pabrai gave in his lecture was Tesoro (TSXV:TES):

"What happened with Tesoro is that there was another merger taking place with two large oil refiners. To make that merger happen, they were forced to sell one of the oil refineries to make the budget. Tesoro bought that refinery, they leveraged the balance sheet to buy the refinery, and after they leveraged the balance sheet ... The crack spread narrowed to almost nothing, so their profits went to next to nothing. At the same time, they had a huge amount of debt. The markets looked at the debt, and they saw a lot of uncertainty because it is very hard to predict the crack spread. I looked at the company, the balance sheet, the debt, and so on. The stock was at \$7.5 -- it had gone down a lot. It used to be at almost \$30. It went down to 25% of the price, so I bought 10% of assets at \$7.5. Three months after I bought the stock it was trading at \$1.33 ... We sit there, and then a few months later the crack spread widens, and they're

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### FRO Price Chart



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The problem is, most people are not suited to this style of investing. It requires a long-term outlook, even though the payoff might only be a few months away. You need a long-term vision to be able to look past the short-term factors weighing on the stock and consider the returns from a long-term perspective.

Most investors want a payoff immediately. High-uncertainty, low-risk opportunities take time to play out, but when the bet finally pays off, on an annualized basis, the returns are far more lucrative:

*"Fiat Chrysler (NYSE:FCAU)...The management of the company says that in the year 2018, their earnings are going to be around \$5. If the management is correct about the prospects of the business then basically the business has been priced at 1.2 times earnings for one year. My answer to that is, 'Okay, we'll hold the stock to 2018.' They have \$130 billion in sales of cars. They just started manufacturing Jeep in China. The Chinese love their Jeeps. Raise your hand if you think Chinese love Jeeps. All right, at least a few Chinese love their Jeeps. That's great. Their Jeep sales are going up 5x in the next three years in China. I happen to think that what they're saying makes sense. The market thinks it doesn't make sense."*



The returns on offer more than compensate investors for the extra research required to invest in these opportunities with confidence:

*"Another company which I just wanted to talk about is Teck Cominco (NYSE:TECK). This is again, low-risk high uncertainty ... they had completed an acquisition just before the financial crisis, a substantial purchase. They had taken a bridge loan to close that acquisition. Then the financial crisis happened, they couldn't refinance, all the prices collapsed, and this stock went from \$50 to \$4. It dropped by more than 90% in seven weeks ... The banks don't want to be in the shipping business. The banks were probably going to do what I would call 'extend and protect' -- they would take some fees and penalties from them, but they would extend their loans. In fact, China came in as an investor in Teck Cominco, and in a few months the stock was up seven times, and I sold. We bought at \$4 or \$5; we sold at \$30."*

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Disclosure: The author owns no stock mentioned.

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Rupert Hargreaves

Rupert is a committed value investor and regularly writes and invests following the principles set out by Benjamin Graham. Prior to his investing and writing career, Rupert was as a proprietary currency trader. Rupert holds qualifications from the Chartered Institute for Securities & Investment and the CFA Society of the UK. He covers everything value investing for ValueWalk and other sites on a freelance basis.

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