

BOOK REVIEW/SUMMARY:

THE DHANDHO INVESTOR - MOHNISH PABRAI

WRITTEN BY BJÖRN KIJL

In his latest book 'The Dhandho Investor', value investor Mohnish Pabrai shows you how you can maximize your investment returns while minimizing your risk.

RISK, RETURN AND THE DHANDHO FRAMEWORK

Most people think risk and return are related. All investors are told that if you want to earn high rates of return, you need to take on greater risks. However, value investors like Benjamin Graham, Warren Buffett, and Joel Greenblatt have shown that it is actually possible to make great profits with relatively low risk levels.

Dhandho, literally translated, means 'endeavours that create wealth'. In 'The Dhandho Investor', Mohnish Pabrai describes his Dhandho investment framework with which you can earn high returns with low risk levels.

Mohnish Pabrai is the Managing Partner of Pabrai Investment Funds, a close replica of the original 1950s Buffett Partnerships. Since its inception in 1999, Pabrai Investment Funds, has outperformed all of the major indices and over 99% of other managed funds with an annualized return of over 28% after all fees and expenses – \$ 100,000 invested with Pabrai in 1999 was worth over \$ 659,000 in 2006!

The Dhandho framework consists of nine core principles. We will shortly pay attention to all these principles.

PRINCIPLE # 1: FOCUS ON BUYING AN EXISTING BUSINESS

According to Pabrai, having shares (read: ownership stakes) in a few publicly traded, existing businesses is the best path to wealth. There are several advantages with this way of investing: no heavy lifting is required, on the stock market you can sometimes find real bargain buying opportunities, you don't need a lot of capital to start investing in publicly traded stocks, there is an ultra-large selection of stocks (read: companies) available, and – with online brokers – frictional costs are very low.

PRINCIPLE # 2: INVEST IN SIMPLE BUSINESSES

Simplicity is an extremely powerful construct. For Einstein, simplicity was the highest level of intellect. The Dhandho way of investing is simple, and therein lies its power. Only after buying a specific stock, the psychological warfare with our brains really gets heated (see also Principle #3). To fight these powerful psychological forces, you need to buy painfully simple businesses with painfully simple theses for why you'll likely earn a decent profit and are unlikely to lose much money. If you need difficult spreadsheet calculations or more than one short paragraph for your thesis, you should look at another investment opportunity.

PRINCIPLE # 3: INVEST IN DISTRESSED BUSINESSES

Stock prices, in most instances, reflect the underlying fundamentals. But that's not always the case. According to Pabrai, human psychology affects the buying and selling of stocks much more than the buying and selling of entire businesses. Bad news coming out sometimes leads to extreme fear, stock dumping and a very low valuation as a consequence.

You should look for simple businesses that are under distress, so you can buy them at unreasonably low prices. You can find such distressed businesses by e.g. reading bad headline stories about certain businesses or industries, looking for stocks with low price-to-earnings ratios or reading a book like [‘The Little Book That Beats the Market’](#) written by value investor Joel Greenblatt.

PRINCIPLE # 4: INVEST IN BUSINESS WITH DURABLE MOATS

Only businesses with durable moats – or, in other words, only businesses with sustainable competitive advantages – are able to show above average returns on their invested capital. Such companies are able to earn more money for their investors than companies without durable moats.

Over time, the power of all moats tends to weaken. Charlie Munger once mentioned that of the fifty most important stocks on the NYSE in 1911, today only one is still in business (General Electric). So, even businesses with durable moats don't last forever. You should take that into account, when trying to estimate the intrinsic value of a company.

PRINCIPLE # 5: FEW BETS, BIG BETS, AND INFREQUENT BETS

Warren Buffett once said that diversification can be seen as a protection against ignorance. In the end, investing is just like gambling. According to Pabrai, “looking out for mispriced betting opportunities and betting heavily when the odds are overwhelmingly in your favour is the ticket to wealth.” Having a portfolio of e.g. 100 companies doesn't make sense when you want to earn above average returns.

PRINCIPLE # 6: FIXATE ON ARBITRAGE

Always look for arbitrage opportunities with spreads as wide and long as possible. Arbitrage opportunities help you to earn a high return on invested capital with low levels of risk. An enduring Dhandho arbitrage spread can be seen as a moat or a durable competitive advantage. You should be aware that, over time, arbitrage spreads eventually disappear. The critical question then is: how long is the spread likely to last and how wide is the moat really?

PRINCIPLE # 7: MARGIN OF SAFETY – ALWAYS

The bigger the discount to intrinsic value, the lower is the risk. The bigger the discount to intrinsic value, the higher will be the return. Most of the time, assets are traded at or above their intrinsic value. You should patiently wait for finding cheap stocks with a large margin of safety, a low-risk and a high upside potential.

Having a margin of safety in order to minimize risk of loss is of crucial importance: when you lose e.g. 50% you need to make a profit of 100% for only getting your

money back. Especially in the long term, the cost of loss is extremely high. This is related to the incredible power of compounding (for more information, click [here](#)).

PRINCIPLE # 8: INVEST IN LOW-RISK, HIGH-UNCERTAINTY BUSINESSES

Risks and uncertainty are different concepts. The future performance of a company in distress may be uncertain. But, when you have carefully thought through the range of possible future scenarios and conclude that the odds of a permanent loss of capital are very low, you may have found a lucrative low-risk, high-uncertainty investment opportunity. When extreme fear sets in, stock markets may behave irrational. By applying the Dhandho techniques, you can profit from this irrational behaviour.

PRINCIPLE # 9: INVEST IN THE COPYCATS RATHER THAN THE INNOVATORS

According to Pabrai, innovation is a crapshoot, but cloning is for sure. Therefore, good cloners are great businesses. Look for businesses run by people who have demonstrated that they are able to repeatedly lift and scale the work of the innovators.

FINAL THOUGHTS

'The Dhandho Investor' is a great book for people who want to significantly improve their investment results. The book can be seen as a great extension to and a deepening of the basic value investing principles as described in a book like 'The Little Book That Beats the Market'.

In 'The Dhandho Investor', Mohnish Pabrai clarifies all principles of the Dhandho framework as mentioned above with a lot of case studies and examples. Besides, he also pays attention to subjects like the art of selling stocks, the (non)sense of indexing, and wisely spending the money you can make by leveraging the Dhandho techniques as described in the book.

For more information about or ordering 'The Dhandho Investor' via Amazon.com, just click [here](#).

ABOUT THE AUTHOR

Björn Kijl extensively studies the investment principles of value investors like Warren Buffett, Joel Greenblatt, and Mohnish Pabrai and is a long-time investor himself. Björn holds an MSc in Business Information Technology from the University of Twente in the Netherlands where he graduated cum laude.

The website www.magicformulastocks.com is dedicated to explain (free of charge) why to select stocks with high Returns on Capital in combination with high Earnings Yields. The website also gives access to a regular e-newsletter on value investing.

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