Q&A

Buffett Disciple Mohnish Pabrai on Bank of America, Citi, Google, and Hyundai

Hedge fund manager Mohnish Pabrai sees value in big financial stocks, Google, and Korean shares.

By JOHN KIMELMAN
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In seeking out the advice of professional stockpickers, it's best to avoid the so-called closet indexers.

Portfolio managers that fit that bill hold 40 or more stocks -- many hold hundreds -- with each comprising a small percentage of the portfolio. They collect active-management fees for performance that, at best, matches the index.

That's not the way hedge fund manager Mohnish Pabrai rolls. The Indian-born Pabrai, who runs the $700 million-asset Pabrai Investment Funds, puts big money behind his convictions. In the investment world, that translates to holding a small basket of stocks and watching them closely.

"I have heard [Warren Buffett's business partner] Charlie Munger more than once say that a well-diversified portfolio needs four stocks," says Pabrai, in a phone interview from his office in Irvine, Calif.

Pabrai's portfolios aren't quite that concentrated. But the value hound is OK with buying a stock that makes up 10% of his fund house's assets, and even letting it run a bit higher than that. He takes a go-anywhere approach, seeing opportunities ranging from the U.S. to South Korea.

A former information technology consultant, Pabrai is a serious student of Warren Buffett's approach to investing. In 2008, he and a friend, value investor Guy Spier, paid $650,000 in a charity auction to have a two-and-a-half-hour lunch with their investment idol at a famous New York steakhouse.

Manager's Bio

Name:	Mohnish Pabrai
Age:	50
Title:	Principal, Pabrai Investment Funds
Education:	B.S. in computer engineering, Clemson University; studied for master's degree in electrical engineering at Illinois Institute of Technology
Hobbies:	Playing bridge

It's hard to know the full extent of Pabrai's performance over the years. By law, as a hedge fund manager, he is not allowed to publish or disclose numbers for noninvestors, including inquiring reporters, since that constitutes marketing the fund. According to BarclayHedge, an Iowa-based fund-tracking firm, Pabrai Investment Fund 3 returned an annualized 9.68% over the past 10 years through Oct. 31 net of fees, outpacing the total return of the Standard & Poor's 500 index by about 1.5% a year. That said, the fund has sharply underperformed the broader stock market this year.

When asked about this underperformance, he replied, "I think it is an irrelevant data point. There is nothing intelligent that one can say about short periods like 10 months. I never make investments with any thought to what will happen in a few months or even a year."

At least investors don't get charged for periods of poor performance. Unlike most hedge fund managers, the long-only investor doesn't charge a flat management fee of 2% on top of performance fees. He just charges 25% on gains made over 6%.

He can keep his fees so low because of his low overhead; the 50-year-old does all the stock research and portfolio management himself.

When Barrons.com last spoke with Pabrai almost 10 years ago, he said active stockpickers should focus on small-cap stocks because it's easier to find mispriced assets in that sector than it is with larger stocks.

Since then, he's modified his stance to take advantage of a few big banks that he believes were unfairly beaten down during the Great Recession.

The bottom-up investor says he's having a tougher time finding value in the U.S. stock market than he did a year ago. One of his favorite stocks is one he doesn't own, at least not yet: Google (ticker: GOOGL).

Though he shies away from discussing stocks he's been buying recently, his insights can inform those who are making their own decisions. Read on for his latest thoughts about the markets.

Barrons.com: *Would you say it is easier or harder to find cheaply valued stocks than it was, say, a year ago?*

Pabrai: I would say it's harder. We haven't had any meaningful investments in U.S.-listed stocks in probably two years. I've found a few things, but they are just really small. The stocks that we have found of any meaning are all out of the U.S.

Q: *Where?*

A: I've found stocks in India, China and South Korea.

Q: *Can you elaborate?*

A: I can discuss names that we've held in the past, but in general I prefer not to talk about my current stocks.

Top U.S. Holdings of Pabrai Fund

(as of Sept. 30, 2014)

Horsehead Holding	(ZINC)
Bank of America	(BAC)
Citigroup	(C)
Posco	(PKX)
Berkshire Hathaway	(BRKA)

Q: *You told me when we talked in 2005 that you tend to shy away from large-cap stocks because there is less opportunity to find mispriced assets. But I noticed in a recent 13F filing that one of your funds has sizable positions in two big banks, Bank of America (BAC) and Citigroup (C). Explain this?*

A: My feeling is that if a bank has proper reserves and it's trading well below tangible book value, that is an undervalued bank. You could shut down a bank today and if the reserves are correct you would get back the tangible book value. So you look at something like Bank of America, for example, the tangible book value of Bank of America is around \$14-\$15 a share, and when we were making the investment it was around \$6 to \$7 dollars a share. It was trading at half of book value, and, of course, clearly at that point the market believed that book value was incorrect.

Q: *So you thought that was a rare case where a large well-followed bank wasn't being efficiently priced by the market?*

A: Yes. It's true that with large-cap stocks, there is less opportunity. But in a situation where there is a national crisis, things are beaten up so badly.

Q: *When did you do most of your buying of Bank of America?*

A: Around late 2011. I bought it right after Buffett bought it.

Q: *Does what you say about BofA apply to your investment in Citigroup as well?*

A: Yeah, I think it applies. Both were sitting at massive discounts to tangible book value.

Q: *Are both Bank of America and Citigroup worth buying at their current prices?*

A: Yes, both are undervalued. Eventually they should trade like Wells Fargo and JPMorgan with similar price-to-book and price-to-earnings multiples.

Q: *I know you like India, South Korea and China. Are there certain national markets that you are particularly bullish on now or is your focus purely on businesses, not markets?*

A: In the case of Korea, a lot of companies have preferred securities, and in many cases they are trading at 50% of common stock. There are hundreds of these preferreds. We are currently invested in Hyundai preferreds.

Q: *In analyzing a business, are you also analyzing the country where the business is based?*

A: Yes. For example, no matter how cheap it gets, we will not invest in Russia. There's a lack of respect for capital. The same applies to Zimbabwe.

Q: *When we chatted nine years ago, you said that you basically avoided retail and technology stocks because companies in those industries have a hard time maintaining a competitive advantage. As examples, you referred to Google and Microsoft (MSFT), saying that these stocks are priced by the market as if they were going to be around and successful for many, many years and who's to say that is going to be the case.*

A: I would say, in hindsight, it was probably a mistake that we didn't buy Google. I don't put Microsoft in the same category. I have no interest in Microsoft. But Google is probably the greatest company ever created in the history of mankind. This is a business that is highly innovative, and they are able to nurture businesses in such a wide range of stuff in such huge markets. As for Microsoft, at best they can copy someone else and after the seventh or eighth version they might get it.

Q: *But does Google meet your value imperatives?*

A: It is actually not an expensive stock, especially when you consider that reported earnings are severely understated because they are investing [heavily] in all of these endeavors.

Q: *Is it safe to say that you wish you had bought Google nine years ago?*

A: Absolutely. I'm saying I should buy it today.

Q: *What about Apple* (AAPL)?

A: Apple also is a phenomenal company, and I think Apple will continue to grow and flourish even with Steve Jobs no longer in the picture. We are seeing a huge amount of respect for the company, and lots of good things are going on. But it is nothing like Google. They cannot do innovation in so many businesses.

Q: *But for all the supposed advantages that Google possesses, Apple has been the far better investment over the last decade.*

A: Yes. But what we are concerned about is the next 10 years. If I were betting on a horse between the two, it is a no brainer that it would be Google. In fact, if you told me the horses to pick from were Amazon.com (AMZN), Google, Microsoft, Apple, and whatever other names you had, I'd pick Google.

Q: *Thanks for your time.*

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