1. Type I vs. Type II Errors

- **Type I (Error of Commission)**: Investing in a poor (or overly risky) business.
- **Type II (Error of Omission)**: Failing to invest in a potentially good opportunity.

Minimizing *type I errors*—those that can truly damage or "kill" the portfolio—is the key to successful long-term investing. If you make fewer Type 1 errors, then the probability of success is higher than making Type 2 errors. Focus more on not making mistakes. Sometimes you'll miss on a great opportunity, accept it and move on.

2. "Big Risks" in Investing

To avoid type I errors, here are a few mental models to adopt

1. **Governance and Integrity Red Flags**
   - A promoter or management team with a suspicious track record can destroy investor capital.
   - Thoroughly vet owners for honesty, transparency, and ethical behavior.
2. **Turnaround Fantasies**
   - Companies with entrenched problems often promise brilliant turnarounds, but the success rate is abysmal.
   - Even "star" CEOs struggle to fix structurally broken or heavily indebted firms. It is safer to avoid them.
3. **Excessive Debt**
   - Leverage can boost short-term metrics (like return on equity), but it endangers a company's survival when conditions worsen.
   - Carrying minimal or no debt keeps a firm flexible through crises.
   - With lower debt, companies have the optionality to go big at the right time.
4. **Serial Acquisitions (M&A Addiction)**
   - Many companies tout "synergies," but mergers frequently fail. Distractions, overpayment, and cultural clashes ruin shareholder value.
   - Avoid businesses run by management teams that habitually pursue large, splashy acquisitions.
5. **Fast-Changing, Uncertain Industries**
   - Trying to "skate to where the puck will be" (e.g., tech, e-commerce booms) often leads to many losers for each rare breakout success.
   - It is safer to favor stable, proven industries.
6. **Misaligned Ownership**
   - Watch out for government-controlled entities, or subsidiaries of global multinationals that prioritize the parent's interest over minority shareholders.
   - In such structures, management or the parent company may have objectives that clash with your long-term returns.

- Also generally avoid conglomerates. Very hard to see outsized success without focus. Especially in India.

7. **Founder Led Companies**
    - I would bet a lot more on founder led companies. Founders are able to maintain the culture of a company and take risks that hired CEOs might not be able to.

3. ROCE

- **Measurability**: ROCE is straightforward to calculate from past financial statements.
- A company with high ROCE but modest revenue growth will generate excess cash.
- **Avoids Most Low-Quality Businesses**: Companies that perennially earn poor returns on capital cannot hide it indefinitely. Firms with a long history of poor ROCE rarely turn into gems.
- **Captures Multiple Favorable Traits**: A strong ROCE record often implies:
    - Competent management and rational capital allocation (they reinvest wisely or distribute capital to shareholders).
    - A real competitive edge (customers are paying high enough prices, or the firm is efficient enough, to achieve good returns).
    - Pricing power or brand loyalty.
    - A culture that has avoided crippling leverage or "wild goose chase" acquisitions.

4. Robustness in a Business

Look for robustness in a business. Some key tenets of as robust business -

1. **High & Durable ROCE**: Companies that consistently earn high returns on capital tend to demonstrate robust internal structures and competitive edges.
2. **Minimal (or Zero) Debt**: A strong balance sheet confers maneuverability to invest in new opportunities or weather crises.
3. **Competitive Advantages**: Whether from brand, cost, or technology, a robust business sustains these edges even as the environment changes.
4. **Fragmented Customer & Supplier Base**: Reduces dependence on any single partner.
5. **Stable Management**: Frequent leadership turnover hints at deeper instability.
6. **Slow-Changing Industry**: Businesses in relatively stable industries can afford the neutral, incremental "mutations" that let them evolve without existential threats
7. **Takes Calculated Risks**

Long-term investors should seek businesses that can adapt in incremental, lowrisk ways. Over time, they evolve in response to market shifts but keep a stable "body plan": strong returns, minimal leverage, and a strong culture.

5. Proximate vs. Ultimate Causes

- Definitions:
    1. **Proximate Causes**: Immediate triggers or catalysts (e.g., short-term market moves, interest rates, quarterly earnings surprises).
    2. **Ultimate Causes**: Deeper, structural reasons a business flourishes or fails (e.g., brand power, cost advantages, prudent management, robust capital allocation).
- Do not focus on "proximate" cues (market sentiment). Instead focus on "ultimate" drivers (long-term business fundamentals).
- **Predictions are futile:** Remember that most folks (including economists) get most predictions wrong. Ignore them. Don't look at forecasts of any kind. Invest large sums of money in enteprises that you understand.
- How do you **separate proximate causes from the utlimate causes? -** Focus on the fundamentals of the company and nothing else. Sometimes proximate causes lie within the company (bad decisions, mistakes etc). Assess if they have caused irreparable damage to the company or if these are temporary issues that can be fixed.

6. Predicting the Future vs Assessing the Present by looking at the past

- **Overconfidence in Forecasts**: A DCF typically requires projecting future revenues, margins, and growth rates—often five, ten, or even more years out. The real world is fluid and long term projections like this are useless. Even "small" changes—new regulations, an innovative competitor—can upend the best spreadsheet. DCF's tidy structure can mask these risks. Generally ignore forecasts and don't engage in forecasting.
- **Focus on Durable Moats**: Use historical **return on capital**, balance sheet strength, and management quality to gauge a company's *resilience* and adaptability.
- **Margin of Safety**: Because the future is unpredictable, do not anchor to an exact "intrinsic value" from DCF. Instead, ensure the price you pay leaves ample room for unforeseen setbacks.
- **Qualitative Analysis Counts**: Evaluate intangible and structural factors (brand, competitive culture, supply-chain resilience), which numbers alone don't reveal well.
- The only financials to prepare for are **from the last ten years**. Also look at how the company is doing relative to the competition. There is almost nothing better than measuring market share of volume, revenue and profit over a long term.
- When evaluating a business, look at risk first, quality next and price last.

7. Convergent Patterns

- **Invest in convergent patterns**, in patterns that repeat. Love the business construct rather than the business. Be attached to a business template. A good example is Naukri - the convergent model of Yellow pages demonstrated that Naukri might end up benefitting from the winner take all outcomes in that model.
- **Outside View:** Get the outside view while making investment decisions. Ex: Want to invest in Indigo? Focus on understanding the outside view of the airline industry first. The outside view is that airlines are great for consumers but not for investors. Does that mean I should not invest in these industries? No, you can as an exception only if the company is an undisputed market leader with key differentiators.
- **Does the industry allow companies to make money?** A key principle of convergence investing.
- **When not to apply Convergent Patterns?**
  - In new fast moving industries.
  - Drastically Different Regulatory / Cultural Contexts
  - Ignoring Local Market Nuances ### 8. Signals

There are a lot of signals out there. Here are the signals to prioritise and (mostly ignore)

- Signals to **Ignore** (or at Least **Discount**)
  - **Overhyped Press Releases & Cosmetic Announcements -**
  - Short-Term "Excitement" in Stock Price from a Press Release etc
  - **Surface Metrics / Headlines**
  - **Personal Product Experience -** Doesn't always translate into a well run company
  - Ignore **management interviews** for the most part unless they are about sharing insights into past decisions.
  - **Earnings Predictions -** These forecasts typically project the next quarter or the current fiscal year, which tells you little about the *long-term* trajectory of a business. Executives might "manage earnings" or set guidance they can comfortably beat in order to impress the market
- **Signals to Focus On**
  - Outside in perspective: What are the dealers, competitors, ex- employees, suppliers and industry experts sharing about the company.

9. GKPI Principles of Investing

GKPI Investing: When we find high quality businesses that do not fundamentally alter their character over the long term, we should exploit the inevitable short term fluctuations in their businesses for buying and NOT selling.

- Do not buy or sell a business based on news flow
- Be lazy when buying and very lazy when selling

When to Sell: - A decline in governance standards - Egregiously wrong capital allocation - Irreparable damage to the business - Look at the actual data and not trends and the news.

Long term investing genuinely should mean long term. Atleast five decades? New businesses do replace old ones but a far lower rate than we think.

9. Great businesses stay great, bad businesses stay bad

- In the business world statis is the default and there is evidence all around us. Most of the leading players of the 90s are leaders today. The new age tech businesses have taken this to another level.
- That doesn't mean you buy these great businesses at any price. Wait for the right moment. The right moment doesn't come often (maybe 1-2% of the time you are in the market). So be patient.

There are a few large and successful firms in most industries. These successful companies are becoming even more successful and weak companies are becoming weaker.

Since the vast majority of businesses do not become great, the default strategy is not to buy. Be a lazy buyer. Buy only if we can find a high quality business that can stay in stasis over decades. If I own such a business, don't sell. Be a very lazy seller.

10. Many more reasons not to sell

10. Avoiding Mistaken Identity

- **Dig Beneath the Surface**: A few standard metrics (PE ratio, margin, growth) are insufficient to judge quality. Investors must study business fundamentals, corporate culture, and past crisis performance.
- **Recognize "Greenwashing"**: Beware of businesses that hype ESG or brand credentials but fail to show genuine operational improvements or sincerity.
- **Check for "Local Adaptation"**: Something that worked in one region or industry may fail in another context. A superficial resemblance to a winning model doesn't guarantee success in a new environment.

11. Investor Parallel: Many Short-Term "Aberrations," One Long-Term Character

- **Quarterly or Annual Noise**: A short-term sales drop, shifting margins, or a supply-chain pinch can look like an existential crisis.
- **Underlying Stability Over Decades**: Zooming out often reveals the company's deep-rooted strengths remain intact (brand, market share, R&D, culture, etc.). Over five, ten, or twenty years, these "stable moats" overshadow quarter-to-quarter gyrations.

- **Skip the Micro-Monitoring**: If the "DNA" of the business remains strong—i.e., its competitive moat, brand power, ROCE stability—reacting to cyclical shifts or negative headlines can sabotage compounding gains.

By acknowledging this mismatch in perceived vs. real change,avoid reacting to short-term data.

12. Key reasons not to sell

1. **Compounding Takes Time (the "Rabbit Explosion")** By selling too soon, you may never see the exponential "back-end" of compounding. Hold forever if the fundamentals remain strong, to capture that late surge in value creation.
2. **Short-Term Hiccups Don't Change the Long-Term Thesis** A brief dip in quarterly earnings or adverse market sentiment seldom signals permanent damage to a robust enterprise. Avoid reacting to near-term noise. Only consider selling if the core premise—like return on capital, competitive moat, governance—deteriorates materially.
3. **Sell Triggers Are Rarely Clear** Even if a business stumbles, it can bounce back if its fundamental strengths remain intact. Pinpointing the exact moment to exit is tricky. Wait for a *truly structural* problem (e.g., a genuine collapse in competitive advantage).
4. **Scarcity of Equally Good Alternatives** High-quality businesses with strong ROCE and honest governance aren't easy to find. Shifting out of a good holding requires finding an *equally* good (or better) opportunity.