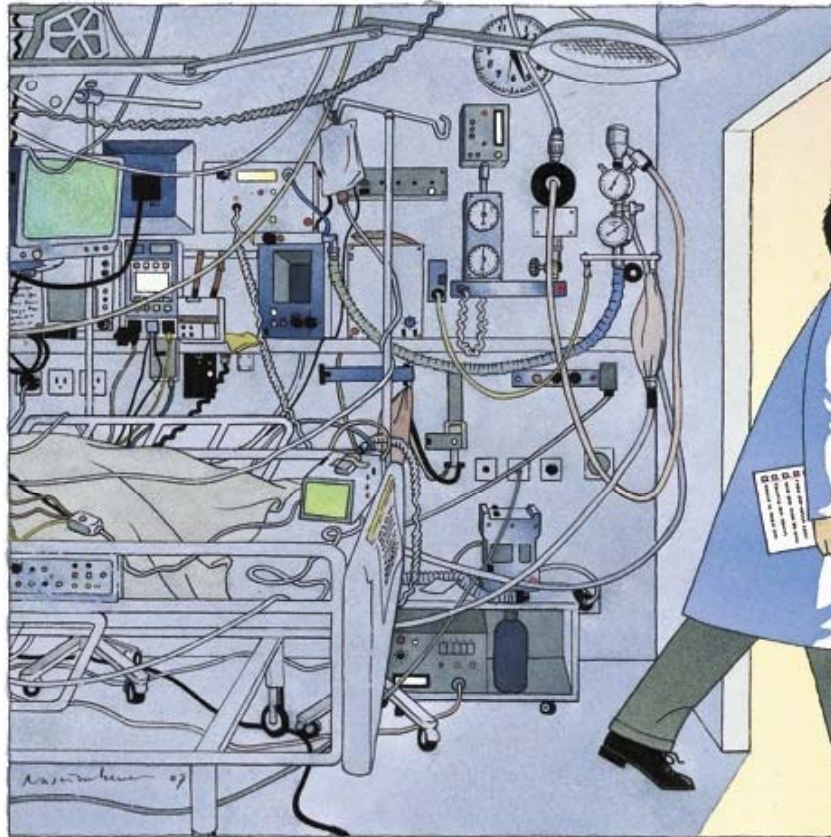


The Checklist



Dexter Sears
SHOE COMPANY

BERKSHIRE HATHAWAY INC.



PINNACLE AIRLINES, INC.



CORT®



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Munger & The Checklist



B-17 Bomber

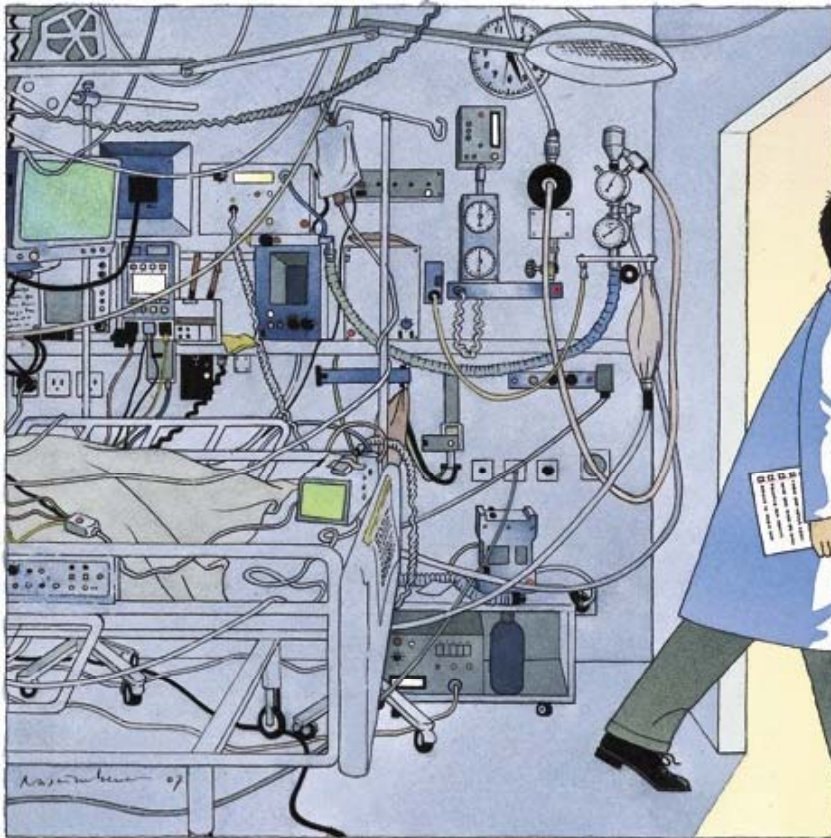


“Too Much Plane for One Man to Fly”

- After the B-17 crash, Boeing’s survival was in question.
 - The aviation checklist was born.
 - Too complex for one man’s memory
 - Four checklists – takeoff, flight, landing, after landing.
- Zero accidents – govt. ordered 12,731 B-17 bombers



The ICU Checklist



- 5 Million Lines put into patients annually in ICUs
- 4% infected after 10 days; 80,000 people.
- Fatal 5-28% of time. Increased ICU time.
- The Line Insertion checklist.



The ICU Line Insertion Checklist

1. Wash hands with soap.
 2. Clean patient's skin with chlorohexide antiseptic.
 3. Put sterile drapes over entire patient.
 4. Wear a sterile mask, hat, gown and gloves.
 5. Put sterile dressing over catheter site after line in.
- Very obvious; well-known; taught to all for ages.
 - At least one step skipped in 1/3 of all insertions.
 - Infection rate after checklist – approached zero!
 - Doctors learning to appreciate checklists.



Why are checklists so effective?

- Our brains are designed to take short-cuts and arrive at answers quickly.
 - When you see the lion, you run. You don't process your options, you just run.

- We are also a mix of rationality and emotions.
 - When we notice a great business is undervalued, we read up on it, run through a number of concerns/questions and arrive at a decision – not as effective as a checklist.



The FAA's Approach to Aviation Safety

- Very effective; Lower probability of dying in an airplane than crossing the street.
- A human life is worth \$3 Million.
- Aviation safety comes from carefully studying each and every plane crash worldwide.
 - Changes to Checklists, pilot training, equipment, procedures, ATC etc.
 - Results are extremely compelling.



Investing and The Checklist

- Not rocket science. Pretty obvious.
 - Start with stuff we've learned from Graham, Buffett, Munger, Klarman, Fisher, Templeton etc.
 - Margin of Safety, Moats, Simple Businesses ...
 - Make a real checklist.
 - Examine all your mistakes that led to a permanent loss of capital – the plane crashed.
 - Add to the checklist.
-



Visceral vs. Direct Experience

- Look at all the great investors and their mistakes.
 - Why did a given investment fail?
 - Could one have looked at that factor and known of a possible problem *before* investment was made?
 - Much much cheaper to learn from the mistakes of others than your own.
- In 2000, Munger bought Cort Furniture for Wesco, Poor investment result. Why?

CORT[®]

Add to the Checklist

- Wesco makes very few investments and even fewer acquisitions.
 - Cort was acquired in Feb. 2000 by Wesco after a long hiatus.
 - Munger compares it to Enterprise Rent-a-car, which is a fantastic company/culture/business.
 - Cort had abnormally high revenues/FCF as a result of internet bubble. Buffett/Munger clearly knew the internet was a bubble.

Add to the Checklist

➤ Checklist query:

- Are the revenues and cash flows of the business sustainable or overstated/understated due to boom or bust conditions? (e.g. Cort)
- Are there temporary tailwinds enhancing FCF?
- Need to appreciate that this is easy to miss with many businesses that have temporary tailwinds that can be hard to detect as being temporary.
- Minds as sharp as Munger and Buffett missed it.



Buffett's Rare Mistakes

- Berkshire Hathaway turned out to be a great investment. Buffett calls it a mistake. What was the mistake?
 - Was a Graham net net. Bought below net working capital.
 - I have made this specific mistake numerous times.
 - It's now on the checklist. No more!

BERKSHIRE HATHAWAY INC.



Learning from Buffett

- A good investment needs two facets to be in place:
 - Downside protection – Margin of Safety
 - Upside earnings engine – Moat
- I've often been mesmerized by the strong downside protection and overlooked the all-important moat.

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The Evaporating Moat

“I liked and admired Ed Colodny, the company's then-CEO, and I still do. But my analysis of USAir's business was both superficial and wrong. I was so beguiled by the company's long history of profitable operations, and by the protection that ownership of a senior security seemingly offered me, that I overlooked the crucial point: USAir's revenues would increasingly feel the effects of an unregulated, fiercely-competitive market whereas its cost structure was a holdover from the days when regulation protected profits. These costs, if left unchecked, portended disaster, however reassuring the airline's past record might be.”

1996 Letter to Shareholders, Warren Buffett



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Add to the Checklist

➤ Checklist additions:

- Is there a solid moat? (e.g. Berkshire Mills)
- Could the moat be shrinking/evaporating? (e.g. US Air, Dexter Shoes)



"The business world is divided into a tiny number of wonderful businesses--well worth investing in-- and a huge number of bad or mediocre businesses that are not attractive as long-term holdings."

- Warren Buffett (in *Money Masters of our Time*)

Using the Checklist

- I went through every investment mistake I've made and am in the process of gathering mistakes made by other great investors.
 - 60 items on checklist so far. Not done yet.
 - No company will get past all 60 with a clean bill of health.
 - Different from healthcare or aviation.
 - Investments will have one or more issues.

Using the Checklist

- Wells Fargo is a great business.
- Checklist “failure issues”:
 - Highly leveraged assets to equity.
 - Could be subject to run on the bank.
 - Could make/have made bad lending decisions.
 - High unemployment, recession will hurt.
- All businesses will fail on some items on the checklist.

What is one to do with Wells Fargo?

- The events of 1929-33, 1937, 1973-74, 2000-02 and 2008-09 have taught us that the ride can be quite rocky.
- Likely to hit these major dislocating events at least a few times in an investing lifetime.
- Any number multiplied by zero is zero.
- All businesses fail on some checklist items.
- Run a diversified portfolio. At least 20-30 names that do not correlate on the same issues (e.g. leverage).

Checklist shows possible failure points

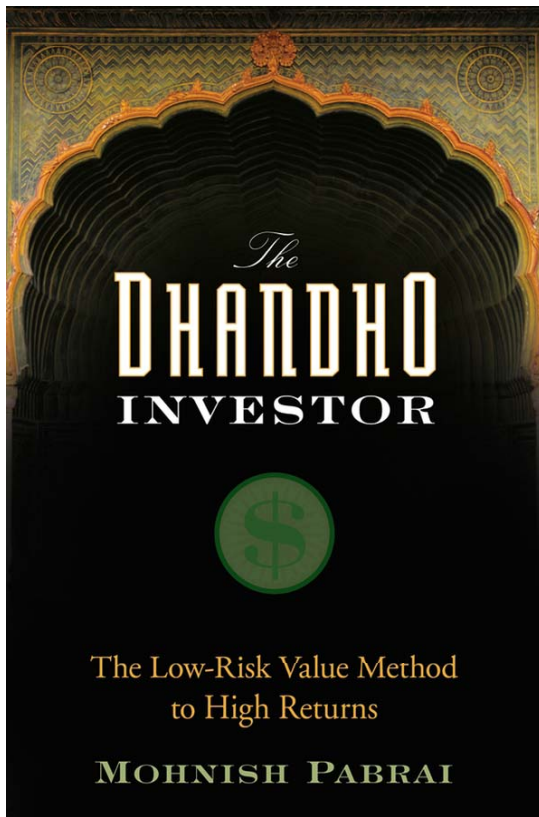
- I used to believe in a 10x10 portfolio until Q308.
- The drubbing of Q408 exposed clear weaknesses in some portfolio holdings. Size was key issue.
 - Moved to a 2, 5 or 10 model.
 - 2% bets are part of a basket or cases like Wells Fargo.
 - 5% bets are typical.
 - 10% bets are made when 7 moons line up.



Lessons Learned from 2008-09

- Graham's entire framework emerged after the 1929-1933 Great Depression and collapse in equity prices.
- Since mistakes are inevitable and businesses always fail on some checklist items, best to go back to Graham 101 and diversify.
 - No need to hold 100 names, but unwise to hold 4.
 - 20-30 names seems just right.
- Believer in the power of the simple checklist.

Thank You.



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