The Checklist

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Munger & The Checklist

B-17 Bomber

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“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

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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.

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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.

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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.

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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?
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-acar, 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.

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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.

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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.

Berkshire Hathaway Inc.  Sears  U.S. Airways

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“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*)

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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.

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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.

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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).

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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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