

The Danger in Buying the Biggest

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There is a French saying, "*Buy on the cannons and sell on the trumpets!*" Like many things French, it's unclear to me whether they are speaking metaphorically or not. Nonetheless, that's exactly what Sir John Templeton did.

When World War II broke out in Europe in 1939, he borrowed money to buy 100 shares in each of 104 companies selling at \$1 a share or less, including 34 companies that were in bankruptcy. Only four turned out to be worthless, and he turned large profits on the others after holding each for an average of four years.

Templeton is considered by many to be, perhaps, the greatest global stock picker of the 20th century, so it seems worthwhile to delve deeper into his perspective on buying stocks at points of maximum pessimism. The opposite of Templeton's approach would be to buy stocks at points of maximum optimism. The most highly valued business in the world might fit that description.

The Most Valuable Fortune 500 Business (1987-2002)

A strategy based on this table would have trailed the S&P

Year	Company	Market Cap. (in billions)	Revenue	Net Income
1987	IBM	\$89	\$51	\$4.8
1988	IBM	\$68	\$59	\$5.8
1989	IBM	\$70	\$63	\$5.2
1990	IBM	\$61	\$69	\$6.0
1991	IBM	\$75	\$65	\$2.1
1992	Exxon	\$69	\$103	\$4.8
1993	Exxon	\$78	\$100	\$5.3
1994	GE	\$90	\$60	\$5.9
1995	GE	\$92	\$70	\$6.6
1996	GE	\$126	\$79	\$7.3
1997	GE	\$170	\$91	\$8.2
1998	GE	\$260	\$100	\$10.7
1999	Microsoft	\$419	\$20	\$7.6
2000	Microsoft	\$492	\$23	\$9.4
2001	GE	\$407	\$126	\$14.1
2002	GE	\$401	\$131	\$16.6

Figures in Billions

Sources: 1987-2002 Fortune 500 Lists and Value Line

If one started with \$10,000 invested in the most valuable business when the Fortune 500 list was released in April 1987 (that year it was IBM) - and every year thereafter reinvested the funds in the new (or same) most valued business, then by 2002, one would have realized an annualized gain of just 3.3%. Over the same period the S&P 500 delivered a far more respectable 8% annualized return.

While the data clearly shows the superiority of the maximum pessimism investment approach, there is something interesting at work here. An examination of Table 1 shows that none of the most valued businesses got much beyond \$100 billion in revenue or \$10 billion to \$15 billion in net income.

In fact, other than three years, the highest net income of the most valuable business has always been under \$10 Billion. Why is that? Is there a natural upper limit on revenue or profitability of a business?

Nature provides some possible answers. Mammals rule the world. Yet the largest land-based mammal is the elephant. There is no evidence that shows that we've ever had mammals much bigger than modern day elephants. Why? Being warm blooded means that mammals are energy hogs.

Mammals have to eat a lot to generate energy. As a result, mammal size is bounded by the energy a given area of land can consistently supply. It is also bounded by internal organs like the heart which have to pump blood to the body's extremities. Thus these extremities are physically constrained from being too far from the heart and that imposes another size constraint.

Large businesses also have their own extremities. And there is a need to rapidly get data back and forth between the central heart (CEO) and all the extremities (customers and foot soldiers). Over the last 100 years, the speed and breath of these arteries have increased dramatically and with it has grown the size of our largest companies.

There is however an upper limit to the brain's (senior management) ability to process the myriad of inputs regardless of the size or speed of the arteries. This limitation translates into a size constraint on most businesses.

In addition, the most valued business is under constant attack from the marauding invaders who want to unseat it. This leads to what Clay Christensen, author of *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*, describes as the disruptive innovation phenomenon – against which the incumbent is nearly powerless.

The Law

All of this leads to Pabrai's Law of Large Numbers. The ultimate principle of this law is that one would be best off never making an investment in any business that generates over \$3 Billion to \$4 Billion in annual cash flow *and* is considered a blue chip. These businesses are very unlikely to be able to endlessly grow cash flow.

Indeed, cash flows are most likely to tread water or start dropping almost immediately after your ill-fated investment. There will be a few companies that will buck the trend, but it is unlikely that they end up in your portfolio. Over the years, I've taken a pass on many a supposedly stellar business purely on the basis of the Law of Large Numbers – and have never regretted it!

Taking insurance while playing Blackjack seems very logical, but is a sucker's bet. Investing in the most valuable businesses around is no different.