

## The Danger in Buying the Biggest

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There is a French saying: "*Buy on the cannons and sell on the trumpets!*" Whether they were speaking metaphorically or not, 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 20<sup>th</sup> century, so it seems worthwhile to subscribe to his proven theory of buying beaten down-stocks at points of maximum pessimism. The reverse of Templeton's approach would be to buy stocks at points of maximum optimism – and a good place to find optimism is among the most valued businesses in the world.

If you 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, by 2002, you would have realized an annualized gain of just 3.3%. Over the same period, the S&P 500 delivered about 10% annualized.

## The Most Valuable Fortune 500 Business (1987-2002)

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

<b>Year</b>	<b>Company</b>	<b>Market Cap.</b> (in billions)	<b>Revenue</b>	<b>Net Income</b>
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

Sources: 1987-2002 Fortune 500 Lists and Value Line

While the data demonstrate the superiority of the maximum pessimism investment approach, there is something interesting at work here. An examination of the table shows that none of the most valued businesses got much beyond \$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, but the largest land-based mammal is the elephant. There is no evidence that shows that we've ever had land mammals much bigger than modern-day elephants. Why? Being warm-blooded, 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.

## **Lumbering**

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

There is, however, an upper limit to senior management's ability to accurately process the various 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*, described as the disruptive innovation phenomenon – against which the incumbent is virtually 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 more and \$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 investment. A few companies will buck the trend, but they're probably not the ones that end up in your portfolio. Over the years, I've taken a pass on many supposedly stellar businesses purely on the basis of the Law of Large Numbers, and I've 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.

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