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# Investors will miss out if they confuse uncertainty with risk

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Dealing with uncertainty is always a key challenge for investors. But dealing with uncertainty doesn't mean avoiding it – on the contrary, it is often fuzziness about a company's future that creates the type of opportunity bargain-hunting investors cherish.

Wall Street in the main hates uncertainty, which manifests itself in depressed share prices of companies whose prospects lack "visibility." But where the market can err is in confusing uncertainty with risk. Just because a company's future is highly uncertain doesn't mean an investment in it is risky. In fact, some of the best potential investments are highly uncertain, but have little risk of permanent capital loss. As hedge-fund manager Mohnish Pabrai describes it in his book, The Dhandho Investor: "Heads, I win; tails, I don't lose much."

Among the many case studies Pabrai presents is the investment he made this decade in the funeral-home operator Stewart Enterprises. Following a debt- fuelled consolidation of the funeral-home sector, Stewart and other big players found themselves too leveraged as the economy soured. Stewart's shares, as high as $28 in 1998, had fallen below $2 by the fall of 2000, trading at a minuscule price/earnings multiple of only three times.

While the market appeared to be betting on Stewart's demise, Pabrai's research indicated otherwise. Funeral homes were actually among the least likely businesses to fail, as non-price-sensitive customers and less-than dynamic competition resulted in stable profitability and growth over time. Stewart was producing positive free cash flow and had hard assets such as land and funeral-home properties valued conservatively at $4 per share, twice the share price at the time.

Stewart still faced great challenges in managing its crushing debt load, but Pabrai did what all smart investors do in dealing with the uncertainty the company faced: he identified the various ways the story might unfold and assigned probabilities to each.

He concluded that there was an overall 80 per cent probability that the company would deal with its debt problems in one of a few ways, in each case resulting in a doubled share price within two years. If the company went bankrupt – a scenario he assigned a 19 per cent chance – he believed the hard assets would more than cover the debt, leaving at least $2 per share in equity value. He saw only a 1 per cent chance of permanent loss of capital from the share price going to $0.

Given the 80 per cent chance of doubling his money and only 1 per cent chance of losing it all, Pabrai took the bet. While there was real uncertainty over exactly when and how the story would play out, he saw the risk of a permanent loss as extremely low. What happened? Soon after his purchase of Stewart shares, the company announced that it planned to sell international assets – which comprised about 20 per cent of revenues and produced little cash flow – to pay down debt. By March 2001 the company had paid down more than $50m of its debt and cash flow remained healthy – to which the market responded, taking the share price above $4. His target price reached, Pabrai sold.

A similar highly uncertain, but low-risk opportunity I see today is EMC's storage business, excluding its stake in VMware. In late 2003, EMC paid $625m for VMware, a leading provider of software to the information storage industry. Following EMC's spin-off of roughly 15 per cent of VMware in August, the company today is valued at more than $23bn, nearly triple the market-cap of EMC's core business!

Is VMware, with less than a quarter of the operating income in 2007 of EMC's core business, worth almost three times as much? Of course not. VMware is a hot stock in a hot sector and is likely highly overvalued, trading at approximately 56 times this year's estimated earnings, while EMC's core business is almost certainly undervalued – hence the opportunity for us.

An investor can isolate EMC's core storage business by buying EMC and shorting out its stake in VMware, which creates an EMC "stub" at approximately $4.50 per share, net of cash. (Note that it can be difficult to borrow VMware shares to short, in which case one can buy puts.) We estimate that EMC's core business will earn $0.60/share next year, so it is trading at a price/earnings ratio of 7.5, an absurdly low multiple for such a high-quality business. We think fair value is three-to-four times this.

One reason for this market inefficiency is the uncertainty about whether and when EMC might spin off completely its stake in VMware. The company has been coy about this, but our analysis of all 46 equity carve-outs of the past 10 years would indicate it's merely a question of time before it spins off VMware and unlocks the unrealised value of its core storage business.

This is a classic case of a low-risk, high-uncertainty investment. At this price, we think we're almost certain to make significant profits on this investment – we just don't know when. The market hates such uncertainty and shuns it, resulting in a bargain for us.

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