Erik Kobayashi-Solomon has worked in the investment industry since 1997 in a wide variety of buy- and sell-side roles on both sides of the Pacific. Past positions have included the head of listed derivative operations for a bulge bracket firm’s Tokyo branch, the market risk manager for a global long-short equity hedge fund, editor of Morningstar’s OptionInvestor newsletter, and architect of the IFC’s (World Bank Group) standardized valuation model for emerging market private equity investments.

The firm Erik founded, IOI, LLC, serves the research needs of value-oriented institutional money managers. In addition to conducting Valuation and Option Boot Camps—popular training courses for institutional analysts and portfolio managers—the firm publishes distinctive, deeply researched valuation reports on U.S. and foreign companies, and shows how to structure asymmetric investments in these companies through a prudent combination of common stocks, options, and cash. IOI’s goal is to tilt the balance of risk and reward in its clients’ favor. Consulting on hedging and income strategies, as well as levered growth investment strategies are all within IOI’s bailiwick.

Erik lives in Chicago, Illinois with his family and enjoys hiking and reading. In his spare time, he volunteers at the local Japanese school to teach children Kendo—the Japanese art of swordsmanship.
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Eventually, I ended up doing third-party research—first at Morningstar where I was an analyst, then market strategist and co-editor of an option newsletter and then at YCharts where I was Director of Research. In 2012, I started IOI, began work on my book, and won a commission to build a standardized equity valuation model for the World Bank’s emerging market private equity portfolio.

**KN: How would you describe your investment philosophy?**

**Erik:** I don’t know if I’d call it an “investment philosophy”. That sounds like something to ask George Soros about, but I can tell you that I’m always trying to do a few basic things well: focusing on value, accepting that I can’t know everything, striving for simplicity, concentrating investment assets, and using leverage prudently.

Simplicity is a big thing for me. If you can’t explain what a company is doing in one sentence, you don’t understand the company. Simplicity means that you have to always keep asking yourself, “Is this information material to a valuation?” If not, it’s better not to spend time thinking about it. There are huge uncertainties to valuing something as large and complex as a modern company, and chasing down every rabbit hole for details will take you further from the answer, rather than closer to it.

Everyone thinks that, because of my background, I must be very focused on quant issues. Actually, I’m suspicious of quantitative strategies simply because I have seen how the sausage gets made, so to speak. If you have a sound framework for valuing companies, construct a simple strategy, and execute that strategy with conviction, you only need a single good idea to generate enormous amounts of wealth.

**KN: How did you incorporate your global experience into your research process?**

**Erik:** I’ve been fortunate to have worked on the sell-side, the buy-side, and in third-party analysis, and also to have seen the processes that drive both quant and fundamental research. These experiences have opened my eyes to the structural factors that affect decision-making of professionals. Career risk, shortened time horizons, the drive to generate commissions, boost subscriptions, or beat a benchmark—all of these factors drive the process of finding, pitching, and making investments in the institutional world. After you see where these structural blind spots are and start thinking about what “risk” means from the perspective of a principal rather than an agent, it really makes it easier to find and assess investment opportunities.

**KN: Value investing and option investing aren’t usually mentioned together. How do you execute an investment strategy that uses both?**

**Erik:** I think it is easier to get a value investor interested in options than it is to get an option trader interested in value investing. Options are, in fact, very simple, directional financial instruments that give value investors a huge amount of flexibility compared to straight stocks. The problem is not with options, but rather, with the people that talk about them.

People talking about options tend to be either pony-tail wearing floor-trader types or ivory tower academic types. In general, value investors don’t pay much attention to either of those kinds of voices. Once someone explains options in a sensible, straight-forward way, value investors clearly see the potential to use options to structure asymmetric payoffs on companies they already know and like.

**KN: What are some of the common pitfalls that you’ve seen fund managers face?**

**Erik:** Well, there are some things that really are structural and hard to shake off. If you have a hedge fund-of-funds breathing down your neck at the end of every quarter and no lock-up clause in your partnership agreements, you’re naturally going to have a hard time looking out more than one quarter in the future. But there are also behavioral factors like the ones I talk about in my book, that affect every human on the face of the earth—both fund managers managing billions of dollars and the guy at the investment club managing thousands.

For instance, humans are hard-wired to be great at pattern recognition; we’re so great at it, that we often try to use pattern recognition to solve problems that should be solved using observation, measurement, or whatever. You can see this happening when someone makes a lot of money in a certain sector or region, then comes across another sector or region that “feels” similar to the first. In that case, more often than not, people get excited about the new idea despite the fact that there might be big differences underlying the two situations.

The really good managers and investors understand that these biases exist and try to find a way to minimize their impact on decision-making. These structural pitfalls and behavioral biases are so important that they take up a whole chapter of my book, in fact, and the valuation method I lay out helps readers sidestep these traps as much as possible.
KN: Your book, “The Intelligent Option Investor”, has been getting high praises and positive reviews. Is this book basically your attempt to teach value investors about options?

Erik: That is exactly right. Options are great tools, but you can only make full use of a tool if you understand how it works. My book is a user’s manual for options, written with a value investor in mind. The first part of the book provides a clear, concise, and memorable explanation about how options work, how they are priced, and why the inherent weaknesses option pricing models have confer a structural advantage on people who know where those weaknesses lie.

The second part of the book lays out a sound framework for understanding valuation by understanding just a few key drivers of value at a firm: how the demand environment translates into revenues, how efficiently the firm converts revenues into profits, what proportion of the profits the management invests, and how effective those investments have been and are likely to be. This part also includes a section on behavioral biases and structural issues as well as two online appendices with actual valuation examples.

The last part of the book shows how to use options in real life situations. How to measure and manage leverage, how to find investable discrepancies between price and value, and a handful of strategies to use to invest successfully.

KN: In your book, you mention Ben Graham and Warren Buffett and how investors can use options to get exposure to the types of value stocks that they look at. Who were your influences for writing the book and your investment style in general?

Erik: It’s funny, but I have always been uncomfortable with the secular cult that has grown up around Graham and Buffett and those kind of value investing “saints.” Because of my knee-jerk reaction against this kind of hero worship, unlike a lot of value investors, I always shied away from carefully reading what Buffett and others had written. A while back, though, a friend of mine loaned me a copy of the Berkshire Hathaway Shareholder Letters and I kind of grudgingly flipped through that book. Over and over again, my eye kept catching on a phrase here or there that I liked and by the time I was done with the book, I had to say, “Man, this guy Buffett really is pretty smart.” [Laughs]

Looking back on it, I suppose that I have been influenced by people who were influenced by Graham and Buffett—people like my old PM—but I’ve also been influenced by mistakes I’ve made myself. I wrote the book for people like my old PM, my old buy-side colleagues, and for investors like myself.

KN: How has writing the book affected your perspective on value and options investing?

Erik: Writing a book is easy. Writing a good book on the other hand—a book that is worth reading, is really hard. While I was writing it, I spent a lot of time challenging my own ideas. I was training for a marathon while I was working on it, and the whole time I was on my training runs, I was constantly thinking “Okay, you wrote XYZ in chapter 3. Do you really have a firm basis for claiming that’s true?”

One of the things that was very hard for me was to articulate what I had learned about leverage from previous, sometimes painful experience. To describe the investment leverage someone gets when using options, I had to come up with a whole new language and convention to measure it. My convention looks at both the risk and potential return of a levered investment, which is something that I have never seen anywhere else. This took a lot of thought and work to articulate properly.

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KN: A lot of people, value investors in particular, say that options are too complex—“Financial weapons of mass destruction,” as Buffett put it. How do you respond to this criticism?

Erik: Like I said before—options are really very simple, directional tools. I can teach a 62 year-old housewife from Des Moines enough about option pricing models in 15 minutes that she has a better sense of how they work than newly-minted Masters of Financial Engineering! My approach is also straightforward. Everything I do revolves around the goal of providing clients a clear, coherent, and effective method for analyzing companies and a framework for structuring asymmetric investments that allow them to tilt the risk and reward balance in their favor. The book is one part of that.

My Option and Valuation Boot Camps are another part of the same thing in a setting that allows me to go into a lot more detail than the book. These camps are a total of around 24 hours of instructional time, plus case studies, questions, and outside readings. This coursework is designed to give participants a unique way of looking at investment risk and return, a way to understand what the rest of the market is saying about the future prices of stocks, a sensible, repeatable framework for making good investment decisions, and a clear framework for using a combination of options and stocks to generate leverage in a prudent way.

The reports are another part of that—investment ideas deeply researched using the framework laid out in the books and boot camps, followed by recommended levered strategies using a combination of options, stock, and cash in reserve.
Valuation assumptions are completely transparent and the resultant valuation is a range based on best- and worst-case scenarios of the company’s valuation drivers. Once you have that kind of a valuation, figuring out how to implement an investment follows naturally. The twist is that the option market does, through its pricing, show what the expectations are for the future price of a stock. The first part of the Investment Strategy section of my reports shows what the option market is saying.

With the valuation range on one hand and the market’s expected price range on the other, you have the critical comparison of price to value that value investors thrive on. When those two ranges don’t overlap, the risk-return balances is tilted in our direction. How we choose to implement the investment—with straight stocks, straight options, or a hybrid of both—that is up to the individual manager.

**KN: Can you give an example of a situation in which you’ve used the Intelligent Option Investing strategy to implement your ideas successfully?**

**Erik:** One company that I have been making recommendations on for a few years is Oracle (ORCL) and this example really illustrates what I mean by intelligent option investing. Oracle fell heavily when they missed their quarter and were trading for around $30 a share. I did a fairly quick valuation and came up with a valuation range that extended from around $30 a share in a worst-case scenario to the mid-$40 range in a best-case one. Because the stock had fallen heavily, a lot of investors were bidding up the price of downside protection. In other words, the price of put options was soaring. My valuation suggested that there was not much downside risk below $30, so I was happy to sell people protection to insure against the stock falling below that level. I sharpened my pencil and did a bit more work on the valuation. Doing so, I realized that the company had an enormously powerful profitability engine in the form of its software updates segment and that this segment was actually becoming more efficient at converting revenues into profits. With this realization, I added to my original position by buying shares and in-the-money and out-of-the-money call options. Why I decided to allocate like I did would take longer to explain, but the end result was that I ended up with a modestly levered investment structure that allowed me to generate 80% more profits from my investment than if I had invested in the stock alone.

This is what I mean when I say, tilting the balance of risk and reward in my favor. Over time, as the share price climbed, I started taking profits on the more highly levered portions of the investment and was finally left with only a position in the stock. Just recently, when the stock fell on what I considered to be nonmaterial information again, I sold more put options to generate yet more yield out of my investment—basically creating a synthetic dividend stream for myself while agreeing to buy the stock at a price I wouldn’t mind paying for it.

**KN: You’ve been trained in Kendo in Japan and hold a black belt. What was your experience in Japan like and what does Kendo mean to you?**

**Erik:** I actually started Kendo in the U.S., years ago when I was in college, and have done it for over 25 years now. I was lucky enough to find some terrific teachers in Japan, and really fell in love with the art then. There are a lot of facets of Kendo that I think are directly applicable to investing.

For instance, in Kendo, there is a saying that the most important weapon of a Kendo master is his eyes and the second is his legs. Without good eyes, you can’t see the opponent’s weakness or judge the strength of his oncoming attack. Without strong legs, you can never move confidently enough to get a good strike in yourself or move out of the way quickly enough to avoid the opponent’s blow.

Investing is the same thing in a way—dispassionately, accurately, and quickly assessing an opportunity, and taking bold, decisive action to take advantage of what you see. I’m past my prime in terms of athletic ability, but the Kendo is still a big part of my life. I taught both my kids—a son and a daughter—to play, and still teach a group of kids at our local Japanese school twice a week. The teachers get together to practice once a month or so and that’s a great stress relief and really good exercise as well.

**KN: Erik, thanks for joining us today.**

**Erik:** Khai, it was my pleasure.

**Founder and Managing Director, IOI, LLC**
https://IntelligentOptionInvestor.com

If you are a professional investor, fund, or allocator and would like to be part of our Harvest Interview Series, contact Khai@hvst.com