AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Notes from the Road

The Importance of Working with Great Partners

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Michael D. Axel, CFA

Jacob D. Benedict, CFA

Ryan A. Kay, CFP®

Warren Duckett and Charlie Ducker, gifts Jacob picked up for his little one during his recent trip to Warren Buffett's annual Berkshire Hathaway meeting in Omaha, Nebraska.

Welcome to our latest "Notes from the Road." We've been busy! Ryan spent several days in Chicago for the Schwab IMPACT Conference. Jacob and Mike were in Florida in January for a manager meeting (always a good place for a winter trip). Jacob travelled to New York twice (a risky place for a winter trip) for manager meetings as well as a value investing conference at Columbia Business School. Finally, Jacob headed out to Los Angeles to visit a company and recently spent the weekend in Omaha for the Berkshire Hathaway shareholder meeting.

We hate to leave our families and we are always anxious to make it back to AMI World Headquarters in Kendallville, Indiana. We find our locale an ideal place to conduct business. As Warren Buffett once reflected on his move back to Omaha:

> I worked in New York for a couple of years, and people kept whispering to me on street corners. And I kept listening to them, which was even worse. So I got back to Omaha, where there's less chance you'll go way off the track.

Our travels may seem outdated in today's world of instant messaging, email, and skype. But yet we find it indispensable. As our experiences continue to build, we keep coming back to a fundamental truth: our long-term success will be determined first and foremost by the quality of our long-term partners. And you simply can't get to know people over the phone the way you do over a cup of coffee.

Charlie Munger once said the following about understanding the importance of incentives:

> I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it. And never a year passes but I get some surprise that pushes my limit a little farther.

We feel the exact same way about the importance of working with good partners (which involves properly-aligned incentives). We believe that we've always been towards the top of our peer-set in paying attention to the importance of working with great partners, but yet we've still underestimated its importance.

David Swensen, the long-time head of the Yale University endowment, recently reflected on this in an interview when he was asked how his approach to investment management had changed over the past several decades:

> You know, I think if you asked me that question 25 years ago, I would have had a reasonably long list of things that I thought were important in an investment management firm. Today, I would say that number one is the character and quality of the investment principals. Number two is the character and quality of the investment principals. Number three – (laughter) – you get the idea. And you have to go further down the list before you get to some of the nuts and bolts. And I'm absolutely convinced that there is nothing more important than being partners with great people.

Now few people explicitly disagree with the idea of working with good partners. Who goes around arguing that we should work with bad partners? But saying something is important and strictly honoring it in practice are two different things. We all know how to eat healthy, but that doesn't make it easy. A good friend likes to say that life is "simple but not easy." And like the ill effects of junk food, bad partnerships eventually take their toll. Stop and imagine the most stressful periods in your life. Outside of health issues and the loss of loved ones, is it fair to say that the impetus for the majority of these periods was bad partners of some kind, either personal or professional?

Charlie Munger has observed that the ultimate form of human achievement comes from organizations operating in a *seamless web of mutually deserved trust*. Let's break down the constituent parts:

- Trust: Each side fundamentally believes that the other one will do what is best for them.
- Mutually Deserved: This trust is deserved, because both parties are high-quality, high-performing individuals or groups.
- Seamless Web: This trust manifests itself without the need for costly, frictional monitoring systems meant to ensure compliance.

If you study Berkshire Hathaway you will see that this is exactly how Buffett and Munger have tried to build the company. Consider the fact that Berkshire staffs its corporate office with less than 30 people despite the fact it employs 377,000 individuals across many subsidiaries. Most companies would have a huge corporate office meant to monitor and manage these sprawling operations. But Buffett focuses on (a) picking the right kinds of partners to manage the subsidiaries in the first place and (b) trusting them to do so effectively. The first part is critical, for as Ben Franklin said, "An ounce of prevention is worth a pound of cure." The best way to fix problems is to try your best to avoid them in the first place![1] Because Buffett has structured Berkshire to operate without a ton of oversight and bureaucracy, not only has the company performed extremely well, but Buffett has had the time and freedom needed to compile the greatest investment track record of all time.

Of course this isn't the way that most of corporate America or Wall Street is structured. We recently visited an amazing organization high on performance and low on bureaucracy. This company routinely attracts the best and brightest in its industry. A winning culture attracts the best people, and the best people build and sustain a winning culture. One of the senior sales executives commented that in his prior career with a competitor, he now realizes that he spent 50% of his time on non-value added activities. That estimate had fallen towards 0% at his current post. What were all of these activities? Building budgets, sitting in meetings, conducting reviews, etc. Think about the power of an organization that can eliminate that kind of activity because it has a *seamless web of mutually deserved trust.* (Naturally, this only will work if the trust is deserved, i.e. if the organization is staffed with the right kind of people.)

[1] Perhaps Buffett's most underappreciated skill is his ability to judge people.

In New York, Jacob had the chance to hear the famed value investor Seth Klarman speak. Buffett famously named Klarman as one of a handful of investors that he would trust with his own money. After graduating Harvard as a Baker Scholar, Klarman had his choice of exciting career opportunities. But a handful of his Harvard professors saw how talented, intelligent, and ethical he was and convinced Klarman to start an investment company – called Baupost – with the initial goal of managing their money as well as the money of their close friends and family.

The original idea was for Klarman to select outside investment management companies to invest the funds while he oversaw operations and portfolio allocation. But after working at it for nearly a year, Klarman convinced his partners that this was a flawed strategy. Wall Street was simply riddled with too many conflicts of interest, destroying the prospects for high-quality partnerships. So instead Baupost decided to build their own internal investment operations. They started focusing on value stocks, event arbitrage and distressed investments and have since branched out to other assets such as private real estate and private equity. Over time they have patiently built external relationships with business and real estate operators. Today Baupost is closed to new clients and manages somewhere in the vicinity of $30 billion, owning one of the finest long-term track records in the money management industry.

It is clear to us that the great long-term investment records – Berkshire Hathaway, Yale University, Baupost – have been built on great partnerships. Then why are they so rare, and perhaps more importantly, what can we do to find them?

Our first line of defense is to ensure that our interests are aligned with our partners' interests. So-called *agency costs* arise when this isn't the case, i.e. when conflicts of interest exist between partners. Unfortunately, conflicts are incredibly common on Wall Street, driven by actions designed to maximize short-term profits at the expense of sustained long-term value creation. Here are two examples of common actions that reveal material agency costs:

- Public company CEOs pursue large, high-priced acquisitions even if it is bad for shareholder value because CEOs of larger companies often get paid more.[2]

- Investment managers raise as much money as possible for their investment strategies even if their performance would benefit from managing a smaller asset base.[3]

There are of course many more examples of agency costs, some of which we've learned through study and observation and unfortunately some of which we've learned through experience. Why do these agency costs persist? Because the investor is at an information disadvantage relative to the managing partner.

But even if no explicit conflicts of interest are apparent, a great partnership isn't simply a check-the-box exercise. Great partnerships also demand great people who combine integrity with intelligence and a strong work ethic. This is where we have to make a subjective judgment: Is this someone that we want to partner with? Do they have a true win-win mentality? Do they have the fiduciary *gene*? Do they truly share our long-term orientation? David Swensen comments:

> You know, the testing for character is largely subjective. One of the things we try to do is to spend time with prospective managers in a social setting, so it's not just sitting across one another at a conference table. But by the time I'm having a final meeting before deciding whether or not we're going to move forward, I'm thinking to myself during the entire meeting: Is this an individual that I want to be my partner? And it's subjective, it's gut feel, but that's the most important criterion as far as – as far as I'm concerned.

And we've learned that more often than not, truly great partners are asking the same questions *of us*. Charlie Munger relays this wisdom with the following anecdote:

> What's the best way to get a good spouse? The best single way is to deserve a good spouse because a good spouse is by definition not nuts.

[2] CEO pay is often based on the size of a company, as measured by its revenue.
[3] Fund manager pay is often based on the size of the fund.

Many great partners will already be recognized by others as such. Further, they will have such an intense focus on long-term success that they will realize that it is not worth their time or the risk to work with problematic outside partners. We once watched a documentary on one of the country's most famous architects. When he was asked for the secret to his success, he quickly replied: "great clients." It is interesting how often we've toured great companies who offer a similar response. (And we agree: our great clients fuel what we do.)

More likely than not, great partners will want to ensure we are suitable just as much as we decide they are suitable because they care so much about the quality of their organization. We want to be great partners so that we attract great partners.

So we've increasingly been asking ourselves: How can we be great partners with the companies we own or the funds that we invest in? This probably includes being supportive during periods of stress; taking a long-term view; not adding to the frictional or operational costs of the manager with unfair requests for information; being informed about the manager's operations; and simply developing a meaningful and transparent relationship with the manager.

Many times, it also involves being willing to support unconventional behavior. The British economist John Maynard Keynes famously wrote:

> Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

In order to materially outperform any peer set, you have to behave *differently* than that peer set. If you behave the same, you will get the same results. But a lot of partnerships are governed by what Buffett calls an institutional imperative: the pressure – either explicit or implicit – to mirror the actions of your peers. In his recently published book *Principles*, famed investor Ray Dalio writes:

> I learned that if you work hard and creatively, you can have just about anything you want, but not everything you want.

Great investors want outstanding long-term results. As a result, they are willing to sacrifice a lot of the conventional behavior demanded from other investors. We have to recognize and honor this if we want to work with these kinds of partners.

Essentially all of our research reports on both stocks and fund managers will identify areas of concern. How should we treat minor red flags? Over time, we've become increasingly cautious about any concerns that relate specifically to the *quality* of our partners, even if they initially might seem inconsequential. A friend frequently recites an old Zen saying: "The way you do anything is the way you do everything." If some potential partner has cut a corner somewhere, why? Is it because they felt they had to in order to compensate for some weakness elsewhere? Or because of lack of rigor?

Note that we aren't talking about mistakes. Mistakes are inevitable. We are talking about things that get to the heart of the manager, such as the inability to admit or learn from mistakes when they are made. Even small red flags – when they concern character or alignment of interests – warrant serious concern and consternation.

Great partnerships are rare, in both investing and in life. We shouldn't hope to find one every month or even year. But when we do encounter a great partner, our hope is that we have the ability to recognize them and the knowledge and conviction to be a great partner ourselves. This, more than anything else, will determine our long-term success.

Thank you for your continued trust and confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay, CFP®