AMI Investment Management
Registered Investment Advisor

Notes from the Road

The Value of Good Partners **March 2017**

Michael D. Axel, CFA

Jacob D. Benedict, CFA

Ryan A. Kay, CFP®

Charlie Munger at the Daily Journal Corporation's Annual Meeting in Los Angeles, CA.

It's been quite a while since we last checked in "from the road" – our apologies! Don't take our silence as evidence that we are doing any less "scuttlebutt" research. Quite the contrary – we've been too busy to write! Over the past several months:

- Ryan attended the Schwab Impact Conference in San Diego
- Jacob met with fund managers and peers in Los Angeles, Milwaukee and Indianapolis
- Ryan travelled to Boston to perform due diligence on 401(k) plan partners
- Jacob attended an industrial conference in Chicago (which we've described before as speed dating with companies)
- Jacob had the chance to travel to Los Angeles twice more for meetings with some inspiring executives and investors, including Charlie Munger (pictured above).

During our recent travels, we've been focused on the idea of partnership. Indeed, working to find great long-term partners is the real purpose of *all* of our research efforts. Whether it's the executives of the companies we own, the managers of the funds we invest in, or the team members at our institutional service partners, our long-term success will largely be determined by the quality of the partners we align ourselves with.

We used to think that good partners were important. We were wrong. They aren't important, they are indispensable. Great long-term partners are the ever rare *free-lunch*. Not only do good long-term partners reduce the amount of effort and resources that you have to expend, but they actively work on your behalf without you even thinking about it. Good partnerships keep paying dividends without any extra work.

This topic was a key focus of Charlie Munger at the recent Daily Journal annual meeting Jacob attended in Los Angeles. Charlie is Warren Buffett's long-time business partner and the Chairman of the Daily Journal Corporation. He is equally brilliant and fascinating. He is featured in HBO's recent documentary on Buffett, which we highly recommend. Munger is 93 years old and a true polymath, a modern day Benjamin Franklin.

Reproduction or distribution of this material is prohibited and all rights are reserved.

Munger has a beautiful saying: "The highest form that civilization can reach is a seamless web of deserved trust – not much procedure, just totally reliable people correctly trusting one another." Berkshire Hathaway – Buffett and Munger's company – is a testament to this idea. Consider the fact that Berkshire now employs over 360,000 people but operates with just 25 people at headquarters. That is trust!

Think about all of the effort that goes into selecting and monitoring partners in today's society. Buffett and Munger worked out a better system – they work only with people they trust, operating in a system that both gives and demands trust, and then they don't worry about all of the typical monitoring costs. Sure, this might lead to some occasional issues, but the net results speak for themselves.

Of course most people would agree that operating with outstanding partners is ideal. But how do we actually go about finding great partners? Warren Buffett offered perhaps the best formula: "[We] look for three things: intelligence, energy and integrity. If they don't have the latter, then you should hope they don't have the first two either. If someone doesn't have integrity, then you want them to be dumb and lazy."[1]

Yet while these intangibles are no doubt the key ingredients for a successful partnership, how can they be readily identified *in practice*? How does one actually go about finding and selecting a great long-term partner?

Consider specifically the case of a *managing partner*, which we define as a partner you select to manage a key task or offer critical advice in an area where you lack relevant expertise. Examples include medicine, accounting, real estate, investing, design and construction, executive management, etc. We rely on such partners all of the time in our daily lives. But Charlie Munger explains why sorting out the good potential partners from the bad ones can be challenging:

> I frequently tell the apocryphal story about how Max Planck, after he won the Nobel Prize, went around Germany giving the same standard lecture on the new quantum mechanics. Over time, his chauffeur memorized the lecture and said, "Would you mind, Professor Planck, because it's so boring to stay in our routine, if I gave the lecture in Munich and you just sat in front wearing my chauffeur's hat?" Planck said, "Why not?" And the chauffeur got up and gave this long lecture on quantum mechanics. After which a physics professor stood up and asked a perfectly ghastly question. The speaker said, "Well I'm surprised that in an advanced city like Munich I get such an elementary question. I'm going to ask my chauffeur to reply."[2]

Munger's point: It can be very hard for someone to distinguish between the real McCoy and a fake if they don't have deep expertise in the given field. In this case, even the physicist in the audience didn't know the lecture was given by Planck's chauffeur!

We are searching for applicable *rules of thumb* to help us identify great partners in practice and, just as importantly, avoid bad ones. This is an active area of research for us. Below we sketch out some of our current mental models, but we'd love to hear your own thoughts, ideas, reflections, etc.

- Munger teaches that the best way to get a good partner is to first be a good partner yourself. Truly great partners will, over the long-run, have their pick of clients, and they will focus on working only with great clients, helping them up their own game.[3] So before we go looking for a great partner, we need to be prepared to be one ourselves. This entails a long-term commitment, reasonable expectations, support during periods of adversity, and efficient, high-quality communication.

- Has the managing partner set reasonable and clearly-defined expectations? Perhaps surprisingly, managing partners often set the bar either too high or too low. In the first case, the goal may be to attract business now and forget about the fall-out tomorrow. In the second case the goal is to set a low hurdle that will be easily cleared. We need partners who set goals that are challenging but achievable.

[1] Tilson, Whitney notes from 2005 Berkshire Hathaway annual meeting.
[2] 2007 Commencement Address to the USC Law School.
[3] A great architect (Eero Saarinen) was once asked what the most important aspect of his success was; his response: "great clients."

- Does winning look the same to the managing partner as it does to us? Conflicts of interest exist when there is a gap between what is best for the managing partner and what is best for the client. These can be both *explicit* (such as commissions or payments for certain products and services) and *implicit* (biases that drive the managing partner to focus on goals detrimental to the client's interests). It is important that the managing partner's incentive system rewards the right kind of behavior and that the managing partner has a timeframe similar to our own (i.e. very long-term). A friend recently pointed out that the average tenure of a Fortune 500 CEO is less than five years, leading many executives to focus on the short-term at the expense of the long-term.[4] Unfortunately conflicts pop up all of the time. Explicit conflicts yield an immediate red flag. Implicit conflicts can be harder to spot, but consider things such as the heroes the managing partner tries to emulate. Peer pressure doesn't go away after high school, and surrounding yourself by the right kind of people and chasing after the right kind of heroes can go a long way towards incentivizing the right kind of behavior.

- Is the managing partner willing to differ from his peer group when it makes sense? In order to get great results, we have to be willing to be different. An executive we respect summarizes this as follows: "When you do as everyone else does, don't be surprised when you get the same results." Every year Buffett writes the following admonition to his top executives:

  > Sometimes your associates will say "Everybody else is doing it." This rationale is almost always a bad one if it is the main justification for a business action. It is totally unacceptable when evaluating a moral decision. Whenever somebody offers that phrase as a rationale, in effect they are saying that they can't come up with a *good* reason.[5]

  The willingness to deviate from peers for good reason can be a huge marker of integrity. Unfortunately, it's not unusual to find partners who haven't even thought about why they made a certain decision – they just blindly copied their competitors. This reveals a dangerous lack of thought. Consider the ongoing insistence of public company CEOs to ignore stock option expenses when presenting a company's earnings power. The rare CEO who has the courage and common sense to avoid such delirious thinking signals both integrity and intelligence. Buffett warns: "The CEO who misleads others in public may eventually mislead himself in private[6]…When managements take the low road in aspects that are visible, it is likely they are following a similar path behind the scenes. There is seldom just one cockroach in the kitchen.[7] From our own experience, we've learned that even tiny concerns over managerial behavior should be given a lot of weight.

- Does the managing partner communicate clearly and effectively and honestly discuss mistakes? If we are selecting a managing partner to manage a key task or job for us, that managing partner should be intelligent. And if that managing partner is intelligent, he or she should be able to communicate in a clear and concise fashion the objectives of the partnership and provide regular updates on performance that are easy to understand. Sometimes these tests are failed at the outset. Certain financial products require hundreds of pages to explain how they work and leave even professional investors befuddled.

  The honest discussion of mistakes is another important marker. Charlie Munger says, "I like people admitting they were complete stupid horses' asses. I know I'll perform better if I rub my nose in my mistakes. This is a wonderful trick to learn."[8] Not only are mistakes how we learn, but managing partners who reveal an inability to admit mistakes signal a deeper problem – *overconfidence*.[9] Overconfidence is perhaps the #1 Achilles heel of intelligent individuals. It's not how smart you are that matters, it's that your perception of how smart you are matches the reality. It can be hard to separate cockiness from confidence, but an ability to transparently discuss mistakes is a worthwhile clue. Of course clients can do their part by understanding that mistakes are inevitable

---

[4] At the 2008 Berkshire annual meeting, Buffett observed, "I think big investment banks and big commercial banks are almost too big to manage effectively in the way they have elected to run their business. It will work most of the time. You may not see the risk. A 1-in-50-year risk – it won't be in the interest of a 62 year old executive who is retiring at 65 to worry about it."
[5] Buffett's annual letter to managers as reported in *The Wall Street Journal.*
[6] Berkshire Hathaway Owner's Manual.
[7] Berkshire Hathaway February 2003 letter to shareholders.
[8] 2011 Berkshire Hathaway annual meeting.
[9] For an illustrative example, read about the incredible downfall of Long-Term Capital Management, staffed by some of the most brilliant minds in finance.

and dropping any illusions of perfection. Indeed, open and honest discussion of mistakes is good for all parties involved. Charlie Munger once observed that "Most of Berkshire's success grew from stupidity and failure that we learned from."[10]

- How does the manager perform during periods of adversity? Our study of the most successful ventures reveals that true outlier success comes from strength and courage during periods of stress. Most people can perform admirably when the conditions are ideal. It's hard to separate from the pack during such periods. But every now and then the world goes crazy or the environment becomes highly stressful. This is *inevitable*, and this is when you need a strong partner the most and when the partner can add the most value. Time and adversity reveal character and ability.

- Someone who has thought about this topic a lot once told us that true experts spend very little time trying to convince other people that they are experts. They don't need to. Instead, they focus their energies and passion on their field of work, which gives them an *intrinsic* satisfaction. Their drive doesn't originate from the hoped for rewards, but from an intense love for what they do. This creates the perseverance and focus needed to achieve outlier results.

- The best way to judge a person's character is to get to know them well and pay attention to how they behave when their guards are down, although even then we can be fooled. A less effective but potentially helpful substitute is to insist that if you don't know the managing partner well, you at least know and respect some other third party who holds the managing partner in high regard. We call this getting within "two degrees of separation."

This list of methods is neither comprehensive nor foolproof. Potential partners can clear the hurdles but still be flawed (especially if they know what the hurdles are). Picking a partner isn't like figuring out an engineering problem or reconciling a company's financial statements. In the aforementioned HBO documentary, Buffett reflects: "Investment problems, they're easy. It's the human problems that are the tough ones." Yet criteria like the list laid out above can go a long way towards helping you reduce mistakes. And perhaps just as importantly, it can force managing partners to behave in the right kind of way, thereby benefiting society and hopefully moving our institutions towards Munger's ideal "seamless web of deserved trust."

Consider an issue recently thrust into the spotlight within our own industry. The previous presidential administration was working to establish a "fiduciary rule" whereby all financial advisors would be required, by law, to act in their clients' best interests. Currently, many advisors can opt to operate under a standard of "suitability," where their recommendations must only be deemed suitable, and not necessarily in the client's best interests. As you might imagine, a large chunk of the industry fought this new law, which would have drastically curtailed the ability to charge excessive prices, utilize flawed fee structures, and pitch expensive products.

The new administration has moved to rollback this development. We won't say much here about the merit of the law one way or the other. (The law had noble intentions but would probably also produce negative unintended consequences.) But – law or no law – why wouldn't most investors work with an advisor who holds himself or herself to a fiduciary standard? Why would investors work with someone who hasn't committed to putting their interests first? (As a registered investment advisor that adheres to the CFA and CFP® Codes of Ethics, AMI has always operated under a fiduciary standard.)

We look forward to updating you "from the road" again soon!

Sincerely,

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

[10] 2011 Wesco annual meeting.

Past performance is no guarantee of future performance. All investments contain risk and may lose value. Any views expressed within this document are the views of AMI Investment Management and/or the authors. They are subject to change at any time without notice. Any graphs, charts or formulas included within this document that depict historical relationships may not be valid during future periods and should not be relied upon to make investment decisions. This material is distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular investment security, strategy or investment product.