Memo to: Clients and Contacts
From: AMI Investment Committee
Re: Manager Selection Criteria
Date: May, 2015 (Updated June, 2017)

[A] Do we like and respect the manager?
"Real estate investors invoke the mantra "location, location, location." Investors seeking to engage an active manager should focus on "people, people, people." Nothing matters more than working with high-quality partners." – David Swensen[1]

Life is too short and the risks are too high to partner with people that we don't trust and admire. We wholeheartedly agree with Warren Buffett's hiring criteria:

> [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.[2]

Humility is also important. Investment markets are filled with highly motivated and intelligent people. But as Mark Twain once observed, it's not what you don't know that gets you into trouble, but instead what you think you know that just isn't so.[3] Hubris has been the Achilles heel for many brilliant investors.[4]

While these characteristics are more important than any other factors, they are intangible, meaning they can't be directly observed.[5] Accordingly, we have to supplement our subjective judgments with more objective criteria.[6]

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[1] *Pioneering Portfolio Management* by David Swensen (2000).
[2] Whitney Tilson's notes from the 2005 Berkshire Hathaway annual meeting.
[3] Buffett: "If we have a strength, it is in recognizing when we are operating well within our circle of competence and when we are approaching the perimeter." Berkshire Hathaway 1999 Shareholder's Letter.
[4] See *When Genius Failed* by Roger Lowenstein (2001).
[5] We once heard integrity defined as "the way someone acts when no one is looking."
[6] Of course one would expect that the right kind of people create the right kind of institutions. In other words, the objective criteria we look for should signal important information about the intangible characteristics of the people running the institution.

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[B] Is there a strong alignment of interests and a sensible compensation structure? Does the manager have a long runway?

"However, finding good people, while necessary, marks only a starting point in the search for a money manager, for strong people in a poorly structured organization face the markets with a significant unnecessary handicap. In a world rich with alternatives, compromising on structural issues makes little sense." – David Swensen[7]

Humans are driven by incentives. In the intensely competitive world of investment management, any wedge between what is right for the manager and what is right for the investor will drive disappointing behavior and lackluster outcomes. We strive to partner with managers who have structured their organizations so that their interests are as aligned as possible with those of their investors.

Is there a significant co-investment by the firm's principals? Is the manager willing to limit assets under management when size becomes a headwind?[8] Is the expense ratio, and perhaps more importantly the expense structure, appropriate for the given investment strategy? [9] Is management focused on a single investment strategy? Is the management company owned by the principals? Does the manager invest as an activity or calling or is the firm run as a business? Has the manager assembled a strong base of stable, likeminded investors? Does the liquidity of the underlying investments match the liquidity of the fund? Is the manager candid about past mistakes and the current investment opportunity set? Is the manager distracted by other outside interests?

We aim to build long-term partnerships. Trust is built over years and it is inefficient/ineffective to try to find a new dance partner every quarter or year. We hope to partner with managers who have a long runway to build and execute their investment strategies, allowing the beauty of compound knowledge to benefit all parties involved. We agree with Charles Ellis: "Candidly, there are far too many dating and not enough marital relationships in endowment (and pension) management."[10]

[C] Does the manager employ a value investing approach?

"[W]e think the very term "value investing" is redundant. What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value – in the hope that it can soon be sold for a still-higher price – should be labeled speculation (which is neither illegal, immoral nor – in our view – financially fattening)." – Warren Buffett[11]

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[7] *Pioneering Portfolio Management* by David Swensen (2000).

[8] Buffett: "Anyone who says that size does not hurt investment performance is selling…It's a huge structural advantage not to have a lot of money." As quoted in "Wisdom from the 'Oracle of Omaha'" by Amy Stone in *BusinessWeek* (5 June 1999).

[9] We believe that outsized compensation should be driven by outperformance relative to a responsibly chosen benchmark, not from asset gathering.

[10] "Best Practice Investment Committees." *The Journal of Portfolio Management*. Winter 2011.

[11] Berkshire Hathaway 1992 shareholder letter.

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We believe wholeheartedly in value investing, the core of which is the idea that investments should only be purchased if they are priced at a large discount to a conservative estimate of their intrinsic value. Does the manager follow an investment strategy that we can understand? Does the manager respect the efficiency of markets and seek to establish a differentiated view?[12] Is the manager patient enough to wait for the "fat pitches"? Does the manager base investment decisions on in-depth research with a long-term view? Does the manager have the flexibility to focus on his best ideas within his circle of competence? Does the manager have the temperament to differ from the crowd, even for extended periods of time?[13] Is the manager honest and objective enough to readily admit the inevitable mistakes?

[D] Is this approach conservative / risk-conscious?
"Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks, including those never before encountered. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions." – Warren Buffett[14]

Risk – the chance of a permanent impairment of capital – cannot be captured by a number.[15] Accordingly, it is difficult to judge how adept a manager is at controlling it. We don't believe that risk control is built through over-diversification, stop-losses, tail risk insurance, etc. Instead, risk management is borne out of a deep understanding of the manager's investment holdings and the discipline to avoid investments that may offer great upside but entail unacceptable levels of risk.

We believe that great investing is driven by two activities: finding mispriced securities or opportunities and judging whether the risk inherent in such securities is acceptable to bear. Both activities are extremely difficult to execute consistently well, but we believe the latter receives much less attention. Superior investment opportunities entail positive asymmetries, and they are therefore understandably rare.[16] Asymmetries arise out of conservatism and the presence of an edge in markets (see below), allowing the manager to generate alpha through skill, not via financial engineering or risky, binary investments. It is difficult to judge a manager's ability and willingness to manage risk – is a manager skillful, or just lucky? – which means we try to spend an inordinate amount of time on it.

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[12] We believe Buffett's example is important: "As they say in poker, if you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy." Berkshire Hathaway 1987 shareholder letter.
[13] As a friend observes, if you do as everyone else does, don't be surprised when you get the same results as everyone else.
[14] Berkshire Hathaway 2006 shareholder letter.
[15] This doesn't mean that volatility isn't important, only that it is an incomplete measure of risk.
[16] Or as Mohnish Pabrai described it, "heads I win, tails I don't lose much." *The Dhando Investor* by Mohnish Pabrai (2007).

[E] Does the manager have an identifiable edge?
"First, we ask, "What's your edge?" If they haven't thought about it or can't answer, then it's a short conversation. If they do have an edge, why is it sustainable? Why is it systematic? What is it about your firm that allows you to produce that? We are not doctrinaire about what that might be; we just want them to be able to say they have a proprietary skill, proprietary information flow, or proprietary something that is sustainable, ahead of the pack, and always being fine-tuned. We need to hear that they've got something." – Bill Spitz[17]

We want our managers to have some kind of edge in the market. What does this mean? Fundamentally, we are looking for some kind of structural advantage that is (a) hard for other investors to replicate and (b) sustainable/repeatable. It could be in the form of deep industry expertise, the ability to transact in highly complex and inefficient markets, or a proprietary skillset brought to bear in active investment situations. We need to be able to articulate it and observe how that edge has been utilized in past investments and then understand why it should continue to work in the future. We are looking for more than vague advantages. We want to put our finger on what gives the manager a leg up on the competition. While rare, the identifiable "winners" in investment markets will be the ones who begin the race with a head-start. Warren Buffett put it best:

> Your win-loss percentage in tennis will not be determined by the absolute level of ability that you possess. Rather, it will be determined by your ability to select inferior opponents. If you select with care it will be quite easy to attain a winning percentage higher than, say, Cliff Richey while he is playing on the tour. Application of this principle is the key element in bridge, poker, or investments. (Harder to apply in the latter, however – it is easier to identify a couple of palookas at the bridge table.)…If you've been playing poker for half an hour and you still don't know who the patsy is, you're the patsy.[18]

Note: All of the points outlined above refer to the "manager," not the "firm," "company," or "institution." This is intentional. As Warren Buffett observed:

> [I]n no case were the superior records I have observed based upon institutional skills which could be maintained despite changes in the faces. Rather, the good results have been accomplished by a single individual or, at most, a few, working in fairly specialized areas in which the great bulk of money simply had no interest.[19]

Our goal is to form long-term partnerships with a handful of external investment managers that are fundamentally good people, have a deep passion for investing and have structured their institutions as a true partnership. It will be hard to find such relationships. When we do, we aim to do our part by being strong and committed long-term partners.

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[17] *Foundation & Endowment Investing* by Lawrence Kochard and Cathleen Rittereiser (2008).
[18] Memo to the board of the Washington Post, October 14, 1975.
[19] Memo to the board of the Washington Post, October 14, 1975.