Incentive-Caused Bias and Agency Costs

> "It's present in every profession and in every human being. And it causes perfectly terrible behavior… Human nature, with its version of what I call 'incentive-caused bias,' causes this terrible abuse. And many of the people who are doing it you would be glad to have marry into your family compared to what you're otherwise going to get."
> –Charlie Munger

This article is part of a multi-part series on human misjudgment by Phil Ordway, managing principal of Anabatic Investment Partners.

Munger recalled gall-bladder removal surgeries at a community hospital wherein the doctor at fault thought the gall bladder was the source of all medical evil; he was *not* doing it out of malice or greed.

Other examples included sales pitches by CRE brokers (never in 70 years even one within hailing distance of the truth); cost-plus-percentage-of-cost contracts – a felony for the government to write one, but law firms still have this system; and "people who create things like cash registers, which make misbehavior hard, are some of the effective saints of our civilization…the cash register was a great moral instrument when it was created."

Update

This tendency was wrapped into the discussion on "Reward and Punishment Superresponse Tendency," but agency costs probably deserve special attention as a unique sub-segment of this phenomenon.

A stark example came recently when one member of a small team running the family office of a very wealthy, high-profile businessman described his job to me as doing just enough to make sure the head man "barely remembers we're here."

The role of the board of directors is worth considering, especially regarding Munger's rule and the zone of insolvency

Jason Zweig has also noted that while it may be impossible to quantify, both Munger and Buffett believe that Berkshire's structure minimizing agency costs has played a large role in Berkshire's success.