How Bad Mistakes Arise: A Good Idea Taken to the Extreme

This article by Tom Russo has been excerpted from a letter of Semper Vic Partners.

I would like to take a moment to highlight the allegations against Wells Fargo… and to share my rationale for retaining a relatively unchanged investment exposure to Wells Fargo shares (at roughly 6 percent of portfolio assets). I believe that the misconduct arose from a conduct which is often cited by Berkshire Hathaway's chairman, Warren Buffett, when he is periodically asked how seemingly well-run enterprises fall off their well-oiled rails. In situations like this, Mr. Buffett often observes that "bad mistakes" on Wall Street and in business are more often likely to arise from "good ideas" taken to an extreme than from bad ideas from the outset. Bad ideas suffer from early mortality. Capital and talent quickly leave ideas early deemed to be bad, tying up little social resources or capital. Good ideas, however, can survive and flourish for a very long time, even though at the end sticking to the seemingly good idea ends badly. Capital that flows into such ideas, while they seem good, can end up being lost later on when such ideas no longer provide positive results.

The good idea in the case of Wells Fargo began with the realization decades ago that if Wells Fargo adopted a more orderly approach to marketing of their products they could increase the number of banking products which their banking clients engaged. In the early 1990s, they mastered the practice of direct mail banking, realizing, for instance, that if they followed up an unanswered direct marketing letter with an invitation for that person to come to their nearby office to meet with a personal banker, odds would increase sharply that that person would take on additional banking products.

Since there were economies of not having to underwrite the same clients with each new product, the bank could share savings by offering, for instance, checking account clients a premium to the rate that the man-off-the-street would receive for the same deposits. Increasing the number of relationships generated relationship leverage, with both revenue and profit per banking client increasing with each additional product taken.

These early stages of delivering better margins through techniques to better direct bank customers to value-added products started with some deep and valued insights as described below. The fact that the desire to secure such benefits to profits without focus on making their banking clients succeed financially is what I believe led Wells Fargo over time to focus increasingly on the outcome that eventually became referred to as simply "cross-selling". The good idea of customer- centered marketing morphed over time to a "bad idea" of relying increasingly on cross-selling quotas.

"Why are you here?"

In addition to developing direct marketing best practices, Wells Fargo under the early reign of former CEO, Richard Kovacevich, developed in the 1990s metrics for improving the effectiveness of their associate hiring. They engaged third party service firms (like the Gallup organization) to develop recruiting practices and procedures to increase the likelihood that the person hired for a job had proper character for the job into which he/she was hired.

Mr. Kovacevich described to me in the early 1990s how this more scientific recruiting process added value through a story about a teller. He described how he approached one of Wells Fargo's associates in the back of the main vault at the California Avenue main Wells Fargo banking branch. When asked who she was and what she was doing eating lunch in the back depth of the vault, his associate described how she liked the bank vault because it was quiet and because she really liked being away from people. When she described her position as bank "teller", Kovacevich realized that Wells Fargo still had room to grow with fitting personality and character to work.

Wells Fargo learned from such examples and early on employed increasingly appropriate recruitment filters that would recruit for the appropriate jobs. Telemarketers, for instance, were selected from people who not only responded “yes” to their first question, e.g., “Do you like to talk on the phone?” In fact, they looked for those who would follow up their affirmative answer to the first question with an observation of how much they liked to “talk to their mother on the phone over lunch” and not retreat to the comforting silence of a bank vault.

“How can we better serve you, Mr. Smith?”

A related insight shared by former CEO, Kovacevich, at the same time as Wells Fargo applied science to recruiting involved Wells Fargo’s somewhat unorthodox belief in the value of the retail bank branch network. Whereas many of Wells Fargo’s competitors at this time were closing bank branches due to the desire to reduce fixed costs and attempt to engage the first flurry of internet banking services, Wells Fargo, by contrast, considered their bank branches to be the financial emporium where they could “earn lifelong relationships that help people succeed financially.”

Wells Fargo’s historic bank branches were unusually productive due to several important reasons. First and foremost, Wells Fargo relied upon the branch bank environment to recruit their single most critical relationship – the checking account. Wells Fargo retains the belief that the bank which has the checking account relationship into which their clients’ salaries are directly deposited has the best chance to successfully market additional relationships. Second, Wells Fargo invested in sophisticated teller-assist technology. When banking clients come for checking account activities, Wells Fargo tellers automatically know which relationships with each customer might be open for new product offerings in light of the client-specific details which tellers view on their monitors. This assisting software allows tellers to see if/whether a Certificate of Deposit should be rolled over, student loan extended, home improvement loan adjusted, 401(k) investment made, etc. Such advice historically yielded to Wells Fargo enormous client product competitive advantages, resulting with industry record setting productivity.

Third, Wells Fargo considered their bank branch managers to be their main bankers to small business clients in their neighborhoods. This meant that bank branch heads were encouraged to travel extensively away from the bank to meet with prospective/existing clients at client offices. This hands-on lending helped Wells Fargo to develop, over the decades, the extraordinary interest- free demand deposit base which stands at the heart of its successful commercial lending. During times when competitors have to pay for high-cost deposits, Wells Fargo has enjoyed the longstanding advantage of low-cost demand deposits that arose from the fact that their borrowing base has felt loved and well served.

I have long admired how deeply thoughtful Wells Fargo was about how they recruited, trained, equipped, and incented their tellers and their sales force. Wells Fargo recognized that added relationships beyond the platform checking account were crucial to securing additional banking revenue from existing relationships. The purpose behind tellers’ banking client product pitches was not to simply meet a quota of “cross-sold” products, but was designed to help Wells Fargo’s client-facing representatives to have products to help their clients “succeed financially”. With the passage of time, many of the functions which helped build the success of Wells Fargo’s great consumer lending/retail branch banking systems have been adopted by its fast-growing, nationally leading internet banking platform.

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Danger of Single-Variable Analysis

As you can see above, very little adversity arose from the thoughtful ways in which the bank, under CEO Kovacevich over many years, applied technology and intelligent inquiry into the building of a client-focused culture defined by informed selling practices. Nonetheless, bank communication with investors, bank incentives and salary reward package designs seem to have over time become increasingly monodimensional. The scorecard for employee compensation and the yardstick by which Wall Street investors were asked to grade senior management success became increasingly channeled into the single variable – cross-selling. This move towards a simplistic reference merely to cross-sell, I believe, accelerated during the period immediately following the most recent global financial crisis when management throughout Wells Fargo's ranks, from the top to the retail branch, were consumed and distracted by smoothly and completely integrating the largest bank merger in American history, i.e., the Wells Fargo acquisition of Wachovia Bank.

Whenever performance in complex cultures is reduced to single-frame references, investors must realize risks that likely will arise for corporations and their leaders who might attempt to game the system to show that they met such single-frame referenced objectives. Even though the bank's success grew, due to the skills it had put in place to increase the number of relationships each client might have had with the bank, by late 2009, communication about reasons for Wells

Fargo's superior performance no longer referred to the full basket of insights that drove the success, such as those Kovacevich shared with me described above, but simply turned into a body count of how many products a banking representative could cross-sell.

The full value of the progression from hiring well, training well, locating well in effective retail branches, and increasing available tools and analytics to increase the suitability of additional relationships began to unravel around the time that Wells Fargo shifted its attention to bringing under wing the acquisition of Wachovia, which in one transaction nearly doubled the size of all aspects of the bank. Beginning around this time, Wells Fargo management seemed to have embarked upon a far more single-focused approach to bank management, designed to drive single- variable, bank-wide retail cross-sells per employee per year.

I hope that you find my summary of how I believe Wells Fargo slipped into the risk of focusing simplistically and singly on one variable (i.e., cross-selling) to track its economic progress to have been informative. Regardless of how they found their way into such single focus, the consequences that were revealed this September show how dangerous such pressured metrics can become. I have several observations which I share in addition to the many which I am sure that all of my investors have followed in financial and popular press alike:

1. *Management.* It would appear that management failed to drive proper incentives. Cross-sell targets became formulaic and burdensome enough that some associates claim that they felt the need to fabricate "new accounts" to meet "quota". The CEO and most senior management had knowledge that their system surfaced a small percentage of their associates (roughly one percent per year) involved in such defalcation over the past five or six years. They seemingly addressed the instances with associate terminations, but failed to more deeply investigate where systemic conditions may have led to such pressured misconduct in the first place. Moreover, they failed to notify investors of the issue that they faced and, more troubling, failed to protect investors by failing to take steps to subsequently police against such known risks.

2. *Political Fury.* Wells Fargo fell right into the hands of politically charged House and Senate Banking subcommittees which convened to seemingly allow for the collective vetting of emotions that so few "heads had fallen" and so few "personal financial costs" have been borne by all executives of other

banks from which collectively so much Wall Street misconduct arose as early as 2006.

3. *Terrible Optics.* Much like the pressure placed upon the tobacco industry during the 1990's tobacco wars, so too is immense pressure from threatened litigation, regulation, class actions, etc., being placed upon Wells Fargo. Indeed, as I write, Wells Fargo is receiving notice of one class action lawsuit after another for any number of claims including wrongful termination, credit score degradation, emotional distress, fraud, etc.

However, much as we endured as tobacco industry investors during some of the most-dark days of the 1980s and 1990s, I have adopted a similar interpretation of our risks with our holdings in Wells Fargo shares. These risks reflect both company-specific risks and commercial banking industry risks.

Wells Fargo-Specific Risks

My attitude with our Wells Fargo holdings starts from my continued faith in the legal process. Just as with the tobacco industry litigation, every defendant, regardless how socially reviled they may be at a given time, is entitled to their day in court before a jury of their peers, in a trial presided over by an impartial judge. Such courts have to determine if and whether actual harm exists. In the case of Wells Fargo's creation of fictitious client accounts, actual harm identified and already reimbursed by Wells Fargo amounted to just under $5 million.

To date, actual direct financial harm has been modest. Countless allegations regarding wrongful termination, required reinstatement of associates, housing-related losses due to credit impairment, etc., have been suggested during House and Senate subcommittee hearings. However, such allegations become far harder to survive summary judgment if plaintiffs, either singly or by class action lawsuit, cannot establish sufficient actual harm.

It is my belief, that the lack of abundant or obvious harm should go a long way to reduce the extent of financial harm, adverse judgments, etc., that will await Wells Fargo. While the conduct of those let go was deplorable and has caused the firm deep reputational harm, so too has been the conduct of senior management for not having taken sooner and more decisive action to investigate why the low percentage level of fraud was allowed to persist for six or seven years.

We, as investors in Wells Fargo, will have suffered deeply due to the reputational harm to the firm that has followed. Fortunately, however, I do not believe that our firm faces the magnitude of losses experienced by the major money center banks whose shareholders have suffered collectively over $30 billion in fines for financial product misconduct that led to the near collapse of our banking system and consequential enormous financial losses suffered as a result of failing real estate-related derivative instruments which they fabricated.

As a result of my belief that Wells Fargo will be able to satisfy adjudicated claims and that likely settlements will ensue, I believe that, based on what I now know, Wells Fargo shares represent value. The shares declined in value ten to fifteen percent upon the recent news leaving their valuation compelling in light of other similarly positioned banking entities. I believe that the bank will continue to enjoy benefits from its nationwide banking footprint, possessing as it does over 11 percent of nationwide bank deposits. I believe that once the bank stabilizes its options, it will again likely continue its focus on retail and consumer banking, with reinvestment likely to continue into new areas such as credit cards, mortgage lending, and wealth management.

As for credit cards, Wells Fargo's client base still offers opportunity to deliver significant card growth as currently less than 50 percent of Wells Fargo's retail customers, on average, have a Wells Fargo credit card. Moreover, those that currently have credit cards take them out of their wallets all too infrequently. Similarly, Wells Fargo remains underdeveloped in wealth management, a key component for their plans for future growth.

On top of investments underway designed to grow credit and debit card penetration, increase mortgage lending, and grow wealth management, Wells Fargo management understands that they will likely have to return funds to owners increasingly to sustain attractive shareholder total returns. Wells Fargo can no longer grow as it has to date through added commercial bank acquisitions, as they have met the ten-percent bank regulatory threshold of national deposits, preventing any future acquisitions. So limited, Wells Fargo will very likely remain committed to returning a high percentage of distributable funds each year to shareholders through dividend increases (already nearly a four-percent dividend yield) and through share repurchases.

Banking Industry-Specific Risks

I will continue to leave the Wells Fargo investment at roughly the same portfolio weighting with which we entered into September's challenges. I believe that the equity market valuation undervalues Wells Fargo's banking franchise and its high-dividend payment will help to support a decent return.

However, I will remain alert to degradation that could arise in the political arena in which it will have to address allegations of misconduct. I will also have to remain attuned to the impact that the political fallout of Wells Fargo's misconduct may have on furthering industry-challenging legislation and regulation.

Industry prospective returns on capital have been increasingly compromised by not only the well-known near-term challenges posed by our monetary situation and by the effects of QE, but they also are impacted by increasing requirements impacting capital adequacy and permissible business activities allowable to commercial banks. Rumors of a revival of a Glass-Steagall-styled separation of banking activities have arisen in the wake of recent bank misconduct. New demands are constantly considered of the industry by the newly emboldened Consumer Financial Protection Bureau. Even the Department of Labor's recent pronunciations regarding fiduciary standards that must now be assumed for wealth management activities may diminish the appeal of the bank's growing wealth management area.

The list of banking industry factors posing threat of systemic change is long. The political climate in which such proposals are created is severe. Unfortunately, those with the loudest voices and most clout today have as hostile a view towards the banking industry's important role in the economy as did the trial lawyers and regulators of the tobacco industry over the past twenty-five years. During this period of declining tobacco industry standing, the industry was able, nonetheless, to eke out attractive returns to investors. Part of the returns have arisen from the fact that expectations were so low for tobacco-industry returns due to confiscatory steps that tobacco company shares became attractively priced and dividend yields generous. Much the same risk aversion exists today when many other investors size-up prospects for Wells Fargo. I believe that risk reward remains attractive for Wells Fargo shares.

Deposits into the "Bank of Goodwill"

A wise, investment colleague of mine recalled a conversation which he had earlier with a corporate relations crisis consultant that I thought bore upon many of the firm threatening crises that loom over companies today. This corporate relations crisis consultant had told him that she typically found one thing missing amongst the businesses that found their way to her door during periods when their firm's goodwill and survival were imperiled.

She suggested that she typically observes with management from such threatened firms that their common shortcomings were that they failed to prepare for such reputation-threatening moments. She typically asks such managements when they seek her help or expertise in reputation triage, “When was the last time you made a deposit into the bank of goodwill?”

You see, she would explain, successful companies “bank goodwill” during periods when things are going smoothly for use when things go awry. Such banked goodwill comes in handy when times turn tough. However, for businesses that have not sufficiently deposited into their needed bank of goodwill when business runs smoothly, they will find an “Insufficient Funds” notice posted when they attempt withdrawal when crisis hits.

It is ironic, however, that our portfolio company most impacted by insufficient funds in their own bank of goodwill has turned out to be a bank. This is all the more striking because the banking business is, at its heart, so commoditized and competitive that the very best banks realize that the one thing that does distinguish them from competitors is the trust and loyalty that they can build during good times to avoid having “funds insufficiency” during bad times.

Wells Fargo may find itself with insufficient funds at present for a few reasons. First, I believe it is because of Wells Fargo’s march towards relying increasingly just on the existence of cross-sell to define their success. Second, I believe that they did not wish to invest heavily out of their reported income to deliver a regular message that reassured their banking clients that Wells Fargo partners with them for financial success. Just doing well by clients is not sufficient. Companies need to do well by their clients, as well as celebrate publicly that they are doing so.

I have long felt that the entire banking industry and Wells Fargo in particular would have benefited from a 360-degree advertising and communication campaign designed to reassure their depositors and customers that they are part of the solution for Americans’ financial services needs and not part of the problem.

For the past two decades, because of the well-documented misconduct of several of the largest money center banks, banking has allowed itself to be boxed into the corner of adverse public sentiment, allowing others to vilify their motives and discredit their contributions to society. As recently as two years ago, I shared with senior Wells Fargo management at an investor gathering my belief that the banking industry needed to get behind a reputation-restoring advertising campaign to restore the overall reputation of banking. I had in mind campaigns like America’s “got milk?”, “America Runs on Dunkin’”, and “Freight Rail Works” by the US railroad industry. Clearly, investing in advance of specific crisis simply to fortify reputation by making deposits into the bank of goodwill did not seem pressing nor urgent enough at the time to Wells Fargo management. Clearly, management did not seem impressed enough at that time to justify the potential burden on reportable levels of income to direct a portion of income to investments designed to fortify goodwill.

Despite not having made sufficient “deposits” over the past, I believe that Wells Fargo will be able to restore its bank of goodwill. Doing so will be expensive and will take hard work and time to complete. They will have to take important near-term and long-term steps. Along the way, they simply must engage far more frequently in publicly celebrating the good that the bank can offer its served communities. They must tell their story. They must deposit back into the bank of goodwill.

Wells Fargo has already taken important near-term steps. Important management changes already have put in place new talent to address prior problems. The roles of CEO and Chair have been separated at this time. Senior management has had compensation forfeited. Changes have occurred at the operational level. Wells Fargo no longer rewards its employees based on meeting cross-sell quotas. Wells Fargo confirms to all banking customers by e-mail whenever a new account is established. Wells

Fargo has commenced a television advertising campaign to publically declare its commitment to behave well by its banking customers.

Wells Fargo has more to do over the long term. First and foremost, Wells Fargo must reach out to both House and Senate banking subcommittees to insure that Wells Fargo provides answers to remaining questions. They must be honest and direct in their responses. They must be clear about the actual numbers of accounts affected. PricewaterhouseCoopers (PwC) suggested that out of 93 million accounts, only in the case of 2 million could PwC not certify that products were requested by bank customers. This number, 2 million, is unfortunately misrepresented as the number of affected accounts rather than representing just the pool of accounts that upfront could not be definitively dismissed.

To succeed long-term, Wells Fargo must extricate itself out of Congress' and its industry regulator's penalty box. To do so, Wells Fargo must be firm on the facts and forthcoming on all details. They cannot stonewall. For instance, during the Senate banking subcommittee hearing, when Wells Fargo's former CEO was asked whether "other banks focused on cross-sell", he essentially replied that he was not aware of what other banks do. Wells Fargo will have to deliver less lawyerly minded answers in their efforts to respond head-on to politicians and to its own industry's regulators.

To succeed long-term, Wells Fargo will have to publicly celebrate its investments to drive long-term banking customer satisfaction. They will need to celebrate advances in internet banking, servicing tens of millions of their banking customers now online. While many startup banks suggest that they will unseat traditional banks in light of generational moves to digital activities, it is safe to say that cyber security protection, customer appreciation of their ability to interact both digitally and through branches, etc., will likely encourage Wells Fargo's management to continue to promote their extensive digital and mobile banking offerings.

Work remains to be done. For instance, it appears that Wells Fargo could likely benefit from a revised board. Wells Fargo's new chairman might consider ways to reshape the board, possibly by reducing in number, acquiring more diversity in backgrounds, while being simultaneously more skilled in the issues that will most press Wells Fargo going forward (e.g., banking industry knowledge, social network marketing, internet banking, and regulatory environment skills).

Wells Fargo will have to publicly atone. They must meet Congress and regulators directly. They must answer questions about past conduct, nothing hidden. They must be prepared to make full financial restitution where warranted, tackling head-on even arguments concerning alleged adverse impact on mortgages that may have arisen due to credit bureau issues that could have arisen due to fabricated accounts.

Finally, Wells Fargo must invest much more deeply behind their goodwill. They must advertise about the good work underway. Their communication should not be cryptic nor evasive. It should deal directly with past mistakes, honestly accepting deserved criticism and honestly recognizing they fell from their historic standards of earned trust.

Wells Fargo must speak publicly about the good the bank is doing along with communities and with its banking clients. They must celebrate their associates' support of non-profits (nearly $300 million in 2015). They must continue their support of minority small businesses (procuring as Wells Fargo did in 2015 over 12 percent of its banking supplies and services from small businesses). They must celebrate the bank's support of the environment (over $15 billion of loans extended in 2015). They must celebrate loans to small businesses (over $20 billion extended in 2015). Finally, they should celebrate rewards received for Wells Fargo's workplace environment (e.g., 2015 workplace award from DiversityInc as the #1 company for LGBT employees, 7th top company for veterans and 11th top company for diversity). Their communications should be honest, sincere, and not written by counsel.

We must recognize that the issue of the bank of goodwill extends far beyond just the example of Wells Fargo when reviewing our portfolio holdings more broadly. For instance, we do have in our portfolio examples of companies that have prioritized "making deposits into the banks of goodwill" as a matter of course for their businesses, helping to win their shareholders benefits that come from sustained goodwill. Unilever supports carbon emissions impact reduction, affordable clean water, consumer self-esteem (e.g., Dove's "Real Beauty" campaign), and environmental protection through reduced energy, plastic, and water consumption during product manufacturing. Heineken, likewise, has publicly celebrated their investment over the years to cut water and electricity consumption by over 40 percent over the past two decades even while their production volumes increased by over 40 percent.

As with so many such developments, both Heineken and Unilever celebrate how their companies have done very well by "doing good". They save costs of manufacturing by reducing materials consumed by reworking manufacturing flows. Eliminating waste by manufacturing redesign also means paying less for ingredients otherwise costly to dispose thus increasing our operating profits!

We also have had examples of portfolio companies, even some whose company-wide standards recognize the need to make such deposits, but which have tripped up in given markets only to discover when that occurred that they had, for whatever reason, failed to make needed "deposits" in specific markets.

The case of Nestlé India has been quite instructive as to how normally caring companies can confront reputational attacks. In this case, Nestlé India experienced "a run" on its bank of goodwill when ill-founded rumors surfaced that its Maggi noodle soup could pose harm to children due to trace elements of metals and other harmful elements allegedly discovered to be present in their product. Nestlé discovered as they attempted to respond to such questionable allegations that their Indian division had underinvested in building and sustaining its goodwill. Lacking the ability to "withdraw funds" to counter allegations, that quickly swirled throughout India's extraordinary tabloid press, Nestlé India quickly found that its national goodwill for its trusted brand in India quickly plummeted from 98-percent brand trust to 8-percent brand trust. Subsequently, after costly product disposals and other brand support steps that cost in excess of $350 million, Nestlé has been able to begrudgingly rebuild its brand trust back to 88 percent, still sadly short of the esteem earlier enjoyed.

While Nestlé was unable, as described above, to make any early "withdrawals" when the Indian Maggi soup crisis hit to forestall reputational damage, they were able to largely build back their consumer trust in that important market. Moreover, in keeping with their posture as a "learning company", Nestlé has evidenced more recently growing skills in confronting early any attempts by others to deplete its bank of goodwill as well evidenced by an article that recently appeared that deflected "potentially" bad news impacting Nestlé's investment in a biotech company whose product failed to meet regulatory approval and whose share price collapsed thereafter.

In the face of similar, potentially troubling press, Nestlé was able to deflect the effect of this isolated incident by dipping into its bank of goodwill and responding directly to the press about how that adverse experience was acceptable in the broader context of a company that has developed ongoing extensive efforts to harness the power of health and wellness across its extraordinarily broad portfolio. Clearly, Nestlé bumped up against specific setbacks but they avoided the reputation costs by directly engaging with journalists and laying straight the record. Such skills sadly remain called upon regularly from firms like Nestlé who must counter claims that potentially could impact goodwill with direct and honest answers and engagement rather than retreat.