

## Episode 6: Nick Sleep on Habits | Brokerage Sweeps | Misjudgment

We are out with Episode 6 of *This Week in Intelligent Investing*, featuring Elliot Turner of RGA Investment Advisors, Phil Ordway of Anabatic Investment Partners, and Chris Bloomstran of Semper Augustus.

*Enjoy the conversation!*

In this episode, John hosts a discussion of:

- A Nick Sleep quote on habits [[source](#)]; led by Elliot Turner:

If Frank Capra is right that “*a hunch is creativity trying to tell you something*” then our hunch is that the growth rate in online retailing is held back by consumers’ psychological biases. We are all creatures of habit, and most of us give up comfort blankets quite reluctantly. It therefore takes time for a new regime to be adopted and, for instance, to buy books online instead of buying them at the local store. Perhaps then, after we have become comfortable with buying books online, we may experiment with something else, trainers say, or magazine subscriptions, or plant pots, or bike saddles or grocery. The process requires a good retail experience (price, convenience, selection etc.), the building of trust, and is often fanned with personal recommendations (social proof) and even bragging rights for the early adopters. The process is more of a drift than epiphany. Our hunch is that the growth rate in online retailing is regulated, not by physical capacity, although that can be a limiting factor, but more by the rate at which our own incumbent habits and associations are replaced with more rational behaviour.

- Brokerage sweep options and how they have changed to the detriment of the small investor; led by Chris Bloomstran
- An update on Charlie Munger’s *The Psychology of Human Misjudgment* [[audio](#), [transcript](#)]; led by Phil Ordway [[related series](#)]

*The following transcript has been created by MOI Global. It has been edited slightly for clarity but may contain errors.*

**John Mihajevic:** Welcome to another episode of This Week in Intelligent Investing. The crew is back together this week, with Elliot Turner, Chris Bloomstran, and Phil Ordway all joining us. Elliot, you have an interesting quote you wanted to read and have it serve as our discussion starter, so please go ahead.

**Elliot Turner:** Great job last week holding the fort while we were gone. The interview with Larry Cunningham was fascinating.

I wanted to launch into a conversation around a quote from Nick Sleep's letter collection that I was introduced to and find extremely interesting and timely. These are some themes I've been intrigued by for quite a while and invested around some of them though I had never been familiar with this quote. It hit me as quite stark and something I wished I'd been exposed to earlier. It's a framework I wish I had thought about sooner.

The quote goes like this, "If Frank Capra is right that a hunch is creativity trying to tell you something, then our hunch is that the growth rate in online retailing is held back by consumers' psychological biases. We are all creatures of habit, and most of us give up comfort blankets quite reluctantly. It therefore takes time for a new regime to be adopted, and, for instance, to buy books online instead of buying them at the local store. Perhaps then, after we have become comfortable with buying books online, we may experiment with something else - trainers, say, or magazine subscriptions, or plant pots, or bike saddles, or grocery. The process requires a good retail experience, price convenience selection, the building of trust, and is often fanned with personal recommendations, social proof, and even bragging rights for the early adopters. The process is more of a drift than epiphany. Our hunch is that the growth rate in online retailing is regulated not by physical capacity - although that can be a limiting factor - but more by the rate at which our own incumbent habits and associations are replaced with more rational behavior."

This was Nick Sleep writing about his investment in Amazon in the mid-2000. He was early to understand the power of Amazon, the opportunity to change consumer behavior and extend the core business well beyond where it started in books. He stuck through with that investment for over a decade, generating phenomenal returns along the way.

Why is this relevant and interesting today? Well, if the limiting factor was not physical capacity but rather our behavior, COVID and the corresponding lockdowns have been the ultimate catalyst to change our behavior by necessity. It doesn't even take a better experience. It was effectively a mandate that we experiment and try new kinds of shopping. I think many people have become less reluctant to buy things online over the past few years, but the acceleration has been phenomenal since COVID. Even within the online world, Amazon has done a great job of shaping our behavior to buy things on its platform, but more recently, Amazon hit physical capacity limitations on what it was able to deliver on. I found myself ordering a whole lot more from whether it be Walmart for household consumables or Dick's Sporting Goods, where we got rollerblades for the little ones and hockey sticks. I truly broadened my scope there.

I've been researching many companies. On the one hand, some are COVID beneficiaries, but the change they're experiencing won't be enduring. It's a one-time boost. However, because of these behavior changes, I think there are many companies where the change will be permanent. These companies have acquired customers who will be really high-value for a very long time. I wanted to open this up for discussion and see how this quote resonates with you guys, what you think right now, and how you think about the general transition of the world from physical to digital.

**Phil Ordway:** I think it's absolutely spot on. If you look at the postal service, at least in the US, there is chaos there but also still a vast amount of first-class mail. If you had told people 20 years ago how everything online would explode, they would have assumed the postal service would barely exist. Instead, while it's clearly declined, it remains massive because

many people, myself included, still use paper mail for certain things. Those habits die very slowly. It's a comfort or an ingrained habit. It's like the old saying about progress in physics or the hard sciences, progressing one funeral at a time. I think the same applies here.

**Chris Bloomstran:** My observation is the rapidity and speed at which disruption is taking place, and this disruption by COVID exacerbates it. Changes that were going to evolve over a three-, four-, or five-year period of time are being compressed into a 6-month to a 12-month horizon. I spent a career watching disruption. In the early days, you saw the downtown department stores, the Woolworths and the Sears, morph to where mom-and-pop stores were ultimately replaced by Walmart, and then Walmart itself was displaced by Amazon. These things happened over decades and then years, and now you see disruption in a whole bunch of industries happening in nanoseconds. You've got big manufacturers and companies trying to figure out and solve the distribution riddle.

Nike, for example, which we own a little of, has done a great job selling direct to its customers. It has realized that bricks-and-mortar retail is still its primary distribution network, but you won't find Nike's product on Amazon. It has got enough scale to do this. You have other retailers that will lean on Shopify in trying to solve payment systems. However, it's remarkable to see the change and the degree to which companies are penalized for being behind the curve or rewarded for getting ahead of the curve, certainly in terms of market share, but also in terms of market prices for the publicly traded companies.

We've got position in luxury good company Richemont, a wonderful business run by the Rupert family and headquartered in Switzerland. In jewelry, it has Cartier and Van Cleef & Arpels. It has got a bunch of high-end watch brands, Vacheron Constantin at the highest. Over the last two or three years, it has been trying to solve distribution. If you're selling luxury goods, the last thing you want to see is your goods sold in the gray market at a discount. If somebody comes into one of your stores and buys a watch for \$50,000, you don't want to see that watch sold online two weeks later for \$30,000. Maintaining control of distribution and brand is such an important thing. In the most recent period, the company's sales were off 50% because it is still store-based, and the Chinese aren't traveling. It owns Watchfinder and has Yoox Net-à-Porter, with plans in place to increase online distribution and the whole process of shopping.

If you're a Chinese shopper, you love the concept of traveling to London, Paris, New York, Hong Kong, or Macau and not buying your goods in China. The Chinese shopper will tell you that just the level of customer service is greater when you get out of China. The awareness and history of the brands are greater with the sales representatives. If we're not traveling, sales are still taking place. If you want to go shopping and learn about a Vacheron watch, you better have a great website and be as shoppable on it as with walking into the New York store. The conclusion I draw is that change is happening faster than I ever would have thought, and it makes our jobs as investors much more difficult.

**Mihaljevic:** I'm curious how you guys think this quote would apply today because in the e-commerce area, we've gotten comfortable with online shopping. However, I go back to a quote I think by Jim Chanos back in the day when Blockbuster was still fighting Netflix, and he said anything that can be digitized will be digitized. Do you think that if you applied the Nick Sleep quote broadly today, it could apply to financial services? Ultimately, banking is digital. It's a commodity. If you have a great financial or banking app on your phone, like Revolut out of the UK, why would an average consumer care 10 years from now what bank is behind that app? If it is super convenient and gives them what they want, why wouldn't deposits get sucked up from the brick-and-mortar banks we know today into those apps? What would that

mean for the banking system?

**Ordway:** I'll take that one because I've spent a lot of time thinking about it as we've owned banks over the years. You're largely correct, and you can look to Ally Financial in the US as an example of that. In its GMAC prior life, it didn't have the best name or reputation. It slapped a new androgynous label on it, and the online banking product there has been wildly successful. You've seen other companies try to take that on and copy it, and they'll probably be largely successful. To answer part of your question, I don't know that you could completely ignore who's behind it. Ally has also executed reasonably well and hasn't had any big failures. You have to earn and keep that trust. It certainly was somebody's money, so it won't be sufficient to just have a good user interface. Still, I think your point stands that a commodity business could be even more commodified, and you'll also see the continued digitization of it.

I guess the limiting factor on it would be that there are still some transactions where you want face-to-face interactions, but I think you'll see that approach the asymptote of very, very few. It gets down to some finer points about rural versus urban and where that can be taken to the extremes, but certainly fewer physical branches, brick-and-mortar, fewer in-person transactions. If you'd told somebody 20 years ago about the changes we've seen in digital banking, whether it's the iPhone or even cryptocurrencies, everyone would have assumed there'd be no such thing as a physical bank branch, a bank teller, or even an ATM, let alone physical currency. You still have all that in spades. Physical currency is still very much a part of our economy. In fact, there's a shortage right now in the United States of coins in circulation, and even some physical denominations, like the \$100 bill, have been increasing at a rate ahead of GDP growth for the last several years.

I would say that so long as we have physical currency and this broad suite of services handled by financial institutions and banks, whatever level of activity that is as a share of the overall economic picture will be the limiting factor as to how far you can go on digitizing all that. This means you have a massive runway in front of you, and I certainly agree with the overall direction where that's headed.

**Turner:** I want to chime in on this too because it's something I've thought about a lot. I've presented PayPal twice at MOI conferences. It's an area we've invested a lot behind, strongly compelled by the thesis in general. When he first became PayPal's CEO, Dan Schulman laid out this vision that you can look for areas in financial services in particular where fees are especially high. You use the scale and power of technology to spread those fees over a much larger customer base and drive down fees in all those areas and lead the commodification of some of these processes.

Interestingly, until more recently, I felt that PayPal had underdelivered on his vision and promise, and it was Square that came in building a digital wallet with the cash app and layering on direct deposit, which tied to its payroll services, portfolio capabilities that started with Bitcoin, then stocks, then fractional share purchases of stocks, and getting deeper into every layer of banking and creating effectively a bank account. With COVID, both companies have accelerated meaningfully. They've got far more engagement from their customer base on the payment side and more traction with layering on these extra services. There's no industry totally immune to the forces of technology here. I've seen some banks lead better efforts than others, but it's interesting to think about how both sides could converge towards this almost utopian vision of everything working through your phone. It's extremely powerful.

I think PayPal has recently understood how effective Square has been on this front and

realized it needed to step up its own efforts. It's doing more proactive things and using Venmo too as a platform to be a little more experimental and take advantage of the higher engagement younger generations have in the payment space, to use a little more of a white space and blank canvas to try out and see what it could pull away from the traditional banking industry. To bring it back to e-commerce, I don't think you could have gotten as much trust and traction there without something like PayPal and had this step change we're experiencing today. Who wants to type in a random site and give it their payment credentials, leaving them flying around everywhere on the internet when sites could get hacked? Centralizing it is a way to place your trust in one place whose core essence is about protecting that trust, so I think it's an extremely important area.

**Bloomstran:** The banks were probably a decade late in the notion that you did not need a physical branch bank network to attract deposits. At the peak, in 2008 or 2009, there would have been 85,000 or 90,000 branches in the United States. That's probably down by 10,000 or 15,000 branch units since then. To me, the runway is still really long. You've got so much more business that rides on the MasterCard and Visa network regardless of what the front end of that looks like, and an enormous amount of business activity is still done internationally in cash. We're only in the early innings of the trend toward digitization.

What's going to be interesting is if we run into problems with the acceptance of fiat currency given the level of debt in society. I can't recall the last time I was in a branch of a bank and the last time I used cash for any transaction. I've lived on the credit card, paid monthly, and live on the reward points that come with the Costco card and the various other cards I carry. I try to maximize where I'm eating at restaurants and where I'm getting gas for the 5% back, the 4% back, and the 1% back. To me, it's a long runway, but with one caveat. I think we're going to have issues with fiat currency at some point in my lifetime. What happens on that front with digitization? Do you get a big pause and a sudden demand for currency? That's a point out on the stratosphere.

**Turner:** I wonder what you guys think of how sustainable some of this acceleration in e-com is. Do you view this as a "permanently high plateau" - to use that old and wrong quote of Fisher's - from which we're going to grow in e-commerce? Or do you think some of this behavior will revert back to more traditional channels? How do you think that breaks down by industry or subsector of commerce?

**Ordway:** The vast majority of it will stick, in my view. For all intents and purposes, it is a permanently high plateau. Changes that were coming in the future were pulled forward to now. You give some of it back here and there, but the overall trajectory was inarguably higher over time, and this pulled it all forward. Even if you have a little dip, the overall direction is still enormously positive. The second part of the question is maybe the more important one and much harder to answer. Who are the winners and losers in there? One framework I've been using to diagnose that is the convenience factor. It's part of why Amazon has prospered so much, and probably the one and only drawback I have, personally, in considering something like Costco is that most people dislike going shopping. I'm certainly one of those people. If it's something you dislike doing that you've now stopped doing physically and started doing digitally, that'll probably be the stickiest area.

**Bloomstran:** To me, we're very early in the game still, certainly for the broad swath of retail. I'll go back to my Richemont example. If you're a customer in the market for a \$100,000 piece of jewelry from Cartier or Van Cleef or a watch at the same price point, you've got to have your online distribution. You've got to have your website where the consumer can do essentially all of the shopping, but there are places where you're simply not going to get

away from the retail experience. I don't see the highest of the high end of luxury being purchased online anytime soon. There are nuances, but if you're a baseline retailer in the malls of America, you've got a pretty limited shelf life, and you've taken the disruption that was going to take place over the next 5 to 10 years and compressed it into a very short period of time. A lot of brick-and-mortars will be gone when we deal with the over-leveraged, over-leased, over-built square footage, certainly in retail. In the next year or two, especially when the Fed tries to extricate itself from the system and begins removing liquidity supports if it can, we're in for long drawn-out credit workout, and a lot of that's concentrated in retail for sure.

**Turner:** Morgan Stanley does an annual survey of its interns at the end of the summer on emerging trends to see what is and isn't getting traction. One thing I found especially interesting is that people still have a predisposition to shop at brick-and-mortar. Off the top of my head, it was something like 65% of interns preferred to buy apparel in store, which makes sense for this product category, but for just about everything else, it does feel like this is a meaningful change. People are far more willing to try things online, to try subscriptions, or to take direct deposit in an app. It's hard to think about how we go back, but then I wonder what this means for the amount of physical infrastructure we have dedicated to the real world. How do you transform things from here? How much investment and loss will there be along the way? Have you guys thought about that?

**Ordway:** I would say I've been thinking about it to the extent that I know enough to be terrified. I mean, I don't short anything, and it's certainly not an area where I would spend much time bargain-hunting. It's going to be so hard to do a lot in that space. There's room probably for a few experts to go bottom fishing and find some baby-thrown-out-with-the-bathwater opportunities, but I agree there's going to be a massive reshuffling of physical infrastructure in that world. You see it every day driving down the street with the number of new distribution and warehouse facilities, strip malls, movie theaters, and physical retail of all kind being emptied and transformed in real time. In my opinion, it's going to continue almost unabated for years.

**Bloomstran:** My daughter, who is 19 years old, never sets foot in a retail store when it comes to buying clothes. She'll use Stitch Fix or one of several other platforms, buy four dresses, try them on, and send three back at no cost. This younger generation will increasingly not set foot in retail spaces. On the other hand, there's no displacement of the Costcos and the Dollar Generals of the world. It's nuanced, but the younger you are, the less you'll lean on ever leaving the house to shop for a lot of your base consumer goods.

**Mihaljevic:** One other point Isaac Schwartz of Robotti & Company made at Idea Week was that you're still going to have spaces that consumers go to, but they're not going to be the kinds of stores you see today. They're going to be more about experience and building the brand, so instead of having a small Nike store in every mall to sell shoes or apparel, you might get in one huge mall or one huge space, like a full-sized basketball court, where Nike is just branding. It's about what it wants the brand to mean in people's minds, but all of the actual transacting will take place online.

**Turner:** Isaac's presentation was fascinating. Going from there to what it would look like for grocery delivery and the three different ways you could approach that, he'd be an interesting person to talk to about some of these things, but that's another area.

Just today, we got a delivery from a farm share service we use. Formerly, what they would do is they worked with our daycare, Bright Horizons, and they had a daily drop-off. We'd have to

get our order in by Sunday night, and every Wednesday, when we'd pick up our daughters from Bright Horizons, the box would be there. With COVID, they did a test run in a few zip codes, delivering their product to houses directly. It's taken off so much that they've started growing their entire offering and have built a much better website. They have also started using direct mail flyers. Interestingly, I keep hearing from e-com companies that direct mail flyers are one of the best returns on ad spend you could get.

**Ordway:** They do still work. It's amazing.

**Turner:** Yes, phenomenally well. They are papering the whole neighborhood with these direct mail flyers, and I hear more and more people are converting. I can only imagine what the unit economics of something like that would look like. That was a business I don't think they could have tried to pursue before, but the change happened so fast, and the surplus earnings were so extreme early on that, as I understand, they were able to invest in it and finance it themselves without bringing on anyone else. It's really interesting to think about this stuff.

**Ordway:** One other point I'd make is the concept of reward points. It's a scenario I've spent a lot of time thinking about, not only because I have the same Costco card you do, Chris. I love Costco as much as anybody, and that is a great way to organize your spending although I still use cash occasionally and make maybe one or two bank visits a year. Reward points have been around forever. The concept of getting a reward is ancient, and it's a classic marketing ploy. You look at one area that, in my opinion, is still ripe to be changed, and it's maybe this one because whether it's legislation and regulatory change on the interchange fee level... I mean, it's what the reward points are doing, right? They're trying to encourage you to spend more money in a certain channel so that the various parties involved can stop the interchange fees and keep it away from everybody else, giving you back a tiny sliver of that. It's an enormously inefficient system.

Now, it comes with lots of benefits, and I'm not dismissive of those benefits. Maybe at the very top of that list is how much trust and protection is built into the system. If you use cash, that has a lot of benefits, too. I'm still quite skeptical of the overall worth of cryptocurrencies as a store of value and a medium of transaction, and cash and credit cards both have their places in that. However, if you look at the way the credit card system is set up today, you have zero interest rates and all-time high APRs on balances. Without that, the credit card companies have a hard time making it work. This predates even the current crisis. What opened my eyes to this was when Costco came to the forefront and kicked out American Express after a couple of decades, giving all that business to Citibank and Visa at basically a 0% margin to them on the Costco piece as a merchant. Then, because the rest of the charge volume that comes on the Costco card is so valuable to Citi and Visa, they were willing to take that hit, and it made all the sense for Citi and Visa to do it. It strikes me as an area where it's not going to change tomorrow. I don't think it's going to change this year or maybe even this decade, but the longer it goes on, the more you have to be at least somewhat cognizant of the risk for change.

**Mihaljevic:** One other thought on how the Nick Sleep quote might apply today, and I'm curious if you guys have a view on this. I've been thinking about areas where it's hard to imagine a much greater adoption, but it might go that way. One area I see is gaming and in-app purchases. Some years ago, I thought it was the dumbest thing to exchange real cash for fake cash within a game. Now, however, I see my kids would rather get in-app purchases versus real toys. That's one area where, with some imagination, you could see people consuming a lot more digital goods through gaming than real goods because those games

end up being the new malls where the kids or teenagers hang out, and they want to be seen as doing really well in those spaces. Do you have a take on that?

**Turner:** I also find that interesting. It's something I've been following from afar but trying to pull myself closer to as time goes on. It's been fascinating to see the willingness of people to engage. It's something I view as ephemeral on the surface, but then you get to thinking about how younger generations are more into experiential spend and how you want to be authentic and forge a unique personality online. Some of these alternate realities are like an escape and an immersion at the same time. It's something you keep seeing happen in more and more forums in the gaming world.

We have a position in Nintendo, and I've been watching Animal Crossing and seeing the ways that different companies are trying to engage there, too. There's an opportunity on both sides of things, for gaming companies, for payment companies, and for traditional brick-and-mortar companies to push their identity online too and shape their own unique persona for each of these areas. I think it will continue to happen, and there's no going back from something like this. Obviously, engagement levels are going to be much higher during stay-at-home orders, but the behavior is both addicting and compelling. I think that's indeed something to follow.

**Bloomstran:** I'm probably the wrong guy to ask this question of, John, because when my wife and I walk the dog, we've got a tremendous problem in that I never see kids at the elementary school or the middle school basketball court, the baseball diamond, or the soccer field unless they're playing an organized activity with an organized coach. I'll leave my comment at that.

**Mihaljevic:** Let's switch gears and go to you, Chris, for your topic today.

**Bloomstran:** I was going to talk about an observation of the evolution of the classic money market fund within the brokerage environment. Given that Dow Jones, in all its infinite wisdom, is out with a series of changes to the venerable Dow Jones Industrial Average, I thought it'd be fun to have a couple of quick observations. I hadn't intended to mention this, but a friend of mine asked me yesterday, "When did Intel and Microsoft go in the index?" It turns out in November 1999, Intel and Microsoft were put in at the same time Home Depot and Southwestern Bell went in. Home Depot was flat to down until 2012. Microsoft was a negative return for 15 years. Intel was a negative return for a long time. SPC, now AT&T, is probably negative since 1999. Coming out of the index at that time was Chevron. It's quite interesting that Exxon is now being yanked out, Chevron being the last of the energy businesses.

The energy component in the index is very low. You can make the same case at some level for the S&P 500, which I've spent a lot more time analyzing over the years, especially in the context of passive flows and the pervasive outperformance in the last decade. It's interesting that Chevron was pulled out of the index at the same time Intel and Microsoft went in, and the stock damn near immediately doubled. It came out late 1999, which was a brutal energy bear market, not unlike today's. Oil traded down to \$10 a barrel, and the world thought it was going to \$5. They pulled Chevron out, but they put it back in in February of 2008, so it spent eight years in the penalty box. They put it back in damn near the all-time high, and it proceeded to drop 40% or 50%. The history of when they're moving in and out is really odd and interesting. AIG went in in April of 2004 and essentially failed four years later, going into receivership. Bank of America went in in February of 2008 and came out in September of 2013.

I spend zero time thinking about the Dow in that running a price-weighted index still makes no sense. We talked about the stock splits at Apple and Tesla over the last handful of episodes. It's interesting to look at the three companies going in (Salesforce, Amgen, and Honeywell) versus the three coming out (Exxon, Pfizer, and Raytheon). Salesforce, Amgen and Honeywell are all \$100, \$200-plus stocks. Pfizer is \$38 or \$39. Exxon's at \$40 per share, and Raytheon is something like \$60-\$65. Putting Apple in in 2015 was probably the best move the people at Dow Jones made. The stock is probably up 3x or 4x since then. AT&T is the one that came out at that time. Since it's still a price-weighted index, I wonder whether the impact of Apple on it will now be diminished greatly because of the stock splitting. Were they trying to replace more of a high flier with Salesforce at \$270 a share, albeit trading at 10x sales? I wonder how much of that was predicated on the Apple split.

The timing of Exxon is amazing to me. It's the longest tenured member of the S&P. We own the stock. The company has got some capital allocation issues. I'm sitting here watching the decline in the virus. Hopefully, we get the economy back running and the kids back in school. The number of miles driven, and the use of energy ought to recover when we start to lean back on industrial production. I wonder if they're not making the same type of decisions they made in November 1999, yanking energy out at the very lows of the industry and putting in some tech-type high fliers at what winds up being the peak. We can circle back on that, but I thought it would be fun, and maybe we can have some thoughts on that.

However, I wanted to talk about another observation. Having been an investor for 30 years and having used as our custodians and brokers myriad firms, it bothers me what happened in the financial crisis in that when we all had our brokerage accounts, be they retail or institutional, classically, you would sweep your cash deposits, your dividends into money market funds. For a long time, the fees in those funds averaged about 50 basis points. You had different share classes, some more retail-oriented funds, and if you had smaller deposit balances, your fees could trend up toward 100-plus basis points, which is insane to run a money fund.

You get to the financial crisis, and we took interest rates to zero, and all of a sudden, with T-bill rates at nothing, the government fund had no yield. Yet, you were the manager or sponsor of a fund, and you were theoretically supposed to be collecting 50 basis points. If you had collected 50 basis points on, let's say, a 10-basis-point top line yield, the underlying return to your investor would have been negative 40 basis points, so you wound up with wholesale subsidies of the fund complex. At a point, all of these brokerage firms, from the discount to the mainline Wall Street brokers, all of a sudden flipped to where they mandated that that money would sweep into a bank.

Schwab started a bank. TD was obviously a bank. The big money centers all have banks, so now you don't even have an option. You're compelled to sweep into a bank where you've got \$250,000 FDIC limits. In today's world, you have zero interest rates, 0% to 2.5% on Fed funds, and T-bill rates are single digit, 18 or 19 basis points a couple of weeks ago. So, you're sitting here on a bank sweep to the extent you've had any yield in the last five years. You go back two years ago when we have real interest rates and T-bills were 2.5%, Schwab, for example, had a net interest margin of almost 2.5% at the peak in the first quarter of 2019. The depositor, the retail brokerage client earned very little of that. Schwab would buy bills and the agency securities, short paper, and it would effectively run the difference. If you had the old classic money market fund structure with a 50-basis-point fee, and you were earning 2.5 points on T-bills, let's say, the investor would have had a 2% spread.

The problem I have with the whole structure is that I find it entirely immoral. The Fed has said

it will keep short rates at zero for five years, but my bet would be infinitely longer than five. Given the level of debt we have in our system, I don't think it can bear a normalized yield curve, anything remotely close to what we would have experienced at past points in our career. It's interesting. All these discount brokers and even the main lines have cut their commissions to effectively zero. Fees on the money funds are now anywhere from 11 basis points to above 100 basis points, which is incredible. They're all under waivers today because you can't charge a big management fee to run a money fund when your investment universe is lower yields.

It was odd. Right around the time when Schwab merged with TD, they cut their commission rates to zero. Thus, you've got zero commissions on common stocks. At most of these places, you pay \$0.65 per option contract. They make money on margin to the extent investors are leaning on margin, and those rates range across the universe of these brokers from 4% to 9.5%. You wind up paying progressively less interest on margin debt the larger the margin balance. You get up to \$500,000 or \$1 million, your margin rate starts pushing down to anywhere from 4% to 6%, depending on the house you're dealing with.

I'm sitting here thinking about my business. We have a number of clients that use Schwab as their custodian and broker. We're not paying commissions. We don't run accounts on margin. We started thinking, "How the hell do these guys make money?" A couple weeks of ago, we talked about payment for order flow, which is still substantial. Schwab's CFO effectively said, "Wink-wink, we still get paid plenty for selling order flow." All of these guys do. I worked out what the terms had evolved to in terms of fees on money funds. I looked at Schwab, TD, Fidelity, E-Trade, Interactive Brokers, Robinhood and Vanguard. The gem that leaps out at me is Vanguard. I wouldn't want to do a commercial for it, and we don't do any business with Vanguard at present, but it doesn't sell order flow. You can still sweep to its federal money market fund, which has a modest 11-basis-point management fee, being waived today because T-bill rates are lower.

Typically, across the complex of Vanguard's money funds, you've got 1- to 12-basis-point yields, so you've still got some positive yield as a depositor. The problem I have is that if you're the unwitting retail investor, you're being compelled to sweep to a money fund. If you're for a larger investor, you need to be very careful about account titling. Husband and wife, for instance, can pool, and if you get the account titling right, you can get up to \$500,000 protection. If you get your kids titled right, you can exceed the FDIC thresholds. However, retail investors are going to lay around any level of cash, and most of these folks are unwitting.

If you're a retail investor, and you're being swept into a money fund, today may not be the time to worry about it. I would say you can go out and buy T-bills, which we do. We're up every morning with our clients to the extent we have client cash. We're not into paying fees and money market funds. We're certainly not into letting the house keep the net interest margin spread when I can go buy the same securities they're going to buy, but if we ever evolve back to the point where we have real interest rates, it's incumbent upon investors to realize that we're being robbed of our savings with what are going to be very low interest rates for a very long time. I think even the Fed and central banks are going to push on the long end of the curve to the extent the Fed can lengthen the Treasury's borrowing. We'll be buying a lot more long-dated paper. At some level, I think the whole evolution of the brokerage and money industry has been fairly immoral, and it bothers me to no end that the day we were compelled to sweep to a bank, we had no option and now physically have to go out and make a trade to physically buy a money market fund or a T-bill.

I'm not sure how many of the young folks investing on Robinhood's platform realize the degree to which Robinhood makes incredibly rich margins on payment for order flow. Its order flow business payments are 10x what a Schwab or what a TD would collect. It's not insignificant. It's 2% or 3% of Schwab's revenues, but it's over half of Robinhood's revenues. There are a lot of hidden costs and burdens. When you think you've got zero commissions, and the cost of trading is free, it's not free. The wholesale brokers - the Citadels, the Virtuses, the Wolverines - are effectively making the bid-ask spread. If you go back to pre-decimalization, when stocks traded in eighths and quarters, the whole concept of moving to a decimalized platform was to lower bid-ask spreads. If you look at the dollar revenues the discount brokers were raking in from payment for order flow, they were up 40%, 50%, 100%, or 300% year-on-year versus 2019. Some of that's down to the increase in the absolute number of brokerage accounts and the number of individual retail investors that are trading, which is one of the byproducts of the COVID downturn. We wound up subsidizing unemployed households, paying them more to not work than when they were working, so a lot of that incremental cash has found its way into the Robinhood world. To me, though, it's a "buyer beware" world. These guys are shaving pennies and nickels, and when you add it up, it's not an insignificant sum.

I don't think enough investors come into their capital-oriented investment processes with a genuine understanding that if you buy a good business and own it for a long time and you keep all of these frictional costs...A lot of those used to be way more above-board and transparent. Back in the day, we'd pay Schwab \$39 per trade plus X number of cents per commission. Now it's zero, but I guarantee you its payment for order flow is a lot higher. Despite these massive flows into the stock market, I would bet you that bid-ask spreads are even higher today. There are a lot of unseen costs that absolutely eat away from return. If you're manically turning over your portfolio and buying and selling and buying and selling, you're doing yourself a great disservice. If you're a long-term investor who is going to buy mutual funds or a Berkshire Hathaway and sit on it for a long time, you still have to be careful of your bank sweeps. You've got to be aware that you're sitting in a bank now, not in a money market fund.

This is a thing that's bothered me, and I thought the retail world that might be listening could benefit from the notion of what's happened evolutionary over the last two or three decades.

**Ordway:** I want to take it in part because I think there are so many pieces of that. I agree with the overall direction for sure although I'll push back and play devil's advocate on a few pieces of it. Isn't it true with almost every broker that you can, in fact, opt out of the mandatory sweep? I know it's true at Interactive, and I'm almost positive it's true at Schwab

**Bloomstran:** Interactive partners with banks. We've got a couple of clients that use Interactive.

**Ordway:** Yes, I use them, and you can opt out for sure.

**Bloomstran:** You can at Schwab.

**Ordway:** You can opt out.

**Bloomstran:** No, you are compelled to sweep to Schwab's bank. You opt out by physically writing a trade ticket and buying its prime fund or its federal fund. You have to physically make a trade to move money out of the bank.

**Ordway:** Sure, but you still have the option though. You're compelled in that it's the default option, but you're not forced into it as the only option. I agree. It's not easy. It's the default option, but to your point, I think it gets down to what the right level of profitability is for the broker-dealers to take out of the system as the croupier. I'm a huge anti-advocate for high frequency trading in all of its forms, and I have somewhat of an issue with payment for order flow, which is a different issue. However, in this case where you've taken commissions down from almost prohibitively expensive to zero, the offset is that you're always going to have some portion of people hold a chunk of their brokerage accounts in cash. They've studied this over many years and many decades. It's been between 9% to 11%, almost without variation in all sorts of cycles. If that cash is just sitting there wasting away, and they can make money off of that instead of make money off of commissions, you can argue both sides of what's better for consumers, but to me, robbed or immoral is a bridge too far.

In terms of payment for order flow, that, to me, raises a whole different set of issues where I agree you don't have a choice of opting out of payment for order flow in most cases. It requires a whole other degree of sophistication and effort as opposed to writing an order ticket and taking some control of your own destiny rather than simply defaulting to the sweep option. Payment for order flow, which brings in much broader market level debates about what the right structure for trading should be, is a whole other issue. I do have a bit of a problem with that, but just saying, "We're sweeping you into our product rather than letting it just sit there," to me, if they were keeping that money and being anti-competitive with it, that would be one argument, but I don't think that's at all what's happening here.

**Bloomstran:** In today's world, it's less of an issue. I mean, Schwab's not out making a lot of commercial real estate loans. It's buying paper. At the point where that 9% to 11% frictional cash is just sitting in the retail account, you weren't making but a few basis points, 10, 20, or 30 basis points. Schwab was keeping the preponderance of that spread. To me, if you've gone from a world where if you had absolute yields, you were entitled to some of that return, they've just made it more difficult for the client to earn what would be a proper rate of return on the cash. I get why compelling into a bank was done — they were absolutely subsidizing their money fund complexes — but buyer beware, and if we ever get back to the point where we have real interest rates, it matters a lot.

Another word of caution. There are still money funds that have absolute yields, but if you can earn 10 or 15 basis points on a federal fund versus a prime, why would you take the credit risk if you're going to wind up with the exact same yield simply buying T-bills or a government fund? The average money market fee now is about one basis point. If you're going to earn one basis point in a federal fund versus a prime, why take the credit risk?

**Turner:** I've grappled with this question. I had a position in Schwab for some time, sold it earlier this year. It was several years old for us, four plus. I was struggling with the idea that the company's mission statement is to champion every client's goal with passion and integrity, empowering them to take ownership of their financial future at every income level and life stage. Historically, the beauty of Schwab is that it has been disruptive to the industry, driving costs lower and truly empowering consumers. I view that as a conflict with its goal of the default election being much lower yield than clients otherwise would get.

I have a strong opinion on payment for order flow. I think it's great and one of the best things to ever happen for the typical small investor out there. Spreads are so small that you won't even ever see a difference. Effectively, when you put in an order, you're getting that price if you're a small investor, and that's phenomenal. Whether you're right or wrong on the investment won't have anything to do with the slippage that you experience by someone

acquiring that order flow, but you would feel the impact of a \$50,000 account paying \$9.99-plus for every trade. That was truly great, in my opinion, but it's hard to reconcile the two, especially from an advisor's perspective where we have a fiduciary responsibility to pursue our client's best interest.

We don't use Schwab. We use TD and Interactive Brokers. They do give you some better selections so you could choose some better options besides the default, but yes, all of this is out the window now that we're back to zero. I thought about this so much for so many years, and then here we are back at zero.

**Bloomstran:** I'd be curious if spreads have indeed come down. I grew up in a world of ace and quarters. I watched the bid-ask when we trade today. We're not very active traders, so a lot of this discussion doesn't impact our clients to the same degree. Our average turnover has been 15% or thereabouts for the last 21-22 years running Semper. But if I take the other side of a trade, I wonder if market liquidity isn't lower than it was prior to the move to decimalization. Citadel is a market-maker acting as a high frequency trader — seeing my order before it's placed on the floor of the exchange, there are a lot of ways around it. You've got to be pretty sophisticated to get around it. I'm sure there's good empirical academic research that would give us this answer, but my sense is market liquidity is lower, and bid-ask spreads are wider, but I could be 100% wrong on that.

**Ordway:** Yes, the empirical evidence would show bid-asks are quite a bit narrower, but your question about liquidity is a good one because liquidity only matters if it's there when you need it, and that's not something you can always empirically test, certainly not in advance. I guess my stance on this is there's a lot of nuance in market structure questions like this. There's no black-and-white answer. I would probably fall somewhere in the middle. I don't think payment for order flow is an unambiguously good thing. In general, I don't think mandatory sweeps are a terrible thing or an entirely bad thing. There are benefits and costs on both sides of it.

In general, if I were running Schwab or Interactive Brokers, it would be a very difficult job to try to balance what was good for the business and what was ultimately the right thing to do for customers. If you do screw your customers, you will eventually pay the price. It may take years or even decades, but it is a tricky balance. As a broker, your incentives will always be to generate some level of activity from your customers that you can profit from. In most cases, it doesn't matter what it is — the more trading you do as a retail customer or even an institutional customer, the worse your returns are going to be, so there's always an inherent conflict. There's certainly an agent-principle problem between a broker-dealer or a salesperson at those institutions or even the CEO making these strategic decisions and what's best for their customers, and I don't think it is completely black and white in any regard.

**Turner:** On the spreads, I want to emphasize that my point was for the average retail investor spreads are much smaller. The more size you're moving, I think spreads are a little wider though it's been easier to find dark pool sources of liquidity and certain names. Phil, the point you made on the frequency with which the typical retail investor trades is really interesting, and it's something I've thought about a lot. As commissions go lower and lower, it's seemingly easier and more compelling to trade more frequently. Yet, the biggest advantages accrue to those who trade the least, in my view. If you're buy and hold and have a fairly small account, your barrier to buying a position that you want to sit on and capturing long-term returns is now a lot lower.

**Ordway:** Exactly, and that's a good example of the paradox. It used to be if the commission was so high that you were afraid or hesitant or wouldn't even make the initial investment, that's bad for you as the customer. As commissions have come down to zero, maybe that gating factor was removed, so you're trading more frequently and acting against your own best interest. It's a tough circle.

**Bloomstran:** In the early days, when I was a kid with my first brokerage accounts, paying \$60 plus \$0.10 or \$0.12 per share or a percentage of the order, I learned very quickly you had to think long and hard about whether you're going to transact. You had to be committed to the position you were going to buy because if you weren't playing around with a lot of dollars and paying \$60, you were shaving off huge percentages, and it would be mid-single, high-single digits. You'd be giving away half a year or one year's worth of expected return. I learned early on that the frictional costs are so high that you really have to be careful about activity. I think you guys are right. The flip side of that is there's no perceived cost to trading, so why not day-trade? Why not sit in front of your computer and buy and sell? I think a lot of returns are being squandered by manic activity.

**Mihaljevic:** Let's move on to our third topic of the day. Phil, you wanted to update in some way the talk you gave at the Zurich Project a few years ago on the psychology of human misjudgment.

**Ordway:** Thanks, John. Most of you are hopefully familiar with Charlie Munger's famous talk, given more than 25 years ago. It's one of the most thought-provoking and impactful things you could ever listen to or read. For John's conference in Zurich in 2017, I thought it would be interesting to take some of the examples he used in "The Psychology of Human Misjudgment" that were by then quite outdated and try to update them. It's become a habit or an ongoing thing to make a collection of these examples because it helps drive home the principles. There are 20-something principles, some of which overlap and some of which have been expanded upon by psychologists and businesspeople since then, but it's a fascinating thing to walk through. I thought that occasionally, as things pop up and catch my attention, I would take the opportunity to highlight those individual concepts because it's such a great way to learn them over time.

The first one is the power of incentives and how absolutely crucial it is in driving all sorts of business behavior. In the original case, Charlie Munger talked about how when FedEx was trying to get up and running with its centralized sorting facility in Memphis every night, it couldn't find a way to get the thing to work, so it was trying to browbeat or incentivize its employees to get all the packages shipped and sent back out in one shift overnight. What finally flipped the switch was instead of paying people by the hour, the company paid them by the shift so that if they were not done by four or five or six in the morning, they had to stay and keep working for the same pay rather than getting more pay. The examples I used in 2017 to update it were Wells Fargo and the scandal that has continued to drag the company down, whereby some quite bizarre and ultimately unprofitable and immaterial behavior driven by incentives to meet sales quotas at the retail level created a massive problem. Likewise at Valeant, where some interesting more corporate-level incentives created a huge scandal.

Today, probably the single most stark example I've seen since that talk emerged a couple of years ago is Boeing with the 737 MAX problem, where you just had a lollapalooza of effects come together. At the base of it, I think it was just an incentives problem. Airbus had come out with a new plane that was extremely successful and a direct threat to the 737, and the strong, clear, black-and-white incentive that Boeing had was to come out with an updated

rival product that did not require any additional training. I don't ascribe any malice, wrongdoing, or evil intent on Boeing's part at all. I think it was a genuine mistake and screw-up in a highly complex environment that was poorly handled and managed. At the very base of it, it was all about incentives. The company was just trying to get to market a product that required no additional training as quickly as possible. In doing so, all hell broke loose, and you can see the stark results of that.

Another one that ties back into our conversation last week with Larry Cunningham is around disclosure, investor relations practices. Look at GE and how low it has fallen in the regard of public markets. For many decades, GE put out very precise quarterly earnings per share guidance, which we would all hopefully agree is not an ideal metric to either track or guide to or incentivize to. Still, that was at the core of everything GE did. In my opinion, it was largely responsible for a lot of the financial mismanagement, even going back into Jack Welch's tenure, which really ruined the company. It again highlights how incentives may not seem like a big thing in a given day, week, year, or even decade, but over time, they can have absolutely disastrous results.

For me, other examples of it in that realm include adjusted earnings and adjusted metrics, where the very strong incentive you have is to report only numbers that flatter the company and allow you to sweep everything else under the rug, causing those problems to accumulate until disaster happens in a big way at the end. Likewise, stock-based compensation, something that continues to fester, continues to be this bizarre world where logic, reason, and common-sense accounting don't apply. If you're getting paid a lot of your comp in stock, your incentives are very strongly to do whatever it takes to get the stock to a certain level at a certain point in time, not to maximize the value of the company in the right direction over longer periods of time.

I thought I would start with that and throw it out there, and I hope to make this an open-ended discussion, and we can solicit ideas. I'm going to keep a running list for each topic we have. Hopefully, you guys can chime in with a few examples if you have any. As we go, I will update this document. I'm sure John can put the original document in the show notes. As we get more good examples that are current for 2020 and beyond, we'll update the document and share it publicly.

**Turner:** This is such a fascinating topic. All of us have had exposure to each of these conversations and examples that you shared. Wells Fargo and its incentives is one I've thought about a lot. Yet, the most important asset for banks is the trust of their customers. You would think their incentives go toward protecting that at all costs. How does that get lost along the way? Wells Fargo took a sterling reputation and ruined it quite fast. I don't know about Boeing. I'm not quite as sanguine on thinking about how its incentives played out there. I don't have direct exposure to the story, but I've read a lot about the culture and how it changed after the McDonnell Douglas acquisition. It was far more like a bottom line-oriented culture, so they cut their cost way to less investment and less care for some of the safety side of things. It's tough to wrap my head around. I'm sure I could come up with a few more, but these ones I've thought about a lot, and it's mind-blowing how it could happen with our blue chips.

**Ordway:** By the way, my point on Boeing is not to absolve the company in any way, shape, or form, likewise with Wells Fargo. If I could summarize it more succinctly, it would be that if you underweight the importance of incentives or get some seemingly minor thing wrong in creating the incentives within your organization, you probably won't notice it right away, but it will very likely end up playing a leading role in a major disaster at some point down the

road.

**Turner:** Such a strong point

**Bloomstran:** Phil, I'm glad you brought up the speech, which is a must-read. Over a number of years, Mr. Munger took three highly academic textbooks and boiled it all down to Phil's list of 20 or 25 thematical areas. You do a complete survey of psychology by reading a 27- or 28-page speech by Charlie. I scrolled through the list last night, and one that's always jumped out at me is his inconsistency of wins tendency, which is just anchoring, at bottom, the avoidance of change. So much corp and investment behavior is set in stone. I talked about Exxon in terms of being booted out of the Dow Jones Industrials. We own Exxon. I've got another investment position in a company called Olin, which is headquartered here in St. Louis. It's a very well-run chemical business that effectively picked up the chlor alkali, vinyl, and epoxy business from DowDuPont when they were merging and had to sell that business to avoid antitrust.

I've got two businesses that are very cyclical and suffering mightily from the downturn. In Exxon's case, very few of its diversified businesses, from refining to chemicals, have been performing well. A third drop in industrial production has harmed the business. Olin, with a lot of end markets with industrial uses, is thriving in pulp and paper, but other auto-related businesses are weak. The point is I'm sitting here with operationally and financially leveraged businesses in both cases and companies that are hitched to being dividend aristocrats, and they are not earning their dividend and their capex. In fact, on a GAAP basis, both are losing money for a period, and neither has come off the payment of its dividends. They've both got decades and decades of adhering to their dividend policy. It's crazy, and it goes to Charlie's inconsistency of wins tendency. It's this notion that "we've always paid it, we think our shareholders want it, they demand it." Well, these companies don't even know who their shareholders are. Their shareholders are ephemeral and fleeting. To me, if you're a cyclical business with both layers of leverage, you ought to have a dividend policy and a capital policy that matches the profitability of the cycle. It's abhorrent to have to borrow money to finance the dividend in the depths of a deep recession.

Aside from that, again, the speech is included in *Poor Charlie's Almanack*, which is probably one of the most useful tools to go through.

**Ordway:** Charlie Munger gave a big shout out in the book to Bob Cialdini's *Influence: The Psychology of Persuasion*, which had come out around the time the original talk was given. This speech was well before Kahneman and Tversky had come into the mainstream. They've done a lot of their pioneering work, but *Thinking, Fast and Slow* is still 20 years off at that point. I had the pleasure of getting Jason Zweig, the great Wall Street Journal reporter and author who helped Kahneman write *Thinking, Fast and Slow*, to comment on what I tried to do when I updated this in 2017. With his permission, I shared it in a paper I sent then, and I'll share his comments now. It says, "It seems clear to me that I've been wrong for many years in saying that the single greatest challenge for investors is to develop self-control. In fact, the single greatest challenge investors face is to see ourselves as we actually are. What makes Warren Buffett, and perhaps even more Charlie Munger, so remarkable is how honest they are about themselves with themselves."

Jason Zweig is phenomenal. I thought that was exceptionally well put on, and he said that off the cuff in an email to me, but these are the kind of thoughts he has. The more examples I can find of this, the more I can hammer it into my own head as to how these things matter, where I'm getting it wrong, and the mistakes I'm making in line with these principles because

they're just insidious, and they're everywhere you look once you start looking for them.

**Turner:** One of the ultimate examples that come to mind thinking from a portfolio manager and investment perspective are some of the early successful longs in Valeant on the way up, like ValueAct and Sequoia, which identified the right thesis but got wooed into an obsession and a love for the business. This blinded them to any problems even as those were coming out one after the other. That's one I definitely think about. It's one of those lessons better to learn by watching someone else than myself fall victim to, but it's definitely one of the things I think about a lot, too. You're predisposed to like something more that you own as it works, especially if it doesn't seemingly untether from certain core valuation metrics, but how dangerous can that be in certain cases? That's one I'd throw out there.

**Ordway:** I'll give you another one, and then I'll stop beating a dead horse. There was a story in the news the other day that I will try to criticize by category rather than by name. Anyone who's read it will know what I'm talking about. A somewhat prominent energy-related company filed for bankruptcy this summer, and in that company, the board had signed off on multimillion-dollar bonuses for the executives five days before the filing. When you peeled it back even further, there had been very aggressive intercompany sales and related party transactions with the CEO and some other insiders. It turned out that the three-person independent committee of board members signing off on these deals and bonuses was led by the CFO of the university from which the CEO had graduated and to which the CEO was a major donor — a pretty obvious incentive-driven conflict of interests, and it resulted in a pretty big disaster. It may not have any long-term repercussions for anyone involved. Unfortunately, you can get quite cynical in this regard, but it's an obvious case of incentives gone wrong. You could probably open up the Wall Street Journal on an almost daily or weekly basis and find stuff like that. It's fascinating.

**Mihaljevic:** Since we're talking incentives, I hear a lot these days about culture and its importance. It seems like incentives and culture are not the same thing, that sometimes maybe you cannot guide all action by incentives. How do you guys think about that dichotomy or how culture and incentives can complement each other to create a company that will do all the right things?

**Ordway:** That's a great question and something I wish we'd gotten to last week with Larry Cunningham about Constellation because it used cash where a big chunk of it has to be invested in the stock as a primary incentive tool rather than options, or rather than restricted stock grants. It's an interesting practice. It's not perfect, but it's an interesting one. I think you're exactly right. Incentives and culture are definitely not the same thing, and the best companies in the world, any of them that I've ever looked at, have a combination of the two, but they are distinct. Most companies have a culture whereby financial compensation and incentives are not the end all-be all. In my view, where financial compensation and incentives take an outsized role, you tend to get bad results. In most companies where truly great things and great progress happens over time, there's some element of culture where people feel like they're a part of a team serving a greater good, be that lowering the cost for their consumers or providing new avenues of growth and advancement for the economy and humanity. There's some sort of "we're all in this together" that is central to most great cultures at most great companies, and that is a separate question from incentives.

**Bloomstran:** I think you're right, Phil. Incentives and culture go absolutely hand in hand, and one can drive the other, but you never find great companies without both. If you spend enough time in proxy statements over the years, you see what works and what doesn't. If you're incentivized by asinine metrics - revenue growth, adjusted EBITDA, or things that

don't drill down to some level of return on equity, return on capital, or return on assets – it's just insane. Think about the current run-up in Tesla. Elon Musk's motivation is to get the stock price up, and that's it. He was awarded 20 million or so option shares a couple of years ago. They vest in increments of 12 tranches (I think), and it's largely driven by revenue growth but also by achieving some average level of market capitalization over 60-day rolling periods. You can do all kinds of crazy things that have no impact on long-term profitability but will very much drive Elon's pocketbook. You go through the gamut of businesses and unfortunately, the businesses that have great incentives and great cultures are few and far between. To your point, when I found them, they always tend to go hand in hand, and you don't have one without the other.

**Ordway:** Totally agree.

**Turner:** That's an interesting point on the Tesla situation too because you want management teams who are incented to do well for their company and a stock that follows. In theory, over the long term, a rising stock price is the reward for good results, but if you tie the incentive purely to stock price, that creates perverse incentives along the way. To find purity in incentive structure is also challenging. You could find the right incentives, the right things to tie them to, but it's really which parts you want to reward. I've seen a few companies try to make better efforts at it more recently, and it's a big part of why I've tended to flock toward companies who are owner-operators. I know many people share the same perspective in the active management world, but I do think that's inevitably the ultimate incentive – to share your interest as a shareholder first as opposed to exposing yourself to the agency problem.

**Bloomstran:** A little bit off point, but I don't have a problem at all with management teams making obscenely large amounts of money. The all-important thing is getting the right incentives on how they get there. John, when I was with you at Zurich last summer, I talked about Cummins and the way the management there is compensated. It's all very much ROE- and asset-driven. The CEO, Tom Linebarger, makes a bunch of money. The majority of compensation comes from performance shares and vesting schedules that are tied toward the profitability of the business. For that, you see great blocking and tackling out of the day-to-day operations of the business, and that compensation structure flows all the way downward, to the highly compensated executives and to the way the division heads are incentivized. When you get that incentive thing right, it's glorious. Very few get it right. The proxy is often very telling. It's good to find them when they're good, but it's so apparently obvious when you find them when they're bad, and those tend to be enough of a red flag to avoid the business altogether.

**Ordway:** Exactly, so maybe we avoid all the potential future disasters by opting out when we see the red flags and the bad incentives if we can. Sometimes they're hidden. It's not obvious in many cases.

**Turner:** Along these lines, one guy I've loved following on Twitter is @NonGaap. Mike has a great Substack, and he's written a four-part series on profiting from corporate governance. He looks at the dark arts of corporate governance in situations where companies seemingly internally know that certain events or catalysts are coming up and use their comp incentive structure to accrue excess compensation for themselves. It's interesting that you can play both sides of these things. On the one hand, look for companies with the ultimate incentive structures to hang in there for the long run. On the other hand, look for companies abusing the fact that there are some of these missed incentives to try to capitalize upon and take positions accordingly. I think it's relevant and interesting to think about.

**Mihaljevic:** Elliot, it reminds me a little of (I think) a Greenblatt lecture on spin-offs and where you could essentially buy a spin-off right before the management's comp thing goes into effect. Until that point in time, they're going to talk down the stock or not communicate in hopes that the stock declines. Then, when their options are struck, they're going to go out with an IRF. That's a way to play that game as an investor where you would essentially do what the insiders are doing, which is trying to buy the stock close to where their options are struck.

**Turner:** Yes, it's not too different from kitchen-sinking in general, this whole idea that you want to set the bar as low as possible when you know there's a pot of gold on the other side of the rainbow for yourself. Being a keen observer on both sides, looking for good opportunities to invest for the long run and the shorter-term opportunities is not something I'm a master of. I'm learning and trying to enhance my effort on understanding the incentive structures at these companies and thinking about this. Spin-offs are one of those opportunities where that exists. Try to hunt around for those and look for good ones. They haven't quite worked as well in recent times, but PayPal has been a fun one for me.

**Mihaljevic:** We'll leave it there. Phil, I think "The Psychology of Human Misjudgment" can provide fodder for us for years and decades to come, so fear not. We will have material to discuss in this podcast.

*This Week in Intelligent Investing is available on [Apple Podcasts](#), [Google Podcasts](#), [Podbean](#), [Spotify](#), [Stitcher](#), [TuneIn](#), and [YouTube](#).*

*If you missed any past episodes, [listen to them here](#).*

## **About the Participants**

Elliot Turner is a co-founder and Managing Partner, CIO at RGA Investment Advisors, LLC. RGA Investment Advisors runs a long-term, low turnover, growth at a reasonable price investment strategy seeking out global opportunities. Elliot focuses on discovering and analyzing long-term, high quality investment opportunities and strategic portfolio management. Prior to joining RGA, Elliot managed portfolios at AustinWeston Asset Management LLC, Chimera Securities and T3 Capital. Elliot holds the Chartered Financial Analyst (CFA) designation as well as a Juris Doctor from Brooklyn Law School. He also holds a Bachelor of Arts degree from Emory University where he double majored in Political Science and Philosophy.

Philip Ordway is Managing Principal and Portfolio Manager of Anabatic Fund, L.P. Previously, Philip was a partner at Chicago Fundamental Investment Partners (CFIP). At CFIP, which he joined in 2007, Philip was responsible for investments across the capital structure in various industries. Prior to joining CFIP, Philip was an analyst in structured corporate finance with Citigroup Global Markets, Inc. from 2002 to 2005. Philip earned his B.S. in Education & Social Policy and Economics from Northwestern University in 2002 and his M.B.A. from the Kellogg School of Management at Northwestern University in 2007, where he now serves as an Adjunct Professor in the Finance Department.

Christopher P. Bloomstran, CFA, is the President and Chief Investment Officer of Semper Augustus Investments Group LLC. Chris has more than 25 years of investment experience

with a value-driven approach to fundamental equity and industry research. At Semper Augustus, Chris directs all aspects of the firm's research and portfolio management effort. Prior to forming Semper Augustus in 1998 – in the midst of the stock market and technology bubble – Chris was a Vice President and Portfolio Manager at UMB Investment Advisors. While at UMB Investment Advisors, Chris managed the Trust Investment offices in St. Louis and Denver. Among his investment duties at the firm, he managed the Scout Balanced Fund from the fund's inception in 1995 until 1998, when he left to start Semper Augustus. Chris received his Bachelor of Science in Business Administration with an emphasis in Finance from the University of Colorado at Boulder, where he also played football. He earned his Chartered Financial Analyst (CFA) designation in 1994. Chris is a member of the CFA Society of St. Louis and of the CFA Institute. He has served on the Board of Directors of the CFA Society of St. Louis since 2002, where he was elected to sequential terms as Vice President from 2005 to 2006, President from 2006 to 2007 and Immediate Past President from 2007 to 2009. Chris has judged the Global Finals and the Americas Finals several times for CFA Institute's University Global Investment Challenge. Chris served for a number of years as a member of the Bretton Woods Committee in Washington DC, an institution championing and raising awareness of the International Monetary Fund, the World Bank and the World Trade Organization. He has also served on various not-for profit boards in St. Louis. His resides in St. Louis with his wife and two children.

*The content of this podcast is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction. The content is distributed for informational purposes only and should not be construed as investment advice or a recommendation to sell or buy any security or other investment, or undertake any investment strategy. There are no warranties, expressed or implied, as to the accuracy, completeness, or results obtained from any information set forth on this podcast. The podcast participants and their affiliates may have positions in and may, from time to time, make purchases or sales of the securities or other investments discussed or evaluated on this podcast.*