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PERSPECTIVES

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Look Out for Hubris

By Bill Koehler, CFA, President and CEO

In 1992, a gentleman named Roger Hertog addressed a small group of investment professionals of which I was a member. The meeting occurred in New York where Roger served as President of S.C. Bernstein, one of the preeminent investment management firms in the country. Roger later oversaw the merger of Bernstein into Alliance Capital in 2006. He is now 80 and still greatly respected as he leads the Hertog Foundation while also serving as Vice Chairman Emeritus of Alliance Bernstein.

When Roger spoke to us that day he said two things that I have never forgotten. He said the best metaphor for the investment profession is "peace of mind" and to be successful in the investment profession you have to "run scared." Roger's wisdom has stuck with me for almost 30 years. As I read Morgan Housel's latest essay, Dangerous Feelings, this week, I recalled Roger's words. Both Morgan and Roger address an issue that has been, arguably, more hazardous to investment portfolios than any other over time.... overconfidence or hubris.

The best metaphor for the investment profession is "peace of mind" and to be successful in the investment profession you have to "run scared".

I have attached the essay below. Morgan spoke to our Kansas City CFA Society in April this year and I had the pleasure of visiting with him after the presentation. He has a way of zeroing in on the soft issues that can influence bad decision-making, not only in the investment realm but in other life circumstances. His excellent book, "The Psychology of Money", is a worthy read for any investor.

Dangerous Feelings
September 30, 2021 By Morgan Housel

I sat down at my fancy desk on the edge of my chair waiting for the market to open, ready to have another $50,000 day, and thinking life couldn't get any better than this. This time, I was right. It didn't."

– Investor Jim Paul describing the moment he went from cocky and overconfident to broke and unemployed.

Success has a nasty tendency to increase confidence more than ability. The longer it lasts, and the more it was tied to some degree of serendipity, the truer that becomes.

It is why getting rich and staying rich are different skills. And why most competitive advantages have a shelf life. Jason Zweig put it: "Being right is the enemy of staying right because it leads you to forget the way the world works."

It is of course possible to indefinitely maintain whatever skills brought you initial success. Lots of people and a handful of businesses have done it.

But when success is maintained for a long period the greatest skill often isn't technical, or even specific to your trade. It's identifying and resisting a few dangerous feelings that can nuzzle their way in after you've achieved any level of success.

A few of the big ones:

1. The decline of paranoia that made you successful to begin with.

A common irony goes like this:

- *Paranoia leads to success because it keeps you on your toes.*
- *But paranoia is stressful, so you abandon it quickly once you achieve success.*
- *Now you've abandoned what made you successful and you begin to decline – which is even more stressful.*

It happens in business, investing, careers, relationships – all over the place.

Michael Moritz of Sequoia was once asked how his investment firm has thrived for 40 years. "We've always been afraid of going out of business," was his answer.

It's a rare response in a world where most successful people step back, take stock of all they've achieved, and assume they can not only breathe a sigh of relief but that their skills will run on autopilot.

A dangerous situation is when your goals (achieving enough success to relax) counter your skills (focus, paranoia, persistence). It hits you when you feel like past hard work entitles you to a break without realizing the cost of that break, however much it might be necessary and deserved. It's part of why people who quit while they're ahead are so admirable – it's often not so much that they gave up, but that they're aware of what made them successful and when that trait begins to wane.

2. Finding other peoples' flaws more than you look for your own improvements.

A sad twist to Orville and Wilbur Wrights' life is that they didn't make much money from their invention. They were nearly irrelevant as soon as the airplane caught on.

Part of the reason the Wrights fell behind so quickly was that while competitors spent their time designing better planes the Wrights spent their time suing people for patent infringement.

Chasing competitors through court became an obsession. At one point in 1916 Orville demanded that every airplane produced anywhere in the world pay him a $10,000 royalty, high enough that no manufacturer could afford it – which was the point. Competitors, particularly those in France and Germany, ignored the demand and the Wrights spun their wheels in court for years while competitors spent their time designing better planes. By the time the patent wars were over, the Wrights' flyer was obsolete.

A version of this happens when you see an investor spending all day on Twitter explaining why their competitors are wrong. I often wonder when they find time to figure out whether they, themselves, are right.

Charlie Munger says you shouldn't have an opinion on something unless you understand the opposing side's view as well as they do. It's good advice, but it's easy to take it too far. It's almost always easier to find a flaw in a system than it is to discover why or how something might work, in the same way that it's easier to destroy a relationship than build one.

> *You shouldn't have an opinion on something unless you understand the opposing side's view as well as they do.*

A dangerous feeling is when your position on a topic centers around criticizing the other side versus evaluating why you're right – or even better, why you might be wrong.

It's a seductive trap because pointing out flaws is so much easier and more convincing than finding *the obscure force that will make something work. It often signals that you don't actually understand a topic but you want to be involved, and finding other people's flaws is all you can come up with because you don't have your own position to analyze. This may have been true for the Wrights, who were genius in the early engineering days of the aircraft but lacked the skills needed to bring it to the next level.*

3. The feeling of mastering a topic, particularly if that topic adapts and evolves.

The first law of hard work is that you expect there to be a payoff. How could it be any other way?

But a dangerous feeling occurs when you want the payoff of years of hard work to be an assumption that you've mastered a topic. Or that you don't need to update your views because you already spent years of hard work learning those views.

You see it all the time in so many industries. Veterans fall behind the younger generation because if veterans admitted that they had to adapt to what the younger generation is doing they'd feel like the hard work they put over their career was for nothing.

Even if you know your field evolves, the idea that what you learned in the past may no longer be relevant is so painful that it's easy to reject. The longer you've been in a field the truer that becomes. It's hard for a 50-year veteran to admit that a rookie might know as much as he does. But if what the veteran learned 30 or 40 years ago is no longer relevant, it can be true. And the rookie may be more aware of what he doesn't know, while the veteran is iron-clad sure of his beliefs because he's worked hard and expects a payoff.

Some things never change, and learning them in one era can help you in the next. But the more your field evolves – the more it involves people's decisions – the smaller that set of learnings is, and the more you need to fight the urge to think that your long-term experience means you now permanently understand how the field works.

Investor Dean Williams put it: "Expertise is great, but it has a bad side effect. It tends to create an inability to accept new ideas."

What Morgan is really communicating above is that businesses and their owners have to be very careful not to think they have "arrived." For example, Blockbuster's hubris led to the ascendance of Neflix. The free market has never been more competitive and it will continue to demand results. Capital, including human capital, flows to where it is best treated. We seek to invest in businesses and management teams that, as Roger Hertog advised, run scared. We will continue to look for investment opportunities where the owners with whom we are co-investing remain engaged and motivated to perform as good capital partners.

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