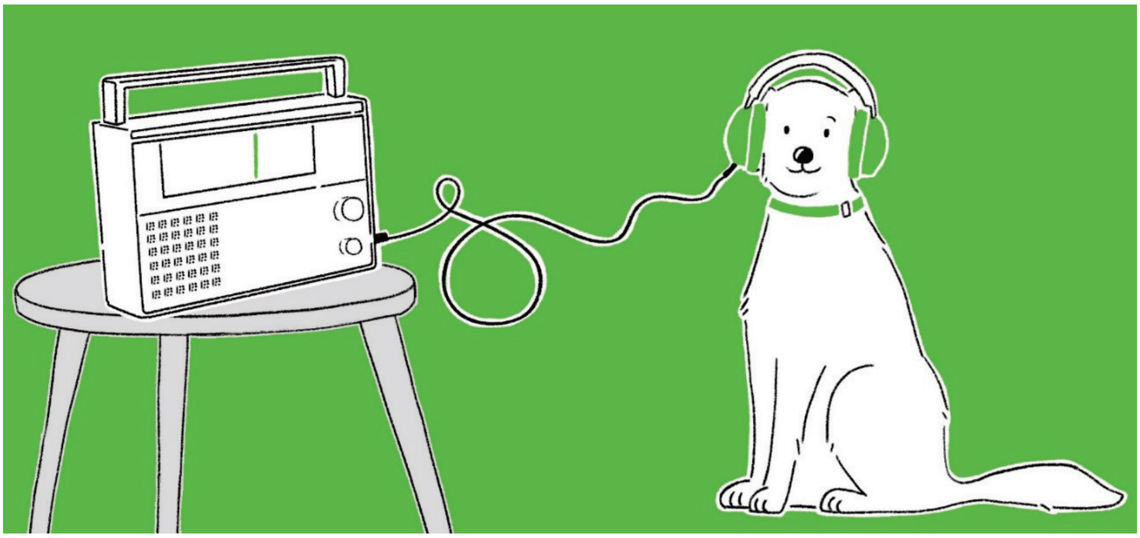
Ruffer Radio

Episode 6 – A bias to belief



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Rory McIvor

Welcome to Ruffer Radio. A series of podcasts in which we'll be exploring the investment universe and sharing our interpretation of what's going on. I'm Rory McIvor and today I'm joined by Bethany McLean, a journalist and author of several books about businesses gone wrong. Bethany is a contributing editor at Vanity Fair and perhaps best known for her remarkable work in the investigations of some of the shadier corners of the financial world. Bethany is this year's guest contributor to the Ruffer Review, our annual publication of thoughts, arguments and ideas intended to colour in our core investment thinking and pull on some interesting lessons from elsewhere in history, art and science. There are even a few jokes in there. Bethany, thanks so much for making the time for us today and calling from home in… Chicago?

Bethany McLean

In snowy Chicago, yes and thanks for having me.

Rory McIvor

No trouble at all. Snowy Chicago. We've just come through a bit of a cold snap here in the UK, but a record-breaking cold snap at that. So today, Bethany, we're going to talk about three sets of pairs. Firstly, visionaries and fraudsters, next Wall Street and Silicon Valley and lastly lessons learnt and lessons skipped or lessons that we've failed to learn. Your article in this year's Ruffer Review is about our willingness to believe and it explores the intellectual, psychological and emotional space shared by visionaries on the one hand and fraudsters. The article is titled 'A bias to belief', but could you just expand on that and what does a bias to belief mean?

Bethany McLean

Sure. I'd start with the fact that most of us in the investment world want to believe because it's in our interest to believe. It's in our financial interest, everyone wants to get rich. So wherever you sit in the spectrum, from somebody who's founded a business, somebody who's running a business, the management team, the portfolio manager who owns the stock, the analyst is putting a buy rating on the stock: all of us are biased to say we want this to work out, we want this to be true. And it's the case with almost every white collar fraud or every story of business gone wrong, every white collar fraud that it's based on the complicity of the victims in some ways because if those of us who invest in this grand thing weren't willing to believe then the thing would never have the capital that it needs to take off. But there are human elements then that start to play into this which is self-delusion, rationalisation and these affect the management team too. You rarely hear of one of these stories where the management team deliberately set out to create a fraud and they deliberately set out to engineer a company that was going to fail so that they could steal money from investors. It's just not the way it works. It's far more of a 'slippery slopes' type of story. So then I started to wonder what distinguishes the management team that sets off with the grand vision that they're trying to fulfil, the entrepreneur that sets off with a grand vision they're trying to fulfil, from the one who ends up in jail for committing fraud, and I started to think well maybe it's just luck, maybe it's just how it all plays out.

Rory McIvor

So that's the difference. It's only really outcome that separates the visionary from the fraudster. And you've spoken of a kind of 'Schrodinger's cat' element to business whereby we believe whatever it is we want to believe, what does that involve?

Bethany McLean

So what I meant by that is that what happened is dictated by what you see at the end. So if you see someone who succeeded, you tend to look at them through the lens of a visionary. If you see someone who failed, you look at them through the lens of a fraudster, but the person could have been either one at the beginning and I think there's some element of luck that plays into it. There may be a little bit… there may be more than that. There may be how far you're willing to go to break the rules, but when you look at a lot of visionaries who succeed, they didn't play precisely by the rules. They're people with grand ideas who believe that their idea is so important that it's worthy of cutting some corners along the way in order to make it happen. There are people who don't want to hear the word no. They're people who are willing to persevere through any kind of problem in order to make their idea work. And in the end, that's not so different from the fraudster who just happens to run out of capital and get caught in the moment when they are perhaps lying to investors in an attempt to get through a rough spot. And I started thinking about this right in the wake of Enron because… not really in the wake of Enron, I shouldn't say, but as I watched Netflix become a prominent and incredibly successful company, I remember thinking well Netflix is really no different than Enron broadband which is, was one of Enron's most controversial businesses. And I thought well, then if Netflix is really no different than the idea behind Enron broadband, what distinguishes Reed Hastings from Jeffrey Skilling. And maybe there are probably a lot of things, some willingness to cut corners, but there's a core of truth to that analogy.

Rory McIvor

So looking at individuals and individuals' role in separating from successful businesses and less successful businesses or failed businesses - there's magnetic personalities at the core of these. And you mentioned this in your Ruffer review piece. Should we be more wary of charismatic individuals and how does that translate into the decisions that we make personally and professionally? Is there a right amount of scepticism?

Bethany McLean

I'm not sure there is a right amount of scepticism. I think without these larger than life characters, the world would be a static and pretty boring place because in the end, it does take a person with an immense amount of charisma to drive forward: an immense amount of charisma or drive or willingness to re-envision the world that leads to big changes and sometimes those big changes are really, really good things or at least arguably good things. So I don't think we want to approach these characters with deep scepticism that leads you to say, I'm never going to believe in them because many of the best things in the world are a result of people like this. But if you find yourself saying oh, I think that guy is that or that woman is so brilliant that I don't have to ask any questions because I'm just going to get behind their brilliance. That's perhaps when it's time to ask yourself some questions on a slightly deeper level. I do find it really interesting that from the outside we think of the world of business as this grey world of numbers, this very rational cold world where people make decisions based on financial outcomes and weigh the probabilities and measure the odds and look at the statistics and it really isn't. It's an incredibly emotional world where people often make their decisions based on belief in another human being or their own desire to get rich. But I find that gap, I guess, between the way we would conceptualise the business world as rational and the actual reality of the business world which is deeply emotional to be fascinating.

Rory McIvor

It's that fundamental paradox between so-called rational markets and emotional investors, emotional people. Do you think, Bethany, it's possible for us not to be persuaded by masterful storytellers?

Bethany McLean

I don't think it is, not for most of us, narrative is deeply ingrained in humanity you know, our earliest ancestors were trying to find ways to tell stories because telling stories is the way we make sense of a complicated world. So we are almost hardwired to believe in narrative and to be drawn to narrative. I think to make yourself somebody who isn't seduced by narrative would be overcoming even thousands, if not hundreds of thousands of years of human history, right? But I think you can be aware of its power and I think being aware of its power is the first step and not necessarily setting yourself free of it, but just like anything else that exerts an enormous amount of power over the human psyche. You want to be aware that it's there and that you too will be seduced by narrative and you're all the more likely to be seduced by it if you don't recognise its power if you don't think that you will be.

Rory McIvor

And what we've seen over the last decade, Bethany, is the emergence of more and more cults of personality and, without wishing to throw any names out there, they have been very prominent in politics and in business. Is there such a thing as a benevolent cult of personality: is Warren Buffett one such example?

Bethany McLean

Well, I think there probably is a benevolent cult of personality, but again whether it was benevolent or deeply dangerous is determined after the fact. So it depends on that person's intention and on how it all plays out, but for sure when you look at the market, there are companies that don't have to make money that are given essentially a pass by investors, by Wall Street because of the cult of personality. So those CEOs are – their vision is – regarded as so impregnable and they are so trusted and believed by the market that they get a pass on making money because people believe their promises that they're going to make money in the future. And then you hold that up next to other usually more old line companies that are held to a very strict standard of quarterly earnings metrics and damn those quarterly earnings better be up a certain amount each quarter and you better not miss by even a penny. And you think, wow, this dispensation to be able to lose money is a huge gift. It's an enormous competitive advantage and that to me is one of the clearest examples of how valuable that cult of personality can be and then you just have to trust that the person who has that dispensation chooses to use it wisely. But I mean even think about that the company that doesn't have to make money that has a really high stock price just because investors are inclined to believe and the person who's running it then has a currency with which they can go make acquisitions, they can make investments, they can make acquisitions and they basically have a hall pass and versus the company that doesn't have any of that. So I was always trained when I was growing up and young that a company and its stock were two different things you know, the company could have a great story and whatever you might want to believe that, but then there was the stock price and the stock price was this rational thing and that's what dictated reality. And I've started to think no, the company, the story and the stock have actually emerged over the last couple of decades or maybe that was never true and I just believed it for a period of time, but I now think the story is the stock and the stock is the story, at least in our current market.

Rory McIvor

What do you think has made it that way? Is that through access to information? Is that because retail traders everywhere, sort of know everything about a company and a stock without necessarily having to delve into its financial statements?

Bethany McLean

I think it's partly because of global interest rate policy, right? The record low interest rates all around the globe have sparked a speculative fervour and made it almost impossible for people to lose. So you see now over since the financial crisis, a decade of history where stocks have mostly gone up and stocks with good stories have really gone up and it's hard for me to believe this, but there are a lot of people trading in the market today who weren't around for the global financial crisis and much less having been around for Enron and the cataclysm that resulted from the collapse of the first dot.com bubble. So people have been trained, not to think that the numbers ever matter. And so I think that that is for sure part of it. I also think the last 20 years have seen the emergence of the creation of enormously big and successful companies out of story stocks. They've worked. The story has become the reality and so when you've seen that happen then you say well, why can't this happen again and you're far less inclined to say well, story stocks never work out. The reality is sometimes they do. And actually being a fascinating intellectual exercise that I've never done and I don't even know how you decide what was the story stock and what wasn't, but if you could look back over history and see how many times they work out well and how many times they crash and burn, that'd be fascinating, right?

Rory McIvor

Absolutely. I think we'll put that to our research team at Ruffer and see what they can come up with. We will keep you posted on that. Bethany, I just want to pick you up on something you mentioned a little bit earlier: you're talking about this long-term competitive advantage that story stocks have and within the investment management industry being a long-term investor is universally seen as a good thing and there is almost universal understanding that quarterly earnings are not the best way to incentivise management or stockholders. Bethany, I was wondering, is there a balance and if so, what does the right balance look like in your mind?

Bethany McLean

Well, I think I'm going to disagree with you on that. I think people say that and that's the way it should be and I think very few people operate that way. So at least since the days of Enron and probably before that we've been talking about that, about the importance of the long term, about how companies shouldn't be evaluated based on their quarterly earnings and we've become more and more short-term over that. And the reality is we everybody's on a clock and so company executives feel like they can't miss quarterly earnings because investors are going to sell their stock and then if investors sell their stock and their stock price declines, an activist investor is going to come in and force the management team out. So they feel like they're on this very tight rope in terms of producing earnings except again for the companies that seem to have this special dispensation investors themselves are on a clock. If investment team returns a performance that is less than the S&P 500, they're going to be faced with the pressure of losing clients. Clients are going to say to them, I think I might pull my money and put it with somebody else. And so those people responsible for managing the funds feel like they're on their own clock, so they can't afford to leave their money in an underperforming company. So I think broadly across the world, we talk a lot about the importance of the long-term and we talk a lot about not evaluating companies based on short-term earnings and the reality of how most people function is very different than that.

Rory McIvor

And there's huge career risk with underperforming a benchmark which I guess speaks to one of the advantages of not benchmarking at all and taking an absolute return approach to investing. Bethany, let's move on to Wall Street writ large and Silicon Valley. So in your piece in the Ruffer review, you spoke of a kind of FOMO, 'fear of missing out', whereby big New York banks are terrified of missing out on the Silicon Valley bonanza. Do you think Silicon Valley is now out of control, untethered morally and financially or is it this new city on a hill?

Bethany McLean

I think there's some aspects to it that are a new city on a hill. There are a lot of really good valuable things coming out of Silicon Valley for sure. But I think the larger story is that it's untethered and it's been untethered because of the complicity of venture capitalists and big Wall Street banks. The people who are supposed to be the gatekeepers, who are supposed to say no to an overly aggressive company management and I think a couple of things have enabled that. One is this cult of personality. Ever since certain big companies have become successful based on a cult of personality. There's this idea that all we need to do is back the person with charisma, the cult of personality and we too will get rich. So the last thing you want to do is look at one of those people and rein them in and say, no you can't. You have to behave like an adult. You're running a company. The idea is it's all kind of become a mixed muddle of the more out of control that's resulted in a sort of idea that the more out of control you are, the more, the better you are, the greater you are, the more innovative you are. And in reality, those two things don't necessarily have anything to do with each other, but that's enabled a whole lot of bad behaviour. I think big Wall Street firms are so terrified of missing out that instead of looking at a company that's trying to go public and saying this doesn't work. The underwriters who should be the adults in the room and look at a prospectus and say no, no, no, we're not taking this public. You need to fix this. They're so desperate for the fees and so desperate to be part of this whole thing that instead of playing the job of the adults in the room, they play the role of enabler. One of the oddest things to me has been the flip from the first dot.com bubble. So in the first dot.com bubble, public market investors, mainly small investors and mutual funds or who were trading on their own are the ones who got fleeced. And private market investors, the venture capitalists, the executives, made a ton of money, even off companies that that later failed. You could take anything public and people would buy it. This time around what's fascinating is it's been the public markets who have said no. The private market, whether it's big mutual funds or venture capitalists, have been so desperately afraid of missing out that they've enabled these ever higher valuations and they didn't see that the game had changed. They thought they'd be able to take these companies, turn them around and stupid public market investors would take it off their hands so that they could cash out. And instead this time and I've just been delighted by this, instead this time the public markets have said uh-uh, no way, no thanks, your problem, and I think that's awesome.

Rory McIvor

Is Wall Street in the midst of revolution, and I'm thinking here of a piece you wrote a little while ago about private equity winning Wall Street, the wave of retail trading and just general access to capital markets - are there misdemeanours underway now which we should be looking out for?

Bethany McLean

So I think Wall Street has lost its mojo in many ways and you can trace that to the financial crisis where the big banks screwed up and as a result were placed under an incredibly tight regulatory and capital regime. And what that did was drive risk-taking out of the regulated banking sector and into the non-bank financial sector and the great irony here is that in the wake of the financial crisis, the whole discussion was about the risk of a shadow banking system, a system of money that ran parallel to the existing regulated financial system and all we've done is magnify that by a hundred times. We didn't fix that. We didn't do anything to make it better. We just clamped down here on the big regulated banks and left the rest of this to mushroom over here. I think that's caused Wall Street to lose its mojo because the typical things that enabled Wall Street to make money you know, proprietary investing, making big trades, you can't do any of that any more. So that's moved to private equity firms and to less regulated areas. I think the rise of fintech is another maybe not existential threat to Wall Street, but for sure a threat to Wall Street. There was a recent saga in the markets that has dominated everybody's attention and what I found fascinating about it was that it didn't involve a single big Wall Street firm which shows you how the centre of gravity has shifted. And then there's the rise of alternative currencies, right, that exists outside the fiat money system. And so while you want to say well the big banks are always going to have primacy in our system because they're the ones given the dispensation to be big banks by governments, what if the whole system of money becomes a non-governmental one. So I think there is a sense on Wall Street that... a sense of existential terror which I think then leads them to do stupid things, well, it's not like they didn't do stupid things in the past (laughs).

Rory McIvor

No. That's for you to say, I couldn't possibly comment! And part of that battle between Wall Street and Silicon Valley actually relates to a battle of talent you know, bright graduates are having to decide whether they want to go to big Wall Street bank or perhaps go down to Silicon Valley. And you reference the recent saga in markets and you've also sort of spoken of a, of a mom and pop, I'm probably pronouncing that incorrectly, view of stocks rising, that stocks going up is fundamentally a good thing, that's true in America and I guess also to some extent in the UK and Europe. Short selling though, is it fundamentally a bad thing?

Bethany McLean

So that is one of the things that surprises me about the market today because I think so many of the traders operating in the market today are so sophisticated. They understand things that the investors of yore did not about - how the system is set up to screw them, about how they too can play the game. But I think the thing they get wrong is short selling. They have a weirdly moralistic approach to short selling that somehow anybody betting against a company is a bad person. And I get some of that with some of the sceptical stories I've written. I get attacked on Twitter for it and I get attacked in two ways. One is basically you're a bad person to want to see and want it to have any kind of up... to ever advocate for a stock going down and that's not what I do, but to ever put out anything that's negative that could result in a stock going down. And I think you guys – and they are mostly guys – you guys pride yourself on your toughness and on your sophistication, since when did you think that stocks were only supposed to go up. Since when did you come to think that was some kind of right. I happen to think that short sellers at their best are the policemen, police woman, police people of the markets who find the frauds and they're the only people who are incentivised to say no, this thing doesn't make sense to take another company that doesn't exist anymore. Theranos, had Theranos been a publicly traded company, I think short sellers would have figured it out long, long, long before the eventual collapse came. So I think short sellers play an incredibly important role in the market, but I think their role has been diminished after a decade where thanks to global low interest rate policy, we've had this incredible speculative bubble. Short sellers have lost tons and there are a lot of people in the market today, at least, I get a lot of this on Twitter where people say to me "Don't you realise because the stock has gone up so much." It's back to my comment about story stocks and about the importance of story, "Don't you real–" and a stock being the same thing as a company, "Don't you realise because the stock has gone up so much that your criticism of this company was completely wrong, you stupid idiot." And I say wait, just because the stock went up so much doesn't mean my criticism was wrong. One thing doesn't have necessarily have anything to do with the other. Enron stock went up wildly for a decade before the collapse came. In fact, I think it went up some 70 or 80% in the year 2000, the year before it went bankrupt. Because a stock is rising and doing really well doesn't mean the criticism is off base. It doesn't mean it's on point either, but it certainly doesn't mean it's off base. And I find there's a real naiveté or disconnect in the market today on that subject.

Rory McIvor

Yeah. Let's pick up a little bit on Enron and let's tie this in, I guess to lessons we have learned and some lessons perhaps we've skipped or lessons we haven't learned - your specialism is in investigative and long form journalism often into financial skulduggery. Is it about going after the bad guys?

Bethany McLean

It never has been for me. It's always been about finding disconnects and I think that's a result of being a math major. And if you are trained as a mathematician who does proofs, A has to connect to B to C to D and if there is a step missing in there – if the logic doesn't flow then it draws your attention. And so for me it's always been disconnects and stories. It's always been where the underlying logic of the narrative is skipping something that draws my attention, but it's not going after bad guys per se. In other words, I've never had this kind of moralistic approach to there's a company doing bad things and therefore, I want to take it down and call it out. It's much more about the intellectual interest of a gap where the narrative is skipping something, that's what I'm drawn to.

Rory McIvor

And there's been some progress in the way that companies are governed or perhaps there hasn't - you'll tell me, I guess, Bethany, but has this so-called progress reduced the risk of future scandals or is there another one hiding in plain sight?

Bethany McLean

I wish listeners could see the blank look I'm giving you right now (laughs). I mean I remember writing in the wake of probably the worst piece I ever did, I remember writing in the wake of the convictions of Jeffery Skilling and Ken Lay, the former Enron executives that the world was different now and everybody understood that there was a risk of playing fast and loose with the laws and this was spring of 2006 right as the global financial crisis was getting underway. And then you can look in the US, after Enron went bankrupt, a law was passed in the US called Sarbanes-Oxley and President George Bush stood in the rose garden and talked about how now the world was safe forever after and investors no longer had to fear that people would be out to screw them. It's almost identical in language and tone to the speech president Barack Obama gave in the rose garden after passing the Dodd-Frank law in the wake of the financial crisis. So no, I don't think things have changed in any fundamental way. I think in some ways they've probably gotten worse. Our big problem is that we have a tendency to look in the rear view mirror, try to put rules in place that fix yesterday's problem and then all say to ourselves with great smug satisfaction, look, we fixed it, whereas in reality the markets have moved on really quickly and the problem that's brewing has nothing to do with the problem that just took place. So you know look from Enron to the financial crisis, sure maybe some of the rules put in place in Sarbanes-Oxley addressed some of what happened with Enron. They addressed nothing that happened in the financial crisis. Look at the rules put in place after the global financial crisis as we've discussed to make it much harder for the big banks to get in trouble again and so we've had this incredible explosion in non-bank activity which might be the source of the next problem. So no, I don't, but the world would be pretty boring if everything were tightly regulated and there were no more explosions and I wouldn't have anything to write about so.

Rory McIvor

No, quite right. And if I were to play fairy godmother and to sprinkle some magic dust and say Bethany, you're allowed to make one rule that's going to protect investors, consumers whoever it might be, what would that one rule be that you would introduce?

Bethany McLean

I might force companies to do well, no, this wouldn't work. I was thinking about forcing companies to do a narrative where, or have an outsider come in and do a narrative about how executives actually earn their money and how much of it really, truly was based on the long-term success of the company and how much was based on the short-term because I really think if you could motivate the people who run companies such that they wanted their businesses to be around in 10 years, 20 years, 50 years, 100 years, whatever we think the appropriate timetable is that if people really, really cared and they had to care because that's where their money was coming from that their company succeeded over the long-term, I think you'd have a very different landscape than you do today. But unfortunately, the more rules we try to put in place to create that, the more those rules offer the chance for subversion and the more we see stories of people having made an inordinate amount of money when the thing they were doing failed, and an inordinate amount of money in a really short amount of time when the thing they were doing failed. And I have nothing against, I'm actually a believer in capitalism in many ways and in business and I have nothing against somebody who creates an enormously successful product that makes the world a better place and offers people a chance to make a living, creates jobs. I have nothing against those people making a great deal of money. My big problem is that we seem to have created a system where a lot of people can make a lot of money from failure and that's problematic.

Rory McIvor

I think that is probably fundamental to the woes facing modern day capitalism and throughout your work, it all seems to boil down to human nature and it's almost a great game of whack-a-mole as humans bounce between brilliance and recklessness and vision and fraud, but in your Ruffer Review piece this year, Bethany, you outline that wonderfully. So thank you very much for contributing to that and thank you so much for your time today.

Bethany McLean

Thanks for having me and thanks for the great questions.

Rory McIvor

And as I mentioned, you can read Bethany's article, 'A bias to belief' in this year's Ruffer Review which will be available in early March. To request a copy of the review, you can find a link in this episode show notes. You can subscribe to Ruffer Radio on the App Store, Spotify or wherever you get your podcasts.