view from the Thames by Deon Gouws

The wolf of Dorp Street

A senior team member at leading investment house GMO, James Montier, is one of the brightest minds in financial services.

In 2005, he produced a paper titled "Seven Sins of Fund Management", which is a behavioural critique of some generally accepted practices in asset management.

One of the topics that he focuses on is meeting with the management teams of companies as part of the investment analysis process, which he describes as mutual love-ins. He bases his view, inter alia, on confirmation bias, as most of us tend to hear what we want to hear when we meet these captains of industry.

I share Montier's cynicism. In a previous life, I used to head the equity research team at a large institution in South Africa. Analysts would come back from visiting their favourite companies, waxing lyrical about the quality of management. How did you assess that, I would always ask. The responses were seldom compelling.

I believe there is only one way to assess the quality of management, and that is to consider their track record of delivery over the longer term. And you don't need face time for that: a data subscription and some spreadsheet skills will do.

Take Elon Musk, for example. Love him or loathe him (and I don't think most people actually like the man very much — he comes across as awkward and arrogant, even rude), it's hard to argue with what the boy from Pretoria has achieved in half a lifetime. Who knows where he might end up taking Tesla and SpaceX in decades to come, even if he smokes pot while being interviewed on live television.

In my view, the typical analyst beating the pavement is likely to be impressed by a rock star manager's strong personality and sunny disposition (pessimists don't rise to the top of big companies). While optimism is clearly a valuable trait, one should always be mindful of the fact that company managers generally have an overabundance of it, specifically as far as their own business is concerned.

A perfect illustration of this can be found in The CFO Survey, co-ordinated by Duke University, which has been polling American business leaders every three months since June 2002. Among other questions, participants are asked to rate their optimism about the overall US economy, as well as their own firms' prospects on a scale from 0 to 100. Averages are then calculated for each of these numbers.

Former Steinhoff CEO Markus Jooste
Gallo/Brenton Geach

With more than 2,000 participants across the US, the law of large numbers applies. On average, prospects for the typical company should thus approximate that of the overall economy. But, predictably, that's not how the results pan out. In all but one of 87 consecutive quarterly observations to date, American CFOs are noticeably more positive about prospects for their own companies than they are in respect of the overall US economy.

This is the business equivalent of asking a roomful of people whether they believe that their driving skills are above average for that particular audience, with the vast majority responding in the affirmative. It's an outcome that is mathematically impossible, yet typical in practice.

The great con

Markus Jooste was arguably the most overoptimistic South African CEO in living memory. While not everyone swallowed his Kool-Aid, Shane Watkins of All Weather Capital was quoted on these pages back in December 2017 as saying that "80% of analysts loved him and lapped up his story".

Steinhoff's accounting may have been opaque, but Jooste would always look you in the eye, smile warmly, and he had an answer for everything. Up to a point, the vast majority of market participants agreed that he came across as very believable — just ask Christo Wiese.

But the most successful con artists in the world end up being successful, exactly because they are so believable. Which is why it's probably a better idea to avoid them in the first place. As Montier suggests in his paper, the ability of analysts to spot deception tends to be very poor.

I understand why investment professionals enjoy flying halfway around the world to visit companies and speak to management (especially if your firm is generous enough to buy you a business class ticket and put you up in a five-star hotel).

Just beware of running into the Wolf of Dorp Street. For if you do, there's a real danger that it may end up costing you and your clients a lot of money.

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