RIA Advice

Most people have had an experience or two with something that is out of date. Whether gulping down some spoiled milk, biting into some moldy bread, or sipping a glass of wine that has turned to vinegar, the experience tends to be shocking, unpleasant, and memorable, all at the same time. The lesson quickly learned is that you need to pay attention to how "fresh" certain things are to avoid an unpleasant experience. The same thing happens with social norms, albeit with a longer time frame. Historical practices that were once met with widespread acceptance are today considered unreasonable and uncivil. The main point is that times change; some can adapt, but others either cannot or do not. Since business success depends on resonating with customers, employees and investors, it matters when belief systems get stale. For better and worse, the financial news has been rife with examples of rich and powerful people being discredited by their statements and/or behaviors. This has happened to such a degree that it looks like a pattern. The cases are too numerous to dismiss as anomalous. One of the more recent incidents involved Ken Fisher, who runs a firm with over $100 billion and is worth $3.6 billion himself. At a financial conference, zerohedge reported, he "*shocked* attendees when he compared gaining a client's trust to 'trying to get into a girl's pants'." Those comments alone might have been easy to pass over. Offensive, sure. But they could have been dramatized, or taken out of context, or just not that important. Fisher, however, decided to eliminate any possible doubt that he really meant what he said when he added:

> "***I have given a lot of talks, a lot of times, in a lot of places and said stuff like this and never gotten that type of response.***"

As such, the comments were revealing in a couple of ways. First, the absence of any real contrition indicated he stood behind what he said. He did, however, seem disappointed that he had lost the respect of a lot of people. Most importantly, he seemed genuinely surprised that anyone might take issue with his comments. That surprise was most likely caused by having fallen dangerously out of date with social norms, and that says something about Fisher. In a very different example, Jorge Paolo Lemann, head of the private equity firm 3G Capital made comments at a conference last year that also demonstrated a disconnect with the real world, albeit in a very different way. The *Financial Times* reported Lemann's comments at the time:

> ?***I?ve been living in this cosy world of old brands, big volumes, nothing changing very much,? he said. ?You can just focus on being efficient and you?ll do OK. And, all of a sudden, we?re being disrupted in all ways.***?



The idea that food and beverage products are "not changing very much" seems almost laughably out of touch. Anyone who ever eats out, goes to restaurants or bars, goes to the grocery store, watches tv, follows social media, or interacts with other people is overwhelmed by the amount of change in the food and beverage industry. It is no secret that younger customers want different things. It is also no secret that these changes have been developing for many years, as has disruption in the food and beverage industry. As a result, Lemann's perception that disruption happened "all of a sudden" says more about him than about the market. Specifically, his beliefs about the "cosy world of old brands" had become seriously outdated. To Lemann's credit, he admitted that he felt like ?a dinosaur", so at least he eventually came around to realizing this. It did not come easily, however. It took a shocking rejection of his underlying assumptions about the market, in the form of poor financial results, for him to eventually change his views. Rather than observing gradual change over time, it was more like getting hit with a 2x4 upside the head. Yet another example is that of Christine Lagarde, the new head of the European Central Bank. Shortly before her term began, the *FT*•reported on comments made primarily to a European audience. In particular, she declared:

> *?**We should be happier to have a job than to have our savings protected.**"*

In one sense, it is understandable that Lagarde might want to establish continuity with ECB policy, even if it is problematic in many respects.•In *proclaiming* what people should prefer, rather than *listening* to what people actually do prefer, however, she also revealed a degree of arrogance and condescension that come across as pass• in today's more egalitarian ethos. It may be tempting to write off these examples as just some innocuous bits of disappointing behavior. It's not like it is illegal to have outdated beliefs, and there are certainly plenty of scandals involving illegal activities among the wealthy and powerful class to grab our attention. Further, outdated beliefs can even be a bit humorous when revealed unintentionally. It would be a mistake to dismiss such incidents, however. For one, these are not isolated incidents but rather are emblematic of widespread behaviors and belief systems. The incidents reported are indicative of similar instances that happen every day. The *FT*•describes the landscape:

> *"**In decades prior, Mr Fisher?s remarks may have elicited a warm hum of laughter from the usual greying, male crowd. He may even have impressed some would-be allocator in charge of a family office or endowment with his maverick touch. Not so today. Instead, this has ended up being a costly mistake.**"*

Another problem is that many leaders seem unaware of how completely their personal belief systems fail to comport with those of society as a whole. To be fair, the belief systems of a society are moving targets; they change over time. The *Economist*•explains,

> *"**Over time, public opinion has grown more liberal. But this is mostly the result of generational replacement, not of changes of heart.**" A key factor is that the composition of society changes due to demographics. The Economist explains, "**many socially conservative old people have died, and their places in the polling samples have been taken by liberal millennials.**"•*



While there have always been generational differences, part of what makes today's differences so interesting is the magnitude and breadth of those differences. The generation of Millennials is much more diverse than the Baby Boom or Silent generations. Millennials, as a group, are also far better educated. It's no wonder that significant political differences exist.

As a result, some social beliefs are changing quickly. The *Economist* illustrates with the example of gay marriage:

> ***"As recently as the late 1980s, most Americans thought gay sex was not only immoral but also something that ought to be illegal. Yet by 2015, when the Supreme Court legalised same-sex marriage, there were only faint murmurs of protest. Today two-thirds of Americans support it, and even those who frown on it make no serious effort to criminalise it."***

One important consequence is that this rapid change in social beliefs is exposing a number of leaders and managers as being distinctly out of touch. Whether it be Fisher making vulgar comments to a group of financial professionals, Lemann professing how stable big food brands are, or Lagarde telling people they should prefer jobs over savings, each of these figures revealed that they have completely missed important changes happening across society. In a sense, it is a bit sad when leaders reveal such striking shortcomings. They can seem like beached whales; potentially majestic but so desperately out of their element. One day they were swimming in a set of beliefs that they fully understood and the next, they were stranded and helpless. This phenomenon is not harmless, however, and can affect investors in a myriad of different ways. One important way is through the boardroom. Board members are normally chosen for their business acumen, contacts, and decision-making ability, among other things. Because these qualities often tend to improve with age, most board members are more experienced. While all those qualities are valuable, all of that experience can also engender certain belief systems that are not helpful at all. Indeed, **"experience" can also engender a great number of lessons learned in past environments that are unlikely to recur in future ones.**•This can create a real problem. Whether intentionally or not, the behaviors and beliefs of board members get propagated through the entire company. This point was made clear by the *Economist* in summarizing•Ben Horowitz' new book:•" **Leaders set the tone. If they lie, shout or swear, then others will do the same.**" Likewise, if they make lewd comments, ignore rapidly changing consumer preferences, or treat people as "subjects", others will also do the same. It usually doesn't take long for such behavior to thoroughly permeate an organization. An excellent example of this was Uber. Back in the summer of 2017, when Uber's board was trying to deal with the unseemly behavior of Travis Kalanick, board member David Bonderman made things worse. As the *FT*•reported, "it took less than seven minutes before Mr Bonderman ... interrupted fellow board member Arianna Huffington. As Ms Huffington was telling staff that research showed boards with one female director were more likely to appoint a second, Mr Bonderman interjected: 'Actually what it shows is that it?s much more likely to be more talking'." Is it any wonder that Uber had a "corporate culture known for being aggressive and sexist"?



Although many forego the opportunity, there are things investors can do to reduce such risks. Proxy statements reveal a number of "tells" that indicate which boards and which companies may be especially prone to outdated belief systems, most of which revolve around an element of insularity. For example, low board turnover, concentrated power among a few long-serving members, and boards that are "captive" to a powerful CEO/chairman are all indications of potential problems. Another investment consequence of outdated belief systems involves the competition for talent. Perhaps no business is more affected by the clash of conflicting belief systems than that of business schools themselves. Nitin Nohria of Harvard Business School notes in the *Economist*•that "**younger alumni and incoming classes want 'the place of work to reflect purpose and values'.**" Jonathan Levin of Stanford?s Graduate School of Business (gsb) highlights the **responsibility of business schools "to recognise the societal consequences of corporate actions."** Simply put, a lot of tomorrow's managers and leaders don't want to work within the belief systems of some of today's managers and leaders. Of course, stale belief systems are not solely the purview of leaders and managers. Since belief systems tend not to change much at the individual level, once they become stale, they tend to remain stale. As the *Economist* notes. "It is hard to beat bias out of individuals ..." When this happens on a large scale, it can create systemic risk. For example, a lot of people have experienced enormous appreciation in financial assets over their careers. Given this powerful experience, it is easy for one to believe that it always makes sense to invest in financial assets. This creates consequences for all investors. Price•discovery becomes much more a reflection of an entrenched belief system and much less an ongoing analytical exercise. Prices become disconnected from fundamental reality. What can cause things to change? Certainly, beliefs *can* change. It is possible that investors stop believing that central banks can, and will, continue to support financial asset prices. It is also possible that investors start getting more squeamish about valuations.



Sooner or later, however, the thing that will definitely cause change is demographic replacement. Older generations that have fared extremely well by owning financial assets are gradually being replaced by younger generations that have had far less positive experiences. When a tipping point is reached, attitudes towards stocks are likely to change just as quickly, and permanently, as they did with gay marriage. In sum, outdated belief systems are a fact of life and are often harmless. The main lesson though, is that there are absolutely situations in which stale beliefs can cause extremely unpleasant experiences. Fortunately, there are ways for investors to identify the risk and manage it before it becomes a problem.