

*"Good judgement is the result of experience and experience the result of bad judgement."*

- Mark Twain

In our commentary last month, we introduced the concept of moats and knights – companies with defensible, competitive moats and the “knights” whose sole purpose was to widen them. This month, we’ll further discuss these defenders of the realm; how to identify them and how to ensure quality and integrity is more important to them than profitability (in the belief that profitability cannot be sustained if management is poor).

In 2007, Michael Mauboussin studied the median ROIC trend of a thousand non-financial US companies ranked into quintiles based on their ROIC in 1997 over the following decade. Mauboussin’s report found that 41% of the companies that were in the first quintile in 1997 remained there in 2006. However, less than 4% of the total sample population remained in the highest quintile of ROIC for the full nine years of the study. Having established that only a handful of companies are able to sustain high ROIC while it reverts to the mean for the rest, one has to wonder what the differentiator might be in this limited data set.

We suggest the management team. Today, the distinction between average companies that are benefiting from cyclical industry trends and transitory factors (such as ample supply of liquidity in the economy) versus the companies that have structural and sustainable competitive advantages is extremely blurred. Determining the sustainability of competitive advantages and thereby future returns requires a comprehensive understanding of the business and awareness of any external factors that could disrupt the status quo.

That extensive analysis can only be accomplished through a continued examination of management skill and bias. And, once credibility is established from the initial point of analysis, continued dialogue and a healthy relationship between analyst and management will allow for a credible long-term assessment of the adaptation of management to continual industry change.

Warren Buffett has often mentioned that he would forgo a profitable opportunity if pursuing it meant forging a partnership with someone whom he did not trust. In other words, if you are suspicious of the CEO, you should not invest in that company’s stock. But, as an outside analyst, how can you determine whether management is trustworthy?

One begins by looking at the management track record. What was the last position held by the CEO – was it from the same industry ensuring he stayed within his circle of competence? Consider compensation – is personal wealth aligned with shareholders and does the compensation package indicate a tight corporate governance structure? Can the CEO articulate his business framework well, focusing on its competence and avoiding expansion into areas where expertise is lacking? Is management transparent (avoiding excuses for the occasional poor quarterly result), do they have a positive attitude toward shareholders, or do they claim to “know the future” (Buffett once said “We are suspicious of those CEOs who regularly claim they do know the future — and we become downright incredulous if they consistently reach their declared targets”)?

The analyst must understand that trust in management can only be built up by following the small things they do over time. A healthy degree of skepticism is helpful in the near term since you can’t ever fully trust what management of a new investment is saying. However, over long periods of time as management begins to understand your position is one of business ownership (versus a quick trade) the relationship will grow, as will communication trust between you.

The vast majority of investors are concerned with short term results and, unfortunately, management teams are challenged to defend the short term. However, continued discussion with management should focus on updating the business planning framework and understanding ongoing methods and motivation around capital allocation. Over the long term, that will allow the analyst to measure the true quality and integrity of the knight.