MILL STREET & Co.

PERSPECTIVES
No. 003 | March 2017

Blind Trust & the Expert's View

Dear Reader,

Thank you for taking the time to read about our insights through ***Perspectives***. Before you continue reading, I would like to offer a small disclaimer: If you are looking for a broad list of statistics related to investment performance, a slew of research credentials, or a how-to guide of some sort, you will be disappointed. The insights that we present within this paper are not heavily researched, or supported by more than our personal experiences and related observations. Through the process of composing these commentaries, we have learned a great deal about the subject. Our intention is to be successful in adding some measure of value to your own views and hopefully allow you to see the subject a little differently than you did before.

We are always open to feedback and discussion and welcome all questions, comments, or rebuttals. We can be reached by telephone at 905.764.5465 or via email through contact@millstreetco.com.

Noah Murad
CEO

Imagine a young executive. He gets up every morning, puts on a suit, straightens his tie, polishes his shoes, and goes into his office to meet potential clients. His office building, a large tower in the downtown city core, has 50 floors. The lobby, fit with marble, a concierge desk and coffee shop, has dozens of people walking in a frantic pace to get where they need to be.

His clients, a middle-aged couple who have built and worked in a small business their whole lives, have limited experience and interest in big-city ideas. They are here because they have been told by friends that they need to take care of their retirement and plan for the future, as they prepare for the next couple of decades.

It has been proven that we blindly trust experts and authority figures. The more "letters" next to your name on a business card, the better.

The clients walk into the office where their meeting will take place. There are brochures on a wood table in front of them, with a view of the city through the window they are facing. Our young executive walks in and introduces himself. He begins to discuss all of the products that his firm offers, while his clients listen keenly to what he has to say.

After the meeting, the young executive heads home for the weekend. He meets his friends for drinks, posts some photos on Instagram, and preps his NFL fantasy lineup for this Sunday's football games (the winner of his pool gets a whopping $5,000 for the $500 entry fee). He jokes around about the bonus he is going to make on his sales numbers this year for bringing business in to his firm. In five years, he says, who knows where he will be in his career, but right now he figures he is doing well.

His clients, on the other hand, go home and discuss the scenarios which were laid out for them by the professional they had just seen. These are some of the most important financial decisions that they will make for the next stage of their lives.

Authority Problem

It has been proven that we blindly trust experts and authority figures. The more "letters" next to your name on a business card, the better. In the early 70's the Milgram experiment was published and showed the extreme affect that authority figures can have on our ability to resist instructions that we may not agree with.[1] Many other experiments were conducted since then, but the final point is this:

1 There are actually several other biases which impacted the results of this study, however, following authority is the most famous.

if one person is established as an authority in a given context, we are likely to follow their instructions, even if we wholeheartedly disagree with them, or don't understand them.

Ideally, we should be listening to learned, experienced people who offer true value to us outside of appearance and social standing.

Ideally, we should be listening to learned, experienced people who offer true value to us outside of appearance and social standing. Meaning, if the young financial advisor above walked in slovenly dressed, reeking of booze and urine, it should have no impact on whether or not we take his advice, but this is has been proven not to be the case.

Put another way, we are more likely to follow poor, senseless advice from a nice smelling, well dressed person than good, practical advice from someone who appears unprofessional. The difference between the two is simple: we feel good about working with people we like and who appear to have an idea of what they're doing. The rest (or, specifically, the ability to think critically about what is being offered as advice) is really not as important to us.

But, what makes an expert? Most people agree that having university degrees, industry experience and these sorts of things are part of the criteria. Certainly there should be something more to it than that. A university degree with about five years work experience should get you to the same level of expertise as, probably, every single other person in your graduating class,[2] learning from roughly the same curriculum and talking to the same industry professionals (who also likely learned the same thing). Again, there has to be something more to it than that.

The Man Behind the Suit

The young executive in the story made several life altering decisions which led him to the meeting with retirees that day. He was presented with different options at various times in his life. In university, he had to choose a major for graduate school and he thought about which designation would lead to the highest paying job. When out in the workforce, he then had to make a choice between different organizations that sent him offers. He may have simply chosen the highest paying job, shortest commute, or the one which "made the most sense" for that stage in his career. We cannot logically assume that he chose the job he did because of a genuine passion or aptitude.

2 Then, you could never be more of an expert than the person who graduated before you, but the good news is you will always be ahead of the people who graduate after you.

When we meet a professional, the question, "What makes this person an expert?" is much more difficult to answer than "Do I like this person?" Yet, we are likely to answer the latter question more often than not.

There is something crass about regarding professionals in the workplace this way, rather than giving credit for the education and years of work required to obtain the status. It is also certainly not something we think about when we set up meetings with professionals.[3]

In *Thinking, Fast and Slow*, Daniel Kahneman explains that our mind is constantly trying to lighten it's workload by creating shortcuts. In instances where there are very difficult questions that we have to reason through, we sometimes answer a different, simpler question without realizing it. He uses an example of an executive deciding to purchase stock in Ford. "Do I want to buy stock in Ford?" turned into "Do I like Ford cars?" He decided to buy the shares because he answered the second question, which is obviously very different. This type of thought process is in fact what marketing companies try to encourage through creating brand associations.

When we meet a professional, the question, "What makes this person an expert?" is much more difficult to answer than "Do I like this person?" Yet, we are likely to answer the latter question more often than not. This question avoids having to think about how that person got in front of you in the first place, and how they were selected to give you advice.[4]

Ignoring the more difficult questions also makes career changes more tolerable. To sit through a 5-10 minute presentation from a qualified professional and at the same time consider that in a few years they can be in a totally different industry, say farming, or running a food truck, is not very comforting while you receive important advice. So, it is easier to ignore that these are possibilities, and accept that the person sitting in front of us is the right person to be speaking with on the subject. In fact, this is what we do.[5] By no means do I think career changes are unacceptable, or that these decisions disqualify or demean the work which was done while that person was at their job. The key point here is when

3 Later on, we will talk about Domain Dependence, or the mental handicap we have in being able to apply the same idea to two different contexts.

4 Whenever I go into an office and see degrees, certificates or other achievements put up on the person's wall, I feel a sense of comfort that this person knows what they are doing; and then I realize that I should start paying closer attention or I might succumb to the authority bias.

5 Many psychologists have expanded on Kahneman's work. Cialidini, among others, has written about how our mind prefers to use shortcuts as often as it can. For example, we are more naturally inclined to use something like "he wears a uniform" as why we give a position of authority versus understanding their true value.

we are receiving advice from an authority figure we are not usually making a determination about what is being said.

Now, take our profile of this young professional and consider that had he made slightly different decisions, which perhaps led him to a position in a declining industry, such as a different branch of the same institution (today this would actually be the advisory or management division[6]), and you realize that he was just as close to being unemployed as he was to providing financial advice. This is both striking and painfully realistic.

When we are receiving advice from an authority figure we are not usually making a determination about what is being said.

What about the Professional?

At this point I believe it is important to note that the professional does not know, or realize this. From his perspective, he is employed to do a job based on his qualifications, and is performing his duties to help the company he works for succeed. Off the clock, however, different habits may be more acceptable to him. Many professionals, like our young executive, lead what their clients might even call a double life. For example, there are doctors who smoke, lawyers who advise large corporations on mergers and acquisitions, but who hire advisors to handle their own personal investments, and life insurance brokers who ride motorcycles.

We have a mental handicap, whereby we struggle to understand and apply the same subject in two different contexts. Nassim Nicholas Taleb[7] dubbed this handicap 'domain dependence'. Through regular day to day observations he proposes that we do not have the ability to recognize situations where something that we learned in a different setting would still be applicable in the situation we find ourselves in at the moment.

The doctor who smokes simply cannot place himself in his own patient's shoes when he decides to take up smoking. In *The Feeling of Risk*, Paul Slovic shows many studies which he conducted to prove that psychologically, people who smoke understood the health risks at the time they took it up, but ignored them.

6 Widespread layoffs are occurring today. Here is just one article: http://www.theglobeandmail.com/report-on-business/scotiabank-to-take-restructuring-charge-as-banks-look-to-trim-payrolls/article29820546

7 Nassim Nicholas Taleb is a scholar, statistician, former trader, and risk analyst, with a focus on problems of randomness, probability, and uncertainty. His 2007 book *The Black Swan* was described in a review by the Sunday Times as one of the twelve most influential books since World War II.

This was not dependent on a job, in fact had no correlation with what the person does for a living. In other words, their day to day activities had no influence on these decisions.

Having habits which shorten your life expectancy can reduce the importance of something like financial risks, but in our regular day to day lives we don't see one as having to do with the other.

The implications here are that no level of study, or expertise ensures that we are applying our knowledge consistently across all aspects of our lives. A few months ago I was driving and texting, and my text message was about something related to managing risk in an investment. I realized in that moment, that the biggest risk I was actually taking was with my life.[8] Having habits which shorten your life expectancy can reduce the importance of something like financial risks, but in our regular day to day lives we don't see one as having to do with the other. In other words, the phrase, "I will end up with more money from this investment if I don't die in a crash while driving and texting" is a strange consideration, but is ultimately true.

Taleb finds quirkier day to day examples, like how we take the elevator up to the gym, and then get on the Stair Master. We place "get to the gym" in one area of our minds, and then "exercise" in another. More seriously, he notes the amount of "risk experts" who recommended the purchases of the very same debt products that created the financial collapse in 2008.

A Prevalent Example Today, Relevant for Investors

'Indexing' is a popular investment strategy today. This is where investors buy units in a fund that allocates one's investment dollars across a broad range of stocks that make up a particular market index (for example, the S&P 500). These funds have historically low management fees, which works well to return more to the investor.

One of the key marketing messages of these funds is to repeatedly communicate that one cannot beat the market, and that we should all put money into their products and then passively watch our nest egg grow over the next several decades.

Note, however, that the fund manager, or the founder, never mentions that their largest investment is actually not in the markets at all, but is in a start-up business – their fund (Funds typically have a separate management entity which is owned

8 Marc Maron, a very funny comedian, says that texting while driving is more dangerous than drunk driving, because unlike when you're drunk, when you text and drive you'll find yourself looking up at the road once in a while and thinking "who was just driving the car?"

by the managers. These entities receive the fees which the investor is paying into. Usually this is calculated as a percentage of assets under management).

While these funds do charge less overall management fees than mutual funds and do succeed in passing these savings onto the client, the management entity itself is receiving its revenues independent of market returns. The revenues of the manager's company will typically increase as the assets under management increase. Therefore, the investment in the venture itself, if successful, will increase its value at a rate which will far exceed the broader market returns. In other words, the fund owner who is selling his product based on the idea that you can't beat the market, is actually, at that very moment, beating the market!

Unknowingly, the CEO has given investment advice that he himself is not taking, but his success as an entrepreneur has provided credibility to his message.

In one particular situation, the CEO of an index fund company recommended that everyone invest in indices, but in the same interview proclaimed that the best investment he ever made was in his own company.[9] Unknowingly, the CEO has given investment advice that he himself is not taking, but his success as an entrepreneur has provided credibility to his message.

To be clear, I believe that buying a low cost index fund is a sound strategy for most people and the results speak for themselves. What I mean to point out here is the mental handicap we have in being able to apply the same idea in two different contexts and how this should alter our thinking about the messages which we are both sending and receiving.

Checkpoint

What we have seen so far is that, while we are likely to act on advice from experts and be influenced by people in authority, we rarely do so because we have thought critically about the information we are receiving. In reality, the opposite may actually be the case. We tend to go out of our way not to think too much about it, given we have experts to advise us. Finally, through the example of the typical presentation a professional will make, the emphasis we put on the 'appearance' of knowing, rather than actually knowing, has been illustrated.

On the other hand, when we are the ones providing advice, we have many psychological handicaps that are not easy to detect. And there are often motivations,

9 Some funds that are software based will receive venture capital from venture capital firms. I am sure that during the pitch there was little time spent explaining to the VC how they can't beat the market. In fact, successful VC pitches usually focus on how the firm will make unlimited returns in a short period of time.

It appears that what the 'expert' really is to us is a real world manifestation of our need for psychological security.

such as increasing sales, or a desire to tell people what 'they want to hear', which influence our approach. These influence us to provide advice that we ourselves do not necessarily follow. Domain dependence is an example.

In summary, we find ourselves in situations where a person receives (and usually listens to or acts on) advice from another person who may not necessarily be qualified, or actually personally practice the advice they provide to others.

Now for some possible conclusions.

Security

It appears that what the 'expert' really is to us is a real world manifestation of our need for psychological security. It is a representation of a person who can settle all of our worries about the things which are most complicated, the things which we simply don't have the time to research and understand on our own.

It is a double edge sword. Not only is the expert an authority on the subject, they are also providing information which you will likely find is the societal standard.[10] In other words, the idea that an expert is correct is re-enforced the more you speak to your friends, family and colleagues, who have all heard roughly the same advice or opinion.[11] More often than not, if you speak to someone about why they are with their current financial advisor, their doctor, why they hired *this* lawyer, or *that* insurance broker, the answer is usually the same: "We think our advisors work hard, they know what they're doing, and they're nice, good guys," and so forth. I usually wonder how far these responses are from the following: "I like this person, and nothing bad has happened to me since I hired them."

An acknowledgment of this thought process alone is helpful in being more critical when receiving advice.

Some More Conclusions: Eat Your Own Cooking

The challenge with all of this, then becomes how we reduce our exposure to risks that come from these types of professional interactions. It is possible that people

10 The tendency to behave like the masses is called 'social proof', another bias which is embedded in all of the points being made in this paper.

11 If you would like to see the industry standard for wealth and retirement planning, visit local bank branches and pick up the brochures which they are offering. A quick comparison will show little difference in the advice.

Though no one can guarantee results, it is much more comforting to know that the person standing in front of us will lose and win with us, rather than just win.

who we interact with on a regular basis are providing us with information that is completely useless, like receiving directions from someone using a map from a different city. The person can be nice and the directions well intended, but you are not going to end up where you want to go.

A catch-all for these handicaps (being our authority bias and domain dependence), and probably the best risk management system we have, is ensuring that the people we deal with regularly both win and lose with us. They have to have "skin in the game" or a common phrase I hear is "the interests are aligned". In ancient Rome, bridge builders had to stand underneath the bridges they built when they were tested. If they were built too weak, the builders knew that they would suffer the same result as the people crossing the bridges. In our map analogy above, imagine how different the answer would be if the person providing the directions had to pay for half the gas bill. Or, think about how different the advice of an Index Fund manager would be if he stood to lose the equivalent in fees if the market declined.

Asking yourself what a person has to gain and lose in a situation should lead to the decision to associate more often with people who truly want what is best for us. Though no one can guarantee results, it is much more comforting to know that the person standing in front of us will lose and win with us, rather than just win.

Appendix: How to Eat Your Own Cooking

Warren Buffett is widely regarded as the greatest investor ever. The media covers his classic business cases and showcase his shrewd moves that created value for his shareholders. He is the most interviewed CEO of all time and his letters to his shareholders are read like the gospel.

I believe that the wide attraction to Buffett has held up because there has never been a person with a performance history (that we know of) who has been this dedicated to having skin in the game.

Buffet's influence is so large that he has spawned thousands of funds who have tried to imitate his style. The marketing material from these companies use buzz words and phrases like "buy and hold", "value investing", "long term partnership" and Buffett-isms like "be greedy when others are fearful and fearful when others are greedy", "invest like you have a punch card with only 20 punches on it," and "price is what you pay, but value is what you get."

I believe that the wide attraction to Buffett has held up because there has never been a person with a performance history (that we know of) who has been this dedicated to having skin in the game. If these other companies lack this essence, they will always be a cheap imitation. The best example of this type of behaviour actually took place before he was building Berkshire Hathaway, in 1968.

After running one of the most successful investment partnerships for 10 years,[12] Buffett, who started with a small investment from family, grew to manage over $1 billion (adjusted for inflation) of assets. Then, at the height of his popularity in his community, having beaten the market every year, with no end in sight to his success, he did the unexpected: he closed his partnership.

In his letters to his investors,[13] he explained his reasoning. His market outlook for the next period was not good, and he doubted that he could continue producing the same record of returns. He looked at the next stock market and determined that he could not possibly repeat what he did, a viewpoint which is just as difficult to admit as it is to recognize in the first place. He foresaw that his returns to his investors would be poor and he would still be paid his fee (though his net worth

12 Contrary to Buffett's popular media personality, Buffett's investment partnership was what we would label today a hedge fund, and an activist one at that. Like Ben Graham before him, he would commonly take large positions in companies and get on the board to convince management on how to properly return capital to shareholders. In fact, his takeover of Berkshire Hathaway itself was hostile, where he organized somewhat of a political coup to get Seabury Stanton off of the board and take control.

13 Unlike the letters to shareholder's which may or may not be vetted by PR groups, the letters to his investors were unedited and are considered strong source material for what Buffett thought at the time. Bear in mind that in his late 20's Buffett likely didn't know he would eventually be so well known that people would dig up his old letters and read them again as 'source material'.

Even to this day, if you own a share of Berkshire Hathaway, you own a share in all of Buffett's investments.

would severely decline). He would be trapped in a world where investors would be clamouring, "What have you done for me lately?" while he would collect his fee and move on to the next year, chasing the market index.

Buffett had no incentive to walk away. Indeed, his fee structure at the time was to make 25% of the excess returns he made for his investors above a 6% threshold. Here was a 35-year-old who had his whole life ahead of him to continue earning a management fee and he walked away, unsure of exactly what he would do next. I am not sure there are many people who would do that.

True to his claims to his investors, Buffett did not buy stocks in earnest again for nearly five to seven years after he closed his partnerships. When he did so, he did it under Berkshire Hathaway's auspices. He put all of his net worth and all of his assets under this umbrella, where he would win and lose on all his activity, along with his shareholders. It is rare that one finds a case where an individual commits at this level to having skin in the game. Even to this day, if you own a share of Berkshire Hathaway, you own a share in all of Buffett's investments.