

SKBA CAPITAL MANAGEMENT

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OBSERVATION & OWNERSHIP:

Avoiding the “Wylie Coyote Moment”

By Matthew Zuck

Tolstoy “believed that only by patient empirical observation could any knowledge be obtained; that this knowledge is always inadequate, that simple people often know the truth better than learned men, because their observation of men and nature is less clouded by empty theories, not because they are inspired...”

Isaiah Berlin, The Hedgehog and the Fox, p.46

“No one in the history of the world ever washed a rental car.”

Lawrence Summers

Observation and ownership are two of the keys of a functioning business, economy or organization. This is obvious, but often overlooked, or underestimated. Berlin’s analysis of Tolstoy gets at the observation angle, and we’ve all rented a car, but never washed it.

A fundamental advantage of a market economy is that it solicits and incorporates many observations from different parties by allowing them ownership¹ (equity shares) of the profits or losses. The prospect of profit or loss (ownership) “solicits” the input, and an effective marketplace “incorporates” these observations into prices.

The incremental difference between the value of one individual observation and the informed collective observations of a group *has historically been* a key

¹ The ownership perspective simply acknowledges that in the long term people respond to their incentives, whether you want to credit this observation to supply-side economics, B.F. Skinner, or others.

difference between the United States and much of the rest of the world.² Ownership can be thought of as the difference between how folks treat a rental car and their own car, and in the markets this phenomenon is magnified millions of times.

A focus on observation and ownership informs our investment process here at SKBA. We look for companies that recognize their strengths and weaknesses, recognize the changes in the world around them, and take responsibility for adapting to, or shaping those changes.

The net result of observation and ownership, when they work, is constant learning and improvement within an organization. This improvement and learning is best understood in economic terms as extending the duration of any competitive advantages, or extending the “competitive advantage period.” The competitive advantage period is the period over which a company’s returns in excess of the industry average disappear, or the amount of time that it takes for the returns to mean revert.

The results of observation are not something that shows up as a separate line item on a financial statement. It shows up in the sustainability of a business and the stability of exceptional financial performance, which one would expect to be competed away.

Managements that do not observe, adapt, and take ownership (responsibility) for profits and losses are headed for a “Wylie Coyote moment.” That’s the moment when they run past the edge of a cliff, look down, only to find nothing there but air (often hot) supporting their existence.

² This “information” argument is the core of Hayek’s critique of Communism/Socialism, and also the core of micro-economic price theory.

This Wylie Coyote Moment can be thought of as when a competitive advantage unexpectedly disappears.

One way to protect against the “Wylie Coyote moment” is to find management that is an owner. In other words, where *ownership isn’t a perspective that they adopt in decision-making, it is who they are.*

Aligning Observation and Ownership, in this sense, is a principal-agent problem. Management is the agent that we want to behave as an owner -- driven by empirical observations about their business. If management is in fact an owner, then this lowers the cost of getting them to behave like an owner (dilution from options or complicated contracts), and solves one of our problems at SKBA in analyzing the company and its incentive structure.

This facet of ownership, while not on the balance sheet, is in the annual proxy statement filed with the SEC. We refer to firms where management is also a significant owner as “*owner-operators*” and we tend to prefer owner-operators as investments.³

Another, more traditional, way to identify companies whose business is driven by principles of observation and ownership is to listen. In the manic world of Mr. Market, simply listening, taking notes, and comparing what folks said they would do, with what they did is a powerful tool:

- How are shortfalls of surprises explained?
- Who takes responsibility/ownership?
- *How are plans modified to take account of the unexpected, and does it make sense? Or would it only work in a cartoon?*

³ The Russell 1000 Value and the S&P 500 are both between 10-15% owner-operators depending on precisely what one defines as significant ownership.

Understanding the *differences between perceptions and reality* both within the market and within organizations which produce surprises, price shifts or “Wylie Coyote moments” is a key source of competitive advantage at SKBA.

At SKBA, we spend a significant amount of our time observing companies and *doing our best* to either avoid or exploit the Wylie Coyote moments – as we endeavor to invest the core of the portfolio in businesses run by folks who understand the role of observation and ownership in the operation of an excellent business.

We will make mistakes in this process, but expect to be constantly observing and taking ownership, just as we expect the companies in the portfolio to.

We believe that two factors:

1. This observation-driven assessment of companies from a long-term owner’s perspective, and
2. The long-term orientation of our clients and their understanding of our approach⁴

provide a sustainable source of competitive advantage in the investment business.

We look forward to maintaining these advantages at SKBA and finding colorful, as well as quantitative, ways to communicate them to our clients as we build their real wealth.

Disclaimer: The analysis and opinions expressed in this report are subject to change without notice. They do not represent a buy or sell recommendation and should not be viewed as a promise of future performance.

⁴ In Peter Bernstein’s book *Capital* on the Capital Group, the essential role of the clients in the long-term excellence of the organization was bizarrely omitted.