Dear fellow shareholder,

The Over-Intelligent Investor

"It is remarkable how much long-term advantage people have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."- Charlie Munger

As regular readers know I was for quite a long time, quite a long time ago, a banker. Not one those glamorous investment bankers you'd like your kids to be, hobnobbing with industrial princes (and actual princes) at Davos, but a common-or-garden commercial banker, lending medium-sized sums to middling businesses. Although there was a lot of grunt work – finding a client, negotiating terms, getting approval from colleagues for the loan, documentation and ongoing monitoring – the heart of it was loss aversion. A bank is itself a borrower and most of its capital comes from depositors. The history of banking is a sad story of collapses, and most bank collapses start with bad loans, leading to erosion of capital and depositor flight. To make things even more difficult for us lenders the profit on commercial lending was small. We might borrow from the depositors at 4%[1] and lend to the client at 6%, so our profit on a loan of £1m was not more than £20,000, and this was before salaries and other overheads. And we could lose up to £1m, so the odds were rather skewed against us, and we worked hard to find good borrowers and appraise their prospects and the security offered.

While there were occasional frauds, most bad debt arose from the normal run of bad luck, our customer losing one of their own big customers or suffering an industry-wide downturn. In most of these cases our security (assets we could sell if necessary) was good. The biggest losses I witnessed, where the bank lost close to 100% of its capital, were for another reason – lender overconfidence. Let me tell you about one of these loans. The lender was Charles. He had been an academic star, qualified further in two professions far removed from his university degree and was ferociously intelligent. There was also something ferocious in his character. This sat ill in banking which, at its senior levels, is a collegiate endeavour with opinions freely sought and offered, all in service of making good loans. Charles had found an interesting company in Belgium and it wanted to start a similar business in London. It was supplying all of the technology and plant and the whole project was forecast to make an enormous profit from year three, just as it had in Belgium. It was the sort of thing most bankers would run a mile from: it was a startup, there was no guarantee from the Belgian company and if it went wrong our security was the plant and equipment which would have little resale value. But Charles was gung-ho. He negotiated some equity in the project, so our return went from 2% to 4%. He wrote a thirty page paper covering all of the risks and how they were contained. He presented it to our friendly credit committee with his normal panache and aggression, and it was approved.

The process didn't work. As the recent faltering rollout of vaccine factories demonstrated, technology transplant is delicate and not guaranteed to succeed. The amount of capital needed to cover the now larger losses was big and neither the Belgians nor ourselves were prepared to take the additional risk. The project was shuttered, there were no takers for the specialised plant, the

[1] For our younger readers, in those days bank deposits actually paid interest

loss on the loan was total and the whole bank slightly staggered from this one bad debt. Charles was over-intelligent. He believed he could understand the whole equation and not many people can. Fundamentally, he didn't understand the maths, which was that an upside of 4% does not balance a downside of 100%, unless you have profoundly controlled that downside – not anlysed it but actually mitigated it.

Lending is not much of a craft compared to investing. It was a pleasure to escape the cold tea of the banking parlour for the warm broth of the stock exchange. No more negotiation, no more committees, no more 2%[2]. In fact, the maths are radically different. We can withstand the odd major loss, as the winners should more than compensate. That is why we don't have only one stock in our portfolios. But overconfidence, and its handmaiden overintelligence, is a universal vice. I have come across many Charleses as an investor. Shun the person who writes a thirty page presentation; they have likely overcommitted to their idea. Far more sensible is the individual who admits that no investment is perfect and, on a balance of probabilities, concludes the good aspects will outweigh the bad. Beware the spreadsheet. Use your calculator with caution. If the idea needs a twenty year forecast or three significant figures it is not profitable enough. Maths is a potent tool but a poor master. Indeed, inexactitude is its own margin of safety ("If the timetable slips and we get a lower sale price but the returns are still excellent we are paying a good price.") Investing is risky in its nature, the company will not follow the exact path you chartered, good or bad. And most great investment theses are simple if well explained.

There is nothing wrong with intelligence, of course, but in investing, as in other parts of life, it is best supplemented with emotion, intuition and humility. Humility in front of the facts ("what actually is this business, not what did I think it was?); humility in front of the future, predictable within ranges as it may be; and humility about one's own abilities.

Nominative News

- Has it occurred to you that the epic fight to succeed Warren Buffett is between men called Jain and Abel (say it out loud)?
- On a similarly euphonious note, how delightful that Shoe Zone plc is so committed to its core competence that is has replaced Peter Foot as its Finance Director with Terry Boot

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

[2] Unless you are a fixed income investor

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