Groucho Marx observed; "The secret to life is honesty and fair dealing. If you can fake that, you've got it made."

Mark Twain is reported to have said; "All my life I have been honest—comparatively honest. I could never use money I had not made honestly—I could only lend it."

Investors are indulged with many ways to lose money. Rationality and due diligence can help protect against the more common errors of paying too much or underestimating the impact of competitive forces. Losses from overpaying or from competitive weaknesses are painful yet predictable. But what of losses from corporate fraud or dishonesty? Less predictable, equally painful. While for some companies the impact of dishonesty doesn't seem to go much beyond embarrassment (Wells Fargo), for others it can be franchise threatening (Och-Ziff) or even fatal (WorldCom, Enron, Arthur Andersen).

This raises an obvious question. Can we filter for frankness?

In the spirt of avoiding stupidity as an easier endeavour than seeking brilliance, we could begin our exploration with a look at some of the characteristics that may increase the propensity towards dishonesty.

These include:

- A history of strong 'adjusted' financial metrics, frequently recast in the most positive light.
- A dominant, obsessive or narcissistic CEO.
- An industry that is concentrated and/or hyper-competitive.
- Companies with flawed incentive schemes (e.g. highly skewed to one metric).
- Companies or industries facing extinction.
- Low return, capital intensive industries.
- Companies that do business in countries with weak governance.

But the above doesn't answer the harder question. What features would suggest less likelihood of fraud? I asked an engineering friend this question, and he smiled and said, "where people are involved, there is always the risk of fraud." A sober assessment with more than a grain of truth unfortunately. That said, I suspect investors may find refuge at the intersection of character, culture and capital allocation.

On Character: Good management leads by example. Results are presented honestly and clearly. Mistakes are admitted early, communicated openly and dealt with promptly. Frequently fanatical, with real skin in the game (high insider ownership where wealth creation is through founder shares or purchased shares held for the long term).

On Culture: A good culture reveals itself in a purpose-driven organisation with a strong service ethos. The company is looking to do great work first with a view that the profits will then follow. The culture is nurtured with a balanced blend of humility and ambition.

On the Craft of Capital Allocation: There is an intellectual honesty that flows from a focus on capital allocation. Returns on capital employed (or in the case of capital light businesses, returns on allocated resources) go to the core of frank performance evaluation. Thoughtful capital allocators produce transparent financial metrics that can be reconciled to free cash flow and that can be readily understood in the context of the underlying business.

One can never know for sure, but my sense is that the trifecta of culture, character and thoughtful capital allocation is a good filter for frankness. And, as good as that may be, there is still no guarantee that we won't be blindsided. This should temper any urges toward over-concentration.

L Endersen – August 2017