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In Pursuit of Value

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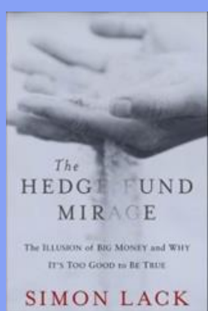
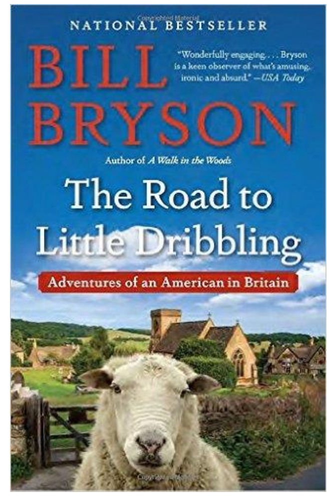


Dunning-Kruger and Investing

The Road to Little Dribbling; Adventures of an American in Britain is Bill Bryson's latest in a lifetime of writing about his observations traveling across America, Britain and Australia. I've found his descriptions of adapting to life in the UK particularly entertaining since he and I migrated across the Atlantic in opposite directions. I can imagine us comparing notes on our life choices over an adult beverage one day.

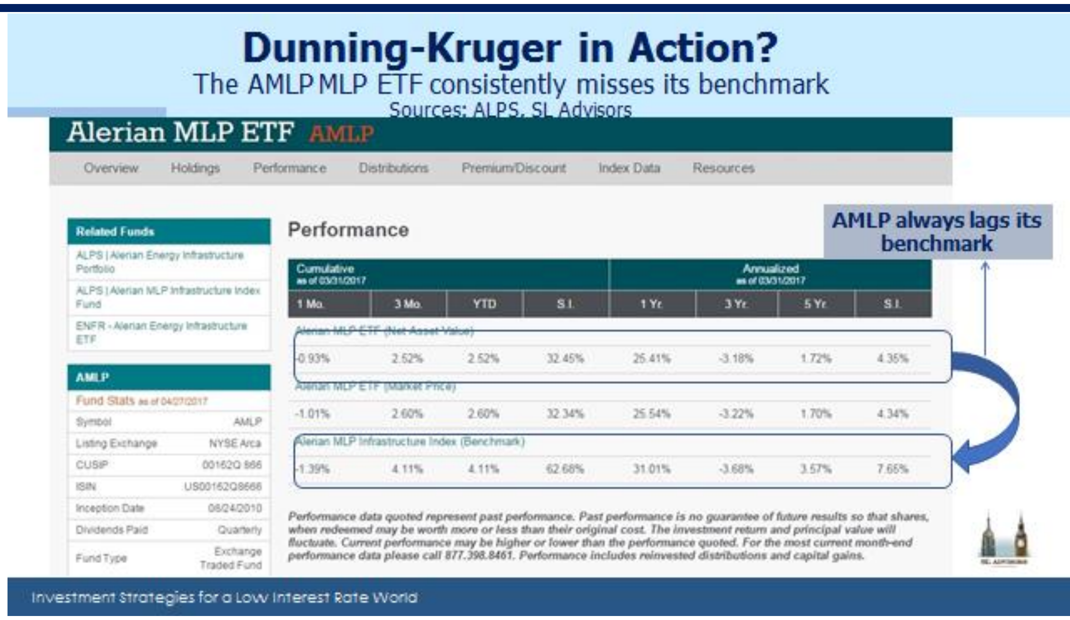


Bryson has become a bit more of a curmudgeon of late, with even less tolerance for life's instances of trivial stupidity. He's a bit like the late Andy Rooney who used to conclude *60 Minutes* every Sunday. The targets of Bryson's grousing include incorrect punctuation everywhere and the UK public transport system (on this he has many sympathizers). In describing one interaction with a cognitively challenged bureaucrat, Bryson refers to the Dunning-Kruger effect. Dunning-Kruger (D-K) is a condition in which someone with weak mental capacity mistakenly thinks they are on the other end of the IQ scale. I was immediately struck by the immense satisfaction to be gained by dismissively classifying almost any stupid behavior as an example of D-K. In short, some people are too stupid to know how stupid they are, and while that's obvious to the rest of us, a pair of psychologists has helpfully formalized a diagnosis. The investment business is blessed with more examples than many industries, and dinner with ones' peers might be enlivened by identifying instances of D-K behavior. In 2000 Dunning and Kruger were awarded the satirical Ig Nobel Prize in Psychology for their work.

We'll return to D-K representatives shortly, but since most newsletters touch on Master Limited Partnerships (MLPs), few will know that travel writer Bill Bryson is tangentially connected with this sector. In 2004 at JPMorgan we met Gabriel Hammond and soon invested in his firm, Alerian Capital Management. Gabriel had a vision for bringing retail investors to MLPs, and part of that included creating an index. While seemingly obvious, it hadn't been done and the result was both the most widely used MLP benchmark as well as a money management firm (SteelPath) that was eventually sold to Oppenheimer Funds.

Having helped make MLPs more accessible to retail investors, Gabriel moved on to apply his talents and part of his recent wealth to launching Broad Green Pictures, a movie production company. In this he was joined by his younger brother Daniel, who had worked at Alerian in the early days. Among their relatively prolific output is *A Walk in the Woods*, based on Bill Bryson's book of his hike along the Appalachian Trail. It's an engaging story and probably Bryson's best seller. The movie starred Robert Redford and Nick Nolte, and if you like Bryson's writing you'll enjoy the movie. The career path that goes from Alerian to Hollywood is eclectic indeed, but Gabe Hammond is not your typical finance guy.

Returning to Dunning-Kruger nominees, regular readers might expect the managers of taxable MLP funds to figure prominently on any list. After all, years ago I distinctly remember watching MLP manager Jerry Swank pour withering criticism on the Alerian ETF (AMLP) with its 35% Federal corporate tax drag. Logically, few buyers should exist for a security that sets out to provide only 65% of the sector's return, but not every investor reads



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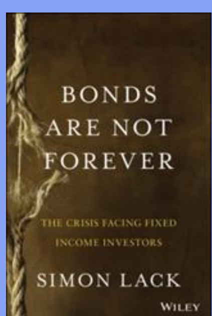

that much. As we've noted before (see Some MLP Investors Get Taxed Twice) $53BN of retail money is apparently quite undemanding. In Alerian's early years they spent considerable time and money researching ways to provide retail investors MLP exposure without K-1s. They ultimately concluded there was no way to avoid the 35% tax drag, and like others before them reasoned few investors would desire such an inefficient vehicle. But later they decided to try anyway, and AMLP was the result. Many investors remain seemingly oblivious to the substantial drag on returns the taxable structure creates, although the results are hidden in plain sight as the screenshot from their website shows. Jerry Swank soon changed his mind too and started his own tax-inefficient fund (Mainstay Cushing, CSHAX). But Jerry misses the D-K list because correctly underestimating some retail investors eventually made him wealthy when he sold his business to New York Life.

Some of the more strident environmentalists might be D-K candidates. Driving to a demonstration against an oil pipeline requires a stunning ignorance of how a modern society functions. Cleaning up the local environment after the environmental protesters against Energy Transfer's Dakota Access Pipeline had left required the Army Corps of Engineers to deploy 835 dumpsters. While protecting the environment is in everyone's interests, some of its more ardent defenders seem to feature D-K behavior quite prominently.

The hedge fund community contains a rich source of D-K candidates. There's a case for including most hedge fund consultants. But it's hard to beat publicly betting with Warren Buffett that hedge funds would outperform the S&P500 over ten years, as one industry professional did in 2007. Even the 2008 financial crisis didn't provide enough of a head start to compensate for subsequent years of fee-drenched mediocrity. We won't name the poor fellow but he's easily found via Google or in Berkshire Hathaway's 2016 annual letter. Few hedge fund managers today would publicly aim so high. Their goals are more modest – generally low single digits with not much volatility. Business success for a D-K patient is surely only possible with similarly afflicted clients, a point that many investors might ponder.