Marshfield Associates

Letter to Clients
December 2023

The Ghost in the Machine

"When I meet someone, I don't want to see them from the front or the back. I prefer the side view. People call it a mental profile for a reason: the side view has stories to tell….".

Yohji Yamamoto

"Back off man, I'm a scientist."

Peter Venkman, Ghostbusters

Objectivity is not all it's cracked up to be. Not only is it elusive, but being in thrall to it risks ignoring or minimizing information that may seem "squishy" (to use a technical term) and lacking in rational provenance but that nonetheless captures an essential truth. We get it. It's quite tempting to think that the pursuit of The Truth involves exclusively the rigorous application of pure reason and the careful parsing of concrete facts and concepts. Keeping at bay the forces of intuition, gut feeling, and ephemeral impressions would seem to be a way of safeguarding that rigor. Certainly, we've written fairly extensively about the challenges to logic posed by the sloppy thinking born of cognitive and emotional bias. Cognitive tics such as confirmation bias and anchoring distort decision-making[1] by short-circuiting rational judgment. These biases need to be called out each and every time they rear their heads. Yet it is not subjectivity that weaponizes these cognitive bogeymen; it is the fact that an otherwise rational process has been hijacked by mental shortcuts that once upon a time served humankind pretty well when hunting, gathering, and warding off enemies. As human beings, we've evolved to be more alert to dramatic than to subtle evidence, we like to be proven right so we pay more attention to information that confirms our "priors", we have fears of "missing out" and so tend to go along with the crowd, and we find it more comfortable to acknowledge wins than to admit to our losses. Such shortcuts interrupt the chain of logic, taking an otherwise objective analysis on a detour into irrationality.

Subjective analysis, on the other hand, is neither a bug in our software nor an irrational response but, rather, a completely separate mode of thinking. And just like objective reasoning, it, too, can be contaminated by a host of standard errors in judgment such as recency, extra vividness, and confirmation bias, among others. Nevertheless, we believe it to be one of the most powerful weapons in our analytic arsenal. We have long sought to tap into and systematize this kind of analysis in order to examine attributes that are real but intangible such as culture, resilience, and the quality of management. The evaluation of such characteristics is, by necessity, at least partly impressionistic, and because of that, difficult if not impossible to subject to independent scrutiny and objective verification—in other words,

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[1] See Living in the Past, April 2021 and Breaking Up is Hard to Do, September 2021.

they are subjective. Subjective analysis can be fast or slow, but often relies upon what we variously call first impressions or gut/snap judgments. These are speedy and cognitively economical but also powerful—and often spot-on—in their implications. They result from the brain reaching a fast conclusion based on relatively few data points, while leaning on experience and expertise to reach what can be highly accurate results.[2] And unlike the distorting shortcuts that cognitive biases represent, these fast-twitch conclusions are simply abbreviations of an understanding that we can't easily put into words; they're not detours that effectively override what could otherwise be an objective assessment. But (cue spooky music) we're okay with and even encourage this kind of occult knowledge.[3] There is a world of pertinent information available to us that doesn't come through the tidy portals of 10Ks and quarterly earnings calls. It's hard to access this world in totally straightforward ways or with an extra dash of diligence, as it often comes to us through flashes of perception or insights that only loosely nod to the facts at hand. Think of the professional tennis player who knows where the ball will land before her opponent even returns the shot. As in that case, we believe that we ignore such "useful cognitive shortcuts" at our peril.

Because we need to be able to address both objectively and subjectively framed questions in order for us to do our job properly, we don't have the luxury of sticking to "just the facts, ma'am". We *need* to rely on something apart from objective fact in order to make such judgments. This, of course, presents us with a series of tough questions: do all fleeting observations, hunches, gut feelings, uneasiness, and excitement count as potentially "valid information" or is some of it too ephemeral and insubstantial to be probative; to which internal voices should we be listening and which should we simply tune out; and, finally, how can we instill some degree of rigor into the process of evaluating such "soft" knowledge? If our intuitions and snap judgments are more than simply artifacts of an earlier world where taking the time to deliberate the facts could end in our death (or simply missing out on dinner), can we repurpose and develop confidence in those intuitions and judgments today, in a world where our survival isn't threatened during the time it takes to perfect a spreadsheet?

Our answer to these questions is by necessity imperfect and, for some of you, perhaps, troubling: we openly invite our research colleagues to articulate their impressions, gut feelings, snap conclusions, and half-baked theories so that we can examine and dig into them—however outlandish—in order to ascertain whether they contain nuggets of useful information. Much as Charlie Munger urges us to "always invert"[4] in order to reveal hidden biases, we like to look at the Rorschach inkblot the company presents from every angle: front, back, and in profile. While this is anything but scientific, this approach nevertheless aligns nicely with our overall discipline in that it requires patience: feel the feelings, note the insights, but exercise forbearance in awarding them a role in our decision-making. One of the reasons we believe in the power of group discussion and assessment is that, while subject to idiosyncratic interpretation, such judgments are nevertheless susceptible to better understanding through the pooling of our collective

[2] It is perhaps ironic that much of what creates bias in more objective modes of thought—shortcuts that bypass more considered rational analysis—actually can prove efficient when it comes to subjective assessments.
[3] At the risk of being even more pedantic than usual, we're using this term in the medical sense of not readily visible or discernible.
[4] Munger believes that by turning a problem upside down and backwards, you can avoid stupid results. For example, instead of only asking, "how can I attain this goal?", one should ask, "what are all the things that could prevent me from reaching this goal?"

cognitive and observational resources. We therefore suspend any conclusion while we look for other information that either bolsters or contrasts with those impressions. In other words, we follow something akin to the concept of “trust, but verify”; we acknowledge the thought or feeling but reserve judgment until we can, in the fullness of time, determine whether it adds to our mosaic or whether it’s simply noise.[5]

Nudge[6]

A client recently asked us why we hew to a 20-stock limit rather than the slightly larger and more diversified one that the investing literature suggests is optimal.[7] The glib response is that it’s worked for us over many years. Our portfolio volatility has been lower than that of the market over time, suggesting that our lack of diversification has not only failed to increase risk but in fact served to dampen it. And we’ll gladly put our long-term portfolio performance up against that of the S&P 500 Index, as the comparison reveals that we have not traded low volatility for more modest performance. The real answer, though, acknowledges our own emotional biases and helps nudge our decisions in the right direction. Because each position has a sizable impact on the portfolio, we are hyper-focused on investing only in companies that conform to our investment parameters. In contrast, as position sizes decline, so the discomfort of buying something whose failure might meaningfully impede performance also eases. Perhaps most salient, though, is the fact that, for us at Marshfield, the pain of underperforming due to poor investment choices is sufficiently intense that large position sizes bait the trap; our pride and competitive spirit do the rest. Understanding and deploying subjective assessments and having a process for eliciting and integrating gut judgments give us, we think, a competitive advantage by providing us a deeper understanding of what makes a company and its management tick. Our commitment is to assemble a portfolio of stocks that represent sustainably good businesses, not to produce a collection of companies

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[5] Philosophers have long wrestled with the peculiarities of the human mind and the degree to which experience influences thought. Today, prevailing theory eschews both the “ghost in the machine” theory, wherein the mind and body are entirely separate entities, and the “blank slate” theory, in which our minds are nothing but that which we learn. Instead, it’s believed that the mind (encompassing both thoughts and feelings) has both the capacity to be influenced by experience and also arrives on the scene for each of us with certain cognitive and emotional presets. The contemporary framework is thus an integrative one, where thoughts, feelings, impulses, and consciousness are all features of both experience and factory-installed settings. It’s our job, for better or worse, to sift through those thoughts and feelings for information that adds value, while mindful of the distorting influence of the congenital glitches in our software. For a useful history of how scholars have thought about the human mind, see Steven Pinker, *The Blank Slate*.

[6] Richard Thaler and Cass Sunstein, two of the luminaries in the field of behavioral economics, published the book *Nudge: Improving Decisions About Health, Wealth, and Happiness* in 2008. The core idea of the book is that the choices people make can be “nudged” in predictable ways through how a choice is presented. This idea is not that different from the concept of incentives, but they propose a kind of bite-sized version that can be used to “nudge” desired behaviors. Since the publication of this work, there has been significant controversy undercutting the “science” underlying much of the research in this area, though Thaler and Sunstein remain largely unscathed. See, e.g., “Economists Loved So-Called Nudge Thinking. But It’s a Dud”, Washington Post, November 7, 2023. Others have not been let off so lightly. Dan Ariely and Francesca Gino have been roundly called out; see, e.g., “They Studied Dishonesty. Was Their Work a Lie?”, The New Yorker, September 30, 2023.

[7] Researchers posed the question of how many randomly selected stocks would be needed to approximate the volatility of the broad stock market. The answer was about 30. See, “Some Studies of Variability of Returns on Investments in Common Stocks”, Lawrence Fisher and James H. Lorie, The Journal of Business, 1970.

we see no ready reason to reject. This confers on us both a heightened sense of responsibility in allowing entry into the portfolio and the concomitant freedom to decline an investment. It's intentionally asymmetric; we want it to be far more difficult to make it into our portfolio than to be kept out.

This does not, however, mean that we should feel free to reject companies on a mere fancy. While the reasons for rejection are myriad (e.g., we do not believe that we can fully understand the business, the company has a poor culture/indifferent management/insufficiently robust returns through a cycle, and so on), the list does not include whimsy. Nor does it mean that we determine what to buy or not according to what our "gut" tells us.[8] There is no room for casualness in this business; if we fail to articulate a cogent reason for rejecting (or embracing) an idea, we risk degrading the overall rigor of our discipline. Any attempt to produce consistent results relies on the replicability of our process and, in particular, our analytical consistency.

Blink[9]

There are numerous pathways through which we as human beings obtain information in order to learn about the world around us. The most direct—and seemingly reliable—is through the application of rational cognition. For example, the answer to the question of how much free cash a company generates in a given year is addressed by assembling the relevant facts provided by the company and then assessing how much cash the company has used versus how much it has brought in over the course of the year. While some distortion can enter into this calculation, and certainly errors can be made, it depends on a largely straightforward and objective gathering of data and the application of a pretty standard analytical framework. We veer off this well-marked path, however, when we are called upon to make subjective assessments. The answer to the question of whether someone is a good leader, for example, is not susceptible to objective factual analysis. Instead, we are called upon to assemble more of a mosaic comprising bits and pieces of anecdotal evidence and useful analogies. Much as one might like to have such, there is no definable set of data whose collection and assessment will on its own yield a reliable answer. This is probably one reason why Boards fail with some frequency in their quest to replace a retiring CEO with the right successor. Gallingly for those seeking a definitive conclusion, there's always one more story, one more analogy, one more insight that could contribute to the clarity of the picture.

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[8] Gut matters to us when it provides insight into a particular aspect of a company or a person that is not readily ascertainable through the application of objective analytical tools. It can become dangerous if applied to the investment as a whole or to attributes that are otherwise susceptible to objective analysis. While, for example, the observation that the "investment just doesn't sit right with me" requires additional thought, it should not be the primary basis for a definitive decision. For a delightful and utterly confusing take on this, see "How Does the World's Largest Hedge Fund Really Make Its Money?", The New York Times, November 2, 2023.

[9] With thanks to Malcolm Gladwell, whose book *Blink: The Power of Thinking Without Thinking* examines the phenomenon of split-second decision-making and how it can in some ways be more powerful (and useful) than considered judgment. In particular, he examines "thin-slicing", wherein a narrow data set that can be captured literally in the blink of an eye serves to fuel the powerful intuitive engine inside each of us.

Some years ago, we owned a substantial position in Wells Fargo. We liked what we saw and heard from management, and it was hard to argue with its results. Dick Kovacevich, the bank's CEO, was the hard-driving architect of the firm's successful strategy of selling multiple products to its customers, which created a degree of entanglement and stickiness that was the envy of the financial world. Wells was also rightly applauded for keeping a firm lid on loan losses through excellent underwriting and the discipline to remain on the sidelines while others kept dancing to the siren song of subprime lending.[10] Although there was a persistent quiet thrumming of discontent among customers of its retail arm, mostly coming from the Los Angeles market where Wells had bought First Interstate Bancorp, no big issues ever bubbled to the surface during Kovacevich's tenure to challenge the prevailing narrative of a risk-averse institution that sought only the success of its customers. Nevertheless, we took note of the drumbeat of consumer dissatisfaction.

In 2007, after an internal beauty contest in which three rivals vied for the top spot, the low-key and well-coifed John Stumpf was chosen to replace the hard-boiled Kovacevich. Stumpf was both elegant and smooth, with a lovely self-deprecating sense of humor. When we first met him, he joked that he grew up in the Nordic part of Minnesota, not far from where the wood chipper scene in the movie Fargo was filmed. But his suave yet folksy approach obscured the fact that something was, in fact, very rotten in the state of Denmark. While we had the vague worry that Stumpf was, as one of us put it, "a suit", there was nothing overt to chase down. It was simply a "feeling" that he might not be up to the task. Although we listened to the nagging voice in our (collective) head, it did not in itself seem actionable, so we waited for more tangible evidence. This came over time in the form of additional sense impressions: Stumpf seemed to use humor as a way of deflecting questions, relying on his deputies to provide detailed answers to our queries. Was this merely collaboration and the show-casing of more junior members of his team or was it a lack of familiarity with the facts? It was still unclear.

Once it became apparent to us, however, that the culture at Wells was increasingly challenged because of the larger footprint the company had assumed when it bought Wachovia in December of 2008, we felt well justified in obeying that vague uneasiness and selling a quarter of our position. By our measure, though, the company was still much like any other, where there were always "rat hairs in the peanut butter".[11] It was simply a question of whether the investment was becoming so hairy it needed more than a trim. Our judgment was impeded in part by another bias—this one emotional and easily identified by us but nonetheless hard to resist—that we had done very well in the investment over a long period of time.

Our doubts were soon lent additional substance, however, in the form of the CFPB sanctioning and fining the bank for having "sold" products to customers who knew nothing about them in an effort to pump up

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[10] Chuck Prince, then CEO of Citibank, famously said in 2007 that, "as long as the music is playing, you've got to get up and dance." This was the year before the great financial crisis, when disciplined institutions understood the imperative to pull back and those less restrained waltzed their way to ruin.

[11] This is a reference to the FDA allowance of four rodent hairs per one regular-sized 16-ounce jar of peanut butter, our shorthand for the recognition that no company is perfect. With apologies if this has put you off your lunch, you can be reassured (or horrified – take your pick) knowing that peanut butter is actually one of the most controlled foods on the FDA list.

cross-selling numbers. While Wells had been doing an admirable job of protecting the bank against the incoming risks of bad loans, it had been doing a slipshod job of protecting customers against the greed and misaligned incentives of its own employees. We sold another third of our position, followed relatively shortly thereafter by the sale of the entire remaining position.

We tell this somewhat humbling story to make a point: what we learned (or were reminded of) from our experience with Wells is that it is important to listen to your doubts, however inchoate or ephemeral, chase down any factual evidence supporting or contradicting them, and then see if you are mostly there (you never, ever get fully “there” on a subjective assessment). Had we done that in this case, we might have sold out of our position in the company before we did. While we weren’t harmed by waiting to sell the final tranche, that may have been more a matter of luck than we’d prefer to admit,[12] and the truth is, we probably had enough confirmation of our original hunch well before we took that decisive action.

Washington Mutual is another of our long-gone holdings about which we developed a strong gut feeling that led to our selling it, in this case far more quickly than we did Wells. The feeling hit us hard after we had unearthed some troubling factual issues that concerned us but that we did not see as dispositive at first blush. WaMu, as you may recall, was a financial juggernaut in the years leading up to the Great Recession. A savings and loan based in Seattle, it spread via acquisition throughout the country, with the goal of becoming the “Wal-Mart of banking”. In that regard, it had some notable success. And yet, years before the cracks started to become visible to the naked eye, and despite WaMu’s intriguing strategy of appealing to “regular” people through innovative branch designs and friendly tellers, we had some reservations about their ability to execute well. Our ears began to prick up in particular with respect to their acquisition strategy. We were concerned about their decision to press ahead with more acquisitions without having fully integrated previous purchases. They were fast-tracking growth in order to stay ahead of the pack but they were slow-walking the blocking and tackling required to address their growing pains. As a result, they lagged in merging legacy technology systems, making it impossible for those systems to talk to one another. It seemed dissonant to us to have acquisition-based growth without a robust and time-sensitive plan for how to knit together all of the systems into a seamless whole.

We thus began to wonder whether Kerry Killinger, the CEO, was truly a talented impresario or simply the Wizard of Oz. Our question was answered when we had lunch with the man himself in 2004 at a conference in New York. As one does in such situations, we sought to take advantage of our access and put to him a series of questions. He waved them away and insisted instead on bragging about how he would be leaving shortly to play golf with John Reed, then the CEO of Citibank. We’ve met many a blowhard in our professional (okay, and personal) lives, and we recognize the type. Call it a bias, but it’s based on many data points and it certainly fit into our tentative narrative that he was not a serious person. We sold the position.

[12] In fact, we were fortunate in that the market surged following the 2016 election.

Sometimes, our "useful cognitive shortcut" yields a positive snap judgment. Recently, our research team went out to Indiana to meet in person with the new CEO of **Cummins**, Jennifer Rumsey. We spent considerable time not just with her but with her CFO, Mark Smith, and other top lieutenants. An engineer by training, Rumsey had been steeped for many years in the culture of the company and had had her chops tested in a variety of roles. She entered the top slot following the retirement of Tom Linebarger, a visionary leader who charted the multi-pronged strategy for the company to address the looming revolution in fuel sources for trucks and other large on- and off-road motorized vehicles. When we make such a visit, we are typically on the hunt for several things, in no particular order, each of which varies in the degree to which it calls on an impressionistic judgment: the relationship between the CEO and his or her colleagues; the degree of strategic fluency demonstrated; the ability to speak both "small" and "large", demonstrating both facility with detail and a sweeping knowledge of the big picture; and a willingness to acknowledge challenges. We specifically look for alignment with the demands of the industry in which the company operates. In the case of Cummins, an engineering-forward business, we look for comfort with the technologies integral to the industry, both as it exists today and as it seeks to evolve.

Immediately following our set of meetings, we pooled our collective observations on the way back to DC. We find it important to do this as soon as we can following a meeting or conversation, as the mind has a way of normalizing judgments relatively rapidly after an encounter and slotting them into our pre-existing frame of reference (aka confirmation bias). Our general impression after this visit was one of competence, facility with concepts both large and small, a purposeful but patient mindset, and a collegial and respectful collective approach of locked arms without lock-step thinking. Our only reservation was that Rumsey seemed willing to follow the breadcrumb trail Linebarger left, tweaking it as necessary, but otherwise using it as a blueprint. And yet, as of now, we are fine with that given that the company is no longer at the strategic development stage but has embarked upon the execution phase. Given what we saw and heard, we think—until we see any evidence to the contrary, for which we will be on the lookout—that she is a quite satisfactory CEO for the blocking and tackling component of their strategic rollout.

One final example of a gut assessment with a positive tilt and how we operationalized it comes in the form of an email from a company whose stock we recently purchased. As you may be aware, shortly after we purchased our first tranche of **Discover Financial Service**'s shares, at a price we found extremely attractive, the company announced the abrupt departure of its CEO and the opening of an FDIC investigation into unspecified compliance deficits at the company. While we had understood upon entering into the position that there were certain regulatory issues that partly accounted for the low share price, we were comfortable with the nature and magnitude of those items. With the Wells debacle still relatively fresh in our memory, though, we decided to take a breath or two (patience!) before buying more of the stock following these announcements, notwithstanding the even more appealing discount to our view of intrinsic value at which it was selling. Unfortunately, "compliance lapses" cover a multitude of possible sins, and the FDIC has broad authority to impose a panoply of sanctions, from relatively benign to existential. When the company's interim CEO held a call to discuss the developments, it was largely without content, on the understandable basis that they themselves were not yet privy either to the extent of the investigation or the outcome of it. Still, we held onto the position, believing the company to be very good at what it did, with a culture of integrity and risk management, and a strong commitment to customer service.

Our patience was rewarded when, on the evening of September 25th of this year, the company sent us an email inviting us to participate in a call discussing various proxy initiatives and to introduce us to their new "proxy and stewardship teams" that would allow them to "learn more about [our] firm's expectations as they apply to Discover." While the email was straightforward and presumably sent to multiple institutional investors like ourselves, our immediate thought—surfaced by one of us but embraced quickly by all—was that something had happened not only to make them feel freer to speak publicly, but to do so in a way that would affirm their governance structure. The email had an intangible upbeat feel that was distinct from their more recent communications. We stress-tested our valuation once again, and then bought more at what we viewed to be a substantially discounted price. Within days, we were rewarded with the public announcement of the conclusion of the FDIC's investigation and the imposition of what, in regulatory terms, amounted to a slap on the wrist.[13]

Noise[14]

The old saw that the first answer you put down on a test is likely to be more accurate than a later one formulated after further thought has roots in the academic literature but also in experiences we've all had.[15] Similarly, much has been written about how that spidey-sense of fear that often fails to break through to form a coherent thought can have serious implications.[16] Experience and expertise, when leveraged by the powerful processing apparatus of the human brain, can often respond far more rapidly to data inputs than more conscious rational analysis. We at Marshfield try to make use of the power of such intuitive leaps without leaving ourselves exposed to relying on mere fairy dust. At the end of the day, however, this is anything but a science, despite what some members of the academic community are wont to proclaim. As noted above, even some of those purporting to approach behavioral finance scientifically have sometimes shown the need to massage the data to the point of relaxation.

Which brings us to the question of noise. Which pieces of the mosaic that we assemble are truly additive to the overall picture and which parts are just random images? By its very nature, in our own work, we

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[13] The company now has to report on a quarterly basis about progress they're making in addressing their compliance deficits.

[14] *Noise: A Flaw in Human Judgment* by Daniel Kahneman, Olivier Sibony, and Cass Sunstein posits that wherever judgment comes into play, there is noise that interferes with its execution, resulting in the kinds of variations we see in such things as differing diagnoses based on the same symptoms in the same patient or the variance in sentences judges give for the same crimes.

[15] On the other hand, the "bat and ball" question highlighted by Daniel Kahneman in his book *Thinking, Fast and Slow* illustrates that there are two modes of thinking, in this case, thinking of the objective kind: fast and intuitive versus slow and methodical. Each has its advantages under different circumstances. See also, "The Simple Maths Puzzle That Shows Us How to Separate Fact From Fiction", Tim Harford, Financial Times, November 3, 2023.

[16] *The Gift of Fear,* by Gavin de Becker, is a must-read on the subject, arguing that every individual needs to learn to trust their gut when feeling those pinpricks of fear.

are dealing with subjective observations by inherently biased (albeit well-trained and experienced) human beings (ourselves). Indeed, each of us has a set of cognitive and emotional predispositions which we carry around, not to mention the random preoccupations that beset us on a daily basis. Such biases both create internal noise and make us susceptible to not understanding the difference between external static and real evidence. In paying attention to gut and intuition, we risk thinking something has probative value when it is simply scat to be filtered out. Our answer to separating the wheat from the chaff is to listen with a receptive and trained ear, to discuss with intellectually supportive colleagues, and to keep all hypotheses on the table until the facts, sense impressions, snap judgments, and rational analysis coalesce with some degree of clarity around a colorable narrative. We are careful to integrate these observations into our checklist process, including examining them for any distorting biases, so that they get the full airing they deserve. At the end of the day, though, if there is even a whiff of something truly noisome, we are obligated to simply say no even if it it's unclear whether or not it's "noisy", in keeping with our preference for committing sins of omission as opposed to those of commission. This approach helps ensure that we ask ourselves the same questions for each company, with an aim toward teasing out what is important and what is not, what may have been colored by bias and what seems relatively free of it, and what may have been a fleeting apparition better fit for the Ghostbusters to address.

Conclusion

Human cognition is both prismatic and plastic. Prismatic due to our kaleidoscopic ability to assess the world around us through a multitude of lenses that enable us to absorb and process feelings, sensory information, and thought, to reason deductively and inductively, and to rely on past experiences to draw analogies to present ones. And plastic because our brains are protean and literally change over time through our use of them, developing new pathways, repaving and expanding those we use often, and finding workarounds for those poorly adapted to our everyday needs. But for every cognitive gift bestowed on us by nature, we have the challenge of how best to use that endowment. Investing, far from limiting us to the right side of the brain and cordoning us off from our sensory receptors, in fact invites us to deploy each of these tools in our search for good stocks. But we need to use them well and wisely, with an eagle eye on ways in which our biases can make them untrustworthy. It is this ability to pull in and integrate information gathered through different modalities, each imparting its own bit of coloration to the mosaic, that differentiates humans from machines. We cannot imagine even a well-fed artificial intellect with the capacity to do the same.

Marshfield Associates