

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Bob Ollech and Jon Bruss
Date: October 19, 2007
Subject: THE HALO EFFECT

We read a lot around here and every so often some of what we read is sufficiently thought-provoking to share. *The Halo Effect*, by Phil Rosenzweig, is just one of those books that might help you become a better manager **and** a better investor. The author systematically takes to task the claims of self-proclaimed business experts and describes in detail nine "business delusions" that he believes often deceive business managers. Rosenzweig makes a case that managers (and investors) are systematically delusional (ouch!) when it comes to understanding the true reasons for strong company performance. If you are a fan of *Good to Great*, *Built to Last*, *In Search of Excellence*, or other high-profile business books, prepare to have your "sacred cows" slaughtered (and maybe ground into hamburger). If nothing else, reading the book should help managers and investors think more critically about truly understanding company performance. A few of the "delusions" are, in no particular order:

The Halo Effect: This is a very common mental shortcut that is born out of people's natural desire for simplicity. It is the tendency for people (including most investors) to look at a successful company's performance and then form sweeping positive attributions about its management, its products and culture from that general impression. (Is this one of the reasons that public companies use investor relations consultants?) Management of a rapidly growing company with a fast rising stock price must be brilliant, right? And, does it not follow that a company with a falling stock price must be run by outmoded buffoons? Cisco Systems' stock rose from a few cents on a split-adjusted basis to over \$60 in the tech bubble, and then cratered to less than \$10 before rebounding to its current price. Is John Chambers, the CEO of Cisco, a genius? A dolt? Just lucky?

How about the Florida banker whose bank expanded its loans and deposits at a 20% clip for several years as his trade area boomed? A far-sighted visionary superbly executing a superior growth strategy others should emulate? The leader of a finely-tuned team of exceptional bankers? Now that economic growth in the market has slowed, and the bank's balance sheet and earnings growth has stalled, is that CEO a less capable manager? Are the bank's lenders less competent? Is the bank doomed to a future of slow growth and sub-par earnings? How quickly people's assessments change when their initial analysis is flawed (see below).

Favoring Single Explanations: Many studies portend to show that a single factor is responsible for a company's performance. Of course, there are many factors which contribute to performance and many are highly correlated; the effect of each one, when subjected to rigorous analysis, is usually much less than suggested. People's need to summarize and simplify often leads them to ignore the impact of the near constant ongoing changes in customers, technology and markets on future performance. Just because something seems plausible doesn't mean it is.

Lack of Rigorous Research: Consultants and journalists often rely on scientifically suspect methods to "prove" a preconceived conclusion. Even worse, too many "professionals" who should know better are ignorant of sound statistical research methods and can't tell good research from bad. As the sayings go, "there are lies, damn lies and statistics," and its companion, "if you torture the numbers enough, they will say anything you want." Any data miner worth his salt can find a dataset to support just about any hypothesis. Unfortunately, despite the fact that most of them are smart and hard-working, many executives (including bankers) have a limited ability to think rigorously and critically, especially about business research. As a result, they are often gullible and willing to believe research that claims to give the "secrets" to high performance. Most consultants are good salesmen and are experts at "selling the sizzle" to executives hungry for a steak.

Confusing Correlation and Causality: There is a strong human tendency to confuse correlation with causality. Two things can be correlated, but it is often the case that neither causes the other. To wit, a 1995 statistical analysis by David J. Leinweber, Ph.D. at Caltech, found that changes in butter production in Bangladesh statistically explained 75% of the change in the S&P 500 Index. The data sets might be highly correlated, but causal? Hardly.

The Myth of Lasting Success: Reversion to the mean is a powerful trend. Almost all high-performing companies regress / revert over time. To think that there is a single recipe for lasting success is to ignore the constant and accelerating changes in markets, technology and competition. There is no formula for lasting success. While some companies adapt to change more readily, only a handful have sustained above average results for more than a few years – a decade or two at the most. Most investors miss the important turning points in a company's history; rather, they cling to opinions formed on the basis of past results. There is a natural tendency to accept the status quo in most organizations, including banks. A rigorous and regular program of strategic assessment can help to extend the duration of above average performance. Many managers dismiss strategic planning as something akin to navel contemplation, a once a year obligation that is endured and forgotten about until next year. Successful companies are often in a continuous state of development, identifying and exploiting new opportunities, while jettisoning business lines which have become outmoded or stale.

Comparing Results and Defining Success on an Absolute Basis: Performance is relative, not absolute. A company can improve and fall behind its rivals at the same time. Ford makes much better quality vehicles than it did 10 years ago; its Japanese competitors, however, have taken an enormous slice of market share and helped to make Ford a less valuable company. Are Citibank, Chase or Bank of America better banks than they were 10 years ago? Well, they are certainly bigger, but if they were truly better, would there have been room for the nearly 200 new banks started annually over the last 10 years-many in the back yards "owned" by these gargantuan institutions? Would they not be posting consistently higher returns on assets and equity? Would they be losing market share to foreign competitors and nonbank financial companies?

Professor Rozenzweig has identified three more "delusions" he contends fool managers and investors, but you can grab a copy from your local library or favorite book store and read about them yourself. As we read the book, one of us was reminded again of the "Pogo" cartoon in which one of Walt Kelly's swamp characters announced to his fellow denizens, "We have met the enemy and he is us!"

Those of us running small banks or investing in them have recently been challenged by market factors which, in many cases, are beyond our direct control. Our accepted conventions have been challenged. We've had a 100 year flood—its seems more often than every 100 years. *The Halo Effect* will not lead you to some magical formula for running a successful company or bank or becoming a leading bank investor, but it should help you become a more clear-sighted and objective manager and investor. It should also help you better understand your own thinking—which is always a good thing.

FORTRESS

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