

Reflections On Being a Fiduciary

What does it mean to be a fiduciary?

The U.S. Securities and Exchange Commission's definition of *fiduciary* is a "duty to eliminate, or at least expose, all conflicts of interest which might incline an adviser--consciously or unconsciously--to render advice which is not disinterested."

Translating the SEC's language into layman's terms, you have to at least mention in the fine print when you're getting over on your clients.

I believe fiduciary carries a deeper meaning. Not only should you be "not disinterested," you should be actively engaged in doing what's best for those in your charge, even at personal expense.¹ You should sit on the same side of the table, and find aligned incentives. It means actually caring that people under your care have a good outcome.

But even "good outcome" is a loaded term.

Is it as simple as "up and to the right"? For how long? And what's the path to get there?

Theory and Practice

In medical settings, researchers distinguish between the **efficacy** and the **effectiveness** of an intervention.

Efficacy trials represent best-case scenarios. Researchers want to know if an intervention produces the expected result under ideal, controlled circumstances. What's the best we can hope for?

Effectiveness trials are more pragmatic. They capture the beneficial effects of an intervention under real world clinical settings. What can we actually expect in the field?

There can be oceanic gaps between efficacy and effectiveness. An intervention may work in theory, yet fail in practice.

¹ Like in 2017 when Farnam Street eliminated management fee on excess cash, cutting firm revenue in half overnight.

The same applies to the world of investing. You may be able to build a portfolio producing hall-of-fame returns over thirty years. But if sickening volatility, large drawdowns, and long periods of underperformance make it psychologically impossible for the client to endure the ride, you may arrive at the promised land, having brought no one with you.

Your ego and your pocketbook may have swollen over those three decades, but you will have failed your fiduciary duty. So up-and-to-the-right can't be the only answer.

How can we minimize the gap between investment efficacy and effectiveness?

Firstly, knowing your clients helps. Are they solely looking for safe passage to the mountain top? How many years do they have to make the trip?

Or might the client also require gripping stories of moonshot companies they can drop at cocktail parties? Can they suffer with equanimity as their dopey brother-in-law gets rich faster than them in the next new thing.

I am sympathetic to the many advisors who knowingly make investment choices they would rather not, attempting to keep clients happy. They have a hunch they aren't doing what's in the best long-term interests of their clients, but there is no long-term if the client fires them in the interim.²

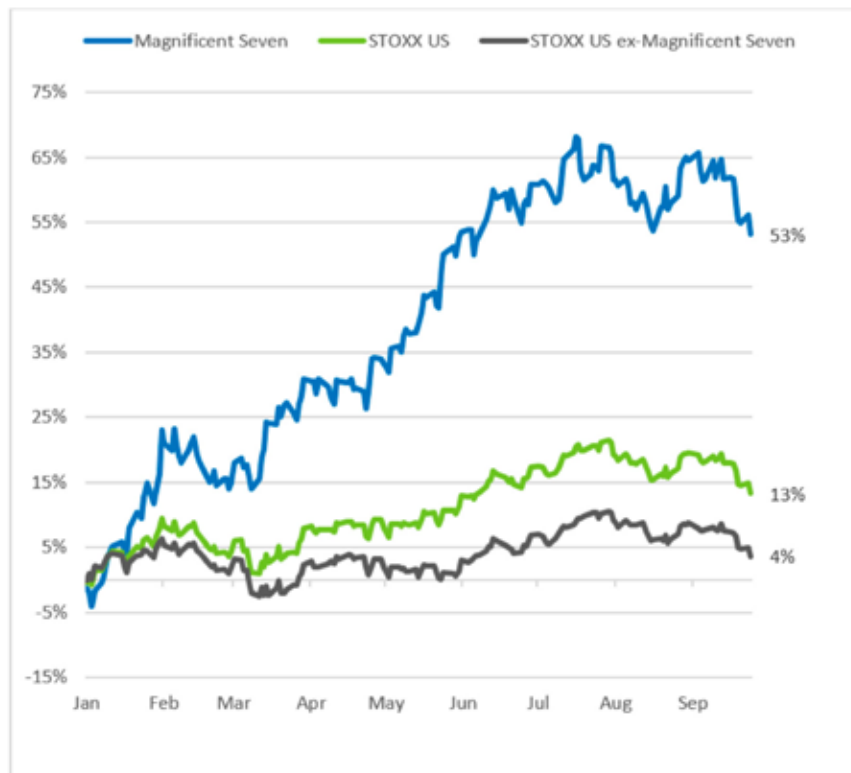
This herding behavior congeals into masses chasing heat. Recent examples include cannabis, electric vehicles, cryptocurrencies and NFTs, and artificial intelligence this year. Before that we had U.S. real estate in the 2000s, dot-coms in the 1990s, Japan Inc. in the 1980s, electronics in the 1960s, all the way back to aviation, TV, cars, radios, railroads, canals, Mississippi, tulips... enthusiasm has always been contagious.

My hunch is that the deliverables of returns and excitement are mutually exclusive.

With a blistering run in 2023, Mr. Market's fickle eye has shifted to the "Magnificent 7." This is the catchy moniker for the mega-tech stocks: Apple, Microsoft, Amazon, Alphabet/Google, Nvidia, Tesla, and Meta/Facebook. All are exceptional businesses with unique advantages and massive scale. The rest of the market has been inert.

² One is reminded of the ill-fated July 2007 comment from Citi's CEO, Chuck Prince: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance." Within a year, his firm was crashing on the subprime mortgage rocks.

Figure 5 – Magnificent Seven vs. US market YTD performance

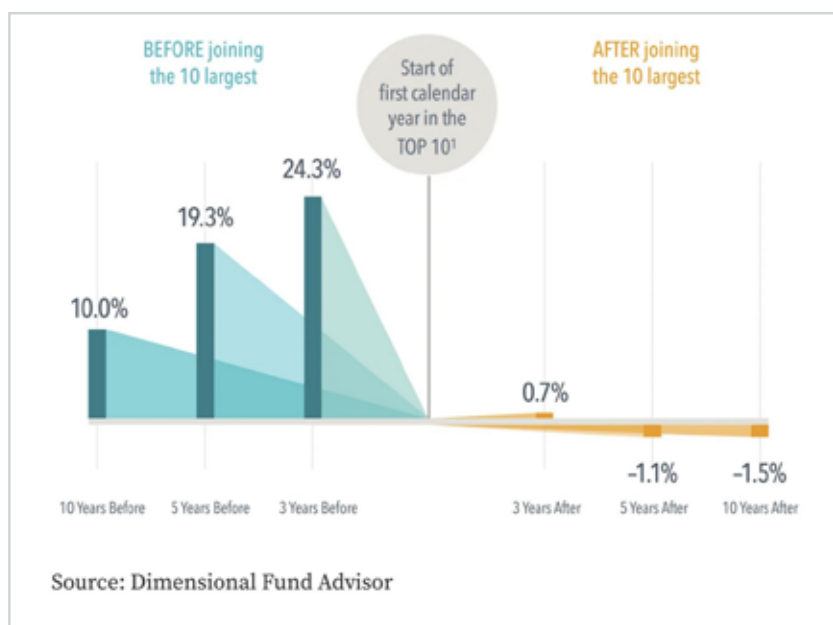


Advisors today are deciding how much of the Mag 7 they must own. If the tech behemoths keep appreciating while their clients are underweight these names, they will underperform and risk being axed.

But the dominance of these seven is secret to no one, and they trade richly due to their historical successes.³

What do the baserates say? Betting on the biggest companies has historically been a losing proposition. Using Fama-French's data from 1927-2019, we see that outperformance to achieve Top 10 status leads to underperformance after inclusion. Markets move in cycles; the catbird seats turn over.

³ According to Grant's Interest Rate Observer, the Mag 7 command 31% of the S&P 500's market cap (\$10.8 trillion), and trade at an average of 53.6 times trailing earnings.



Perhaps this time is different and the Magnificent 7 will be the exception. It's certainly possible that AI supercharges the incumbents to an insurmountable competitive advantage. But if we use the analogs of electricity in the early 20th century or the internet in the early 21st, that's not the way to bet. The history of technological revolutions repeatedly reveals that today's hot new tools become tomorrow's toaster. Capitalism is fierce: excess profits are competed away, and it's the consumer who emerges victorious.

Fiduciary Over What Time Frame?

Back to our exploration of fiduciary matters. It's important to understand the relevant measurement period.

A simple return equation will reveal much of the way the world works.

$$(1+r)^n$$

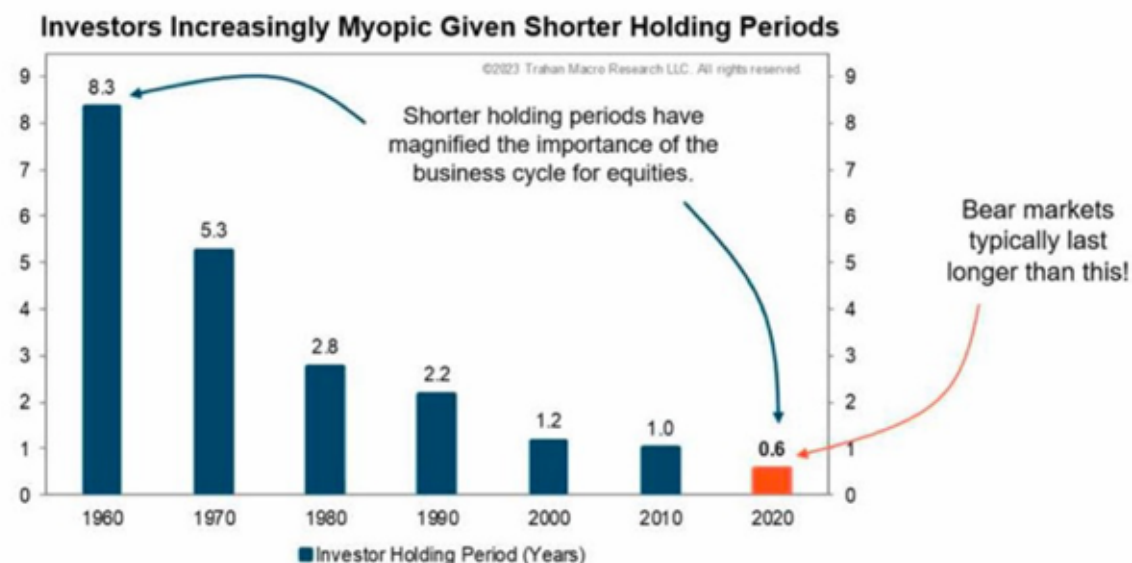
r = the annual rate of return

n = number of periods

Most of humanity is hyper-focused on r .

Investors' holding periods drop every decade. It's down to a little over six months. There are lots of renters, but precious few owners.⁴

The Average Holding Period For Stocks Has Shrunk Dramatically



It's not just investors. More than half of the CEOs in the S&P 500 have been on the job less than six years. There's a shocking amount of turnover in Corporate America. Little wonder they do everything in their power to jack up the r , get paid a boatload of options, and move on before the n matters.

Capital expenditure to create tomorrow's cash flows? Added debt loads which will require refinancing and big interest expenses? Buybacks at whatever price which hollow out cash balances? Stock based compensation schemes carving out large equity chunks for management and employees? Tense labor negotiations? Cheated suppliers? Price-gouged customers?

None of these matter when you're out the door before the bill comes due.

⁴ In February 2023, Tesla's stock averaged 200 million shares of daily average volume. That's more than \$40 billion worth trading every day on a \$600b market cap. More than 5% of the company was shuffled around every single day. At that pace, the entire company would have changed hands more than 12 times in a year. How's that for a hot potato?



The Economist

You see r -chasing in every headline, investor deck, and corporate presentation.

But long-term fiduciaries should be more concerned with n , as exponents are the most powerful mathematical force in the universe.

Let's explore a simple, extreme example to understand the outsized impacts of exponents and time horizons.

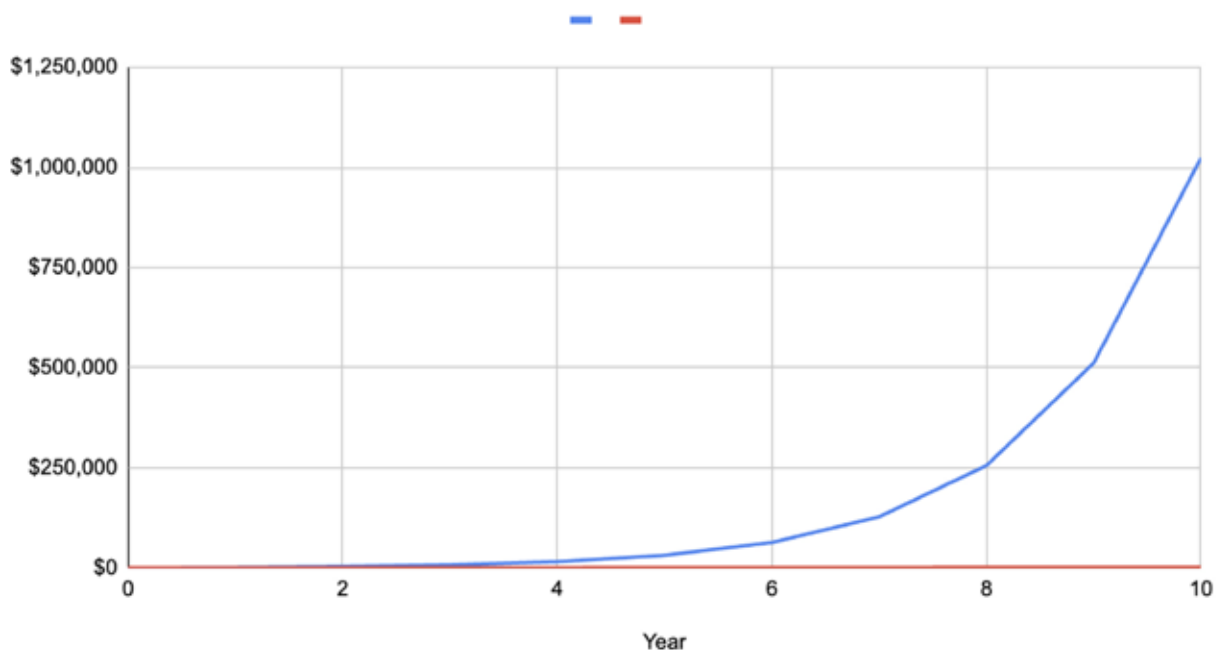
Imagine a hotshot manager knew a way to double your money every year for a decade. (Run, don't walk, from anyone making that promise.)

After ten years, \$1,000 would have grown into \$1,024,000. They would be rightfully crowned the next investment genius, showered with assets and accolades.

Assume that I plodded along earning an unheroic 10% for that same decade. I'd be completely left in the dust. My \$1,000 would have grown to only \$2,594⁵, laughable when compared to the \$1 million. I'd definitely be fired. My red line in the chart below has barely gotten out of bed after a decade.

⁵ What is this... a return for ants?!

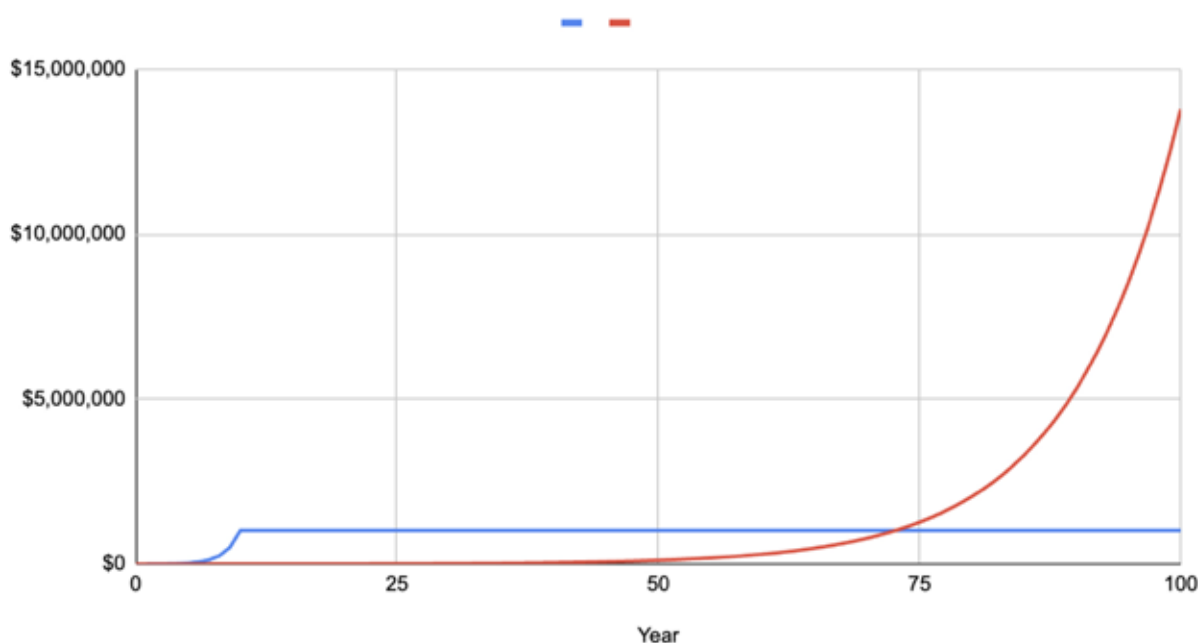
100% Return vs. 10% Return for 10 Years



However, let's tweak our game. Assume now that my 10% return was sustainable for a century, and the hotshot manager's strategy was only good for those first ten years, then didn't go anywhere. This isn't unrealistic as markets tend to self-neutralize strategies which earn abnormal returns. It's the large-return whale who surfaces, only to be harpooned by competitive arbitrage.

After a century, my pedestrian 10% return has compounded \$1,000 into \$13.7 million, more than 13x our hot-shot manager. It shouldn't be lost that the majority of the outperformance occurs in the later innings. Great duration requires even greater patience.

100% Return for 10 Years vs. 10% Return for 100 Years



This stylized extreme example hopefully aids our intuition. And compounding series are quite unintuitive to our species. We evolved on the linear plain; understanding compounding wasn't a matter of survival.

The takeaway: over short time horizons, focusing on the r of returns is how you win. The bigger the better, and a large r excites everyone.

But if you want to be a good fiduciary over a long time horizon, you must ignore the sugar high of r . Instead focus on the meat-and-potatoes n of duration. This approach can look very boring for long stretches, but the power of compounding creates awesome inevitabilities.⁶

The inescapable fact is you must choose an optimization between r and n . Be mindful of which game you're playing.

⁶ Lest you think these examples completely hypothetical, everyone was watching the excitement in the summer of 2021 as the theater chain AMC tripled in price. But how many market participants could tell you that Home Depot had returned 140x over the thirty years from 1990-2020?

Long Duration Cheat Sheet

Here's a brief list of what long duration might look like in a business context.

- Measured, realistic growth rates for revenue.
- Sustainable win-win profit margins.
- A “lazy,” resilient balance sheet.
- Extremely loyal low-churn customers, employees, and suppliers.
- Managerial continuity.
- Owners with similar timelines.
- A reasonably stable multiple to minimize co-owners taking advantage of each other.

As always, we're thankful to have such great partners in this wealth creation journey.

Jake