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Layers of Conservatism

In 2011, Allstate Insurance released a survey on American drivers' ratings of their own driving abilities. 64% of drivers believed "their own driving knowledge, ability and safe driving habits are well above other drivers on the road". Other survey results confirmed a human bias we all know too well; it is usually someone else's fault. 56% of drivers surveyed admitted involvement in a traffic accident, but only 28% of drivers claimed fault for the accident.

Overconfidence is not only limited to every day mundane tasks like driving. Nobel Prize winning psychologist, Daniel Kahneman found that overconfidence is evident in the medical field as well. One study Mr. Kahneman found cited that "clinicians who were 'completely certain' of the diagnoses ante-mortem were wrong 40% of the time."

For the majority of us drivers and some highly educated medical professionals, overconfidence seems to be a problem. It doesn't seem too far a stretch to think that capital market professionals and company managers could also be subject to the behavioural bias of overestimating one's own abilities. In investing, overconfidence and excess optimism can lead to substantial danger when the goal is capital preservation and risk management.

A gross simplification, but consider how a very confident management team is susceptible to providing optimistic guidance that is predicated on everything going right. Next, extremely bright analysts project growing earnings and apply a high valuation multiple to justify an enthusiastic price. If all goes according to plan, investors, analysts and company management are happy. But when priced for near perfection, the margin for error becomes slim.

As value investors concerned with gaining a margin of safety, we at QV have difficulty taking things at face value and often find ourselves going against the grain. In light of over 5 years of rising markets, a respected Ben Graham disciple captures our response aptly; Seth Klarman's approach is to, "make no heroic assumptions in our analysis, hoping, instead that by compounding multiple conservative assumptions, we will create such a substantial margin of safety that a lot can go wrong without impairing our capital much or even at all... Our settings are permanently turned to 'risk-off'."

At QV, we often talk about the compounding quality of businesses, helmed by managers who can efficiently re-deploy profits back into the business at consistently strong returns. But another type of compounding that we look for is ensuring we are analyzing opportunities in light of our own security analysis framework, using our own assessments of income, growth, valuation and leadership.

One manager we sat down with earlier this year exemplifies the type of approach we like. We had the opportunity to meet with Trevor Haynes, the CEO of QV holding Black Diamond Limited (BDI), a remote accommodation and workspace provider. One of the questions posed to Mr. Haynes related to his confidence level on maintaining BDI's market share in the future. Paraphrasing his unique response, Mr. Haynes replied he wasn't confident, because BDI was going to have to work for every opportunity. Nothing was for certain. With recently reported 2013 results of 31% sales growth and similar growth in cash flow, the company continues to execute to plan. Led by a management team that is grounded enough to take nothing for granted we expect BDI to continue to navigate the competitive landscape successfully.

Last week we highlighted how corporate optimism is heating up. Compounding this is a recent Scotia report that has calculated bottom-up EPS growth at 53% for the TSX Small Cap Index in 2014. Today, the S&P 500 hit an all-time intraday high along with six initial public offerings launched. Things do not appear to be slowing down, as nine more IPOs are slated in the US next week. Current market sentiment and the ever present danger of overconfidence bias, remind us of the necessity to be disciplined in our own security analysis framework and to think critically about compounding our own estimates of growth and valuation metrics. Our goal is to control the process to avoid any wrecks, because unlike in a traffic accident, it is clear who is accountable.