Conviction

Conviction is no doubt the foundation of long-term business ownership. How is it formed? What is it like to have it? Why does it falter? In my experience there are two distinct kinds of conviction. *Explicit* conviction, as I call it, comes from having figured something out. It entails a useful prediction, like "our ETA is 5pm" or "majoring in economics will lead to better career prospects than majoring in philosophy." There is an underlying logic to it, which can be explained and used to persuade. *Implicit* conviction, on the other hand, is exemplified by the trust one might have in a family member, a dear friend, a close colleague, to do the right thing, to get the job done, to come through. It is felt as opposed to believed. This kind of conviction doesn't make predictions so much as align with what is good. It doesn't theorize about goodness but rather knows it when it sees it.

In the context of investing, one might develop the thesis that a particular company can capture X% market share, generate Y dollars in annual revenue, achieve Z% operating margins, and therefore has an intrinsic value within a certain range. One might have high confidence because of the presence of competitive advantages and management with a very good track record. One would have a range of expected returns from owning the shares over time. All of this would fall into the explicit category.

Sooner or later, the investment would encounter a confounding surprise. Perhaps execution turns choppy, a new competitive vector emerges out of nowhere, an exogenous crisis turns the world upside down, etc. Old projections are now in doubt, previous plans and strategies are being reworked, everything is less fun. These things are actually happening all the time—something explicit conviction has a way of tuning out! Only genuine and well-placed implicit conviction, a qualitative knowing that the company will do what it needs to and ought to do, is equipped to ably traverse this kind of terrain. Unlike analysis-based explicit conviction, implicit conviction comes from something deeper than the cause and effect we perceive in the unfolding of events—it is both analytical and, crucially, *intuitive* (about which more later).

It is fascinating that the two convictions often exist in tension. For example, early in my career I commonly experienced tension when faced with a bargain price (explicit) for a company I did not particularly admire (implicit). One of my most challenging investments involved an impairment of trust (implicit) coupled with a lower valuation multiple owing to a falling share price (explicit). My best investments have erred on the side of management and cultural excellence (implicit) when faced with disappointing fundamental performance or a seemingly stretched valuation (explicit).

The potential for tension lies in the fact that the approaches of each conviction are disparate. Explicit conviction tends to view the object of its understanding as inanimate, like a machine, made up of parts, having certain inner workings, performing specific functions. Explicit conviction essentially wants to predict and control. It is always at least a bit on edge, hungry to be proven right and for its objectives to be met. By contrast, implicit conviction tends to view the world as alive and therefore sees a company as analogous to a person, having unique characteristics and qualities, apprehended not via dissection but through observation and engagement. Implicit conviction essentially wants to relate and partner. It is patient and forbearing.

The notion of two kinds of conviction working in parallel rings true not only with my own experience as an investor but also with my reading of the greats. For example, in 1998 at a lecture at the University of Florida, Warren Buffett gave the following response to an audience question, which has always stuck with me:

> *The question is whether I have ever bought a company when the numbers told me not to, and how much is qualitative and how much is quantitative. The best buys have been when the numbers almost tell you not to. Then you feel so strongly about the product, and not just the fact that you're getting a used cigar butt cheap, that it's compelling.*

There are the two convictions: one that focuses on the numbers and one that feels.

Then there is the incredible story of Benjamin Graham and GEICO. Graham is known as the father of value investing for having developed and successfully deployed a strategy of buying statistically cheap securities in diversified fashion, and selling positions as they appreciated and became no longer cheap. His investment firm, Graham-Newman Corporation, operated from 1936 to 1956, achieving extraordinary results. Graham is perhaps even better known for being an early mentor to Buffett and writing two seminal books, *Security Analysis* and *The Intelligent Investor.* In the latter's postscript, he reveals the remarkable fact that the majority of Graham-Newman's profits were attributable to a single investment in a growth company—GEICO, the auto insurer, which now writes $40 billion in premiums—held for the last 8 or so years of Graham-Newman's life. It was this single departure from the core strategy that did most of the heavy lifting for the entire operation. He writes, referring in the third person to himself and his partner, Jerome Newman:

> *In the year in which the first edition of this book appeared an opportunity was offered to the partners' fund to purchase a half-interest in a growing enterprise. For some reason the industry did not have Wall Street appeal at the time and the deal had been turned down by quite a few important houses. But the pair was impressed by the company's possibilities; what was decisive for them was that the price was moderate in relation to current earnings and asset value. The partners went ahead with the acquisition, amounting in dollars to about one-fifth of their fund. They became closely identified with the new business interest, which prospered.*
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> *In fact it did so well that the price of its shares advanced to two hundred times or more the price paid for the half-interest. The advance far outstripped the actual growth in profits, and almost from the start the quotation appeared much too high in terms of the partners' own investment standards. But since they regarded the company as a sort of "family business," they continued to maintain a substantial ownership of the shares despite the spectacular price rise.*

The partners' decision to buy was clinched by the moderate "price in relation to current earnings and asset value" (explicit), while holding on for a 200x+ gain owed to thinking of the company as "a sort of 'family business,'" with which they had become "closely identified" (implicit). And this despite the quotation becoming "much too high in terms of the partners' own investment standards" (explicit). There they are again, the two convictions, co-existing in tension.

Another striking example of implicit-explicit tension concerns a company that had built an awe-inspiring track record for over two decades by acquiring small businesses within a single

industry and adhering to strict fundamental and valuation criteria. The company was widely admired and studied as a great compounder. Then in 2021, the founder wrote a letter announcing the company's intention to expand its traditional playbook by pursuing significantly larger acquisitions with a lower return hurdle rate, as well as possibly venturing outside the industry in which its track record had been established. This message proved polarizing. Some of the company's long-time fans turned negative, on the logic that altering the proven formula was likely a herald of the company's decline. Others welcomed additional avenues for capital deployment, on the view that the company's past success came from characteristics that ran deeper than the details of its methodology (i.e., excellence, intelligence, discipline, integrity), which could very well produce new forms of achievement. I would suggest that those who changed their mind on the company revealed their conviction to be more explicit than implicit, while those who stayed the course revealed the converse.

It so happens that shareholders who stuck with the company, following their implicit conviction, have been rewarded for doing so thus far. But my point is not that theirs was the superior approach; it is still arguably too early to render a final verdict, and in any case there is not an objectively "right" way to invest. What I find instructive, rather, is that the two kinds of conviction led to opposite conclusions. I think this highlights the importance of being able to work with implicit-explicit tension with intentionality and skill, which requires seeing each kind of conviction clearly on its own. Each informs the other, and yet it is not in their nature to resolve into a unified perspective. I suspect that in seeking such a resolution, investors often discount or ignore one vantage point in favor of the other. Developing the ability to bring implicit-explicit tension into harmony has been one of my most important learning curves. This skill of mediating between two disparate ways of seeing the world, I've found, is less about knowledge and reasoning than about balance and flow. It is more akin to surfing than to problem solving.

While in everyday life implicit conviction arises naturally, in the context of investing I can't help but feel it is somewhat alien. In part, this is because few companies are truly deserving. Even so, I suspect that implicit conviction is proffered by investors even less than it ought to be. It isn't difficult to see why the investment industry is inhospitable to implicit conviction, and why its partner rules the roost. Implicit conviction forms of its own accord and cannot be planned. It defies quantification, eliciting the charge of being too "fuzzy" to matter. Nor can it be fully captured in words. Implicit conviction is impossible to transmit from analyst to portfolio manager or from portfolio manager to client, which is highly inconvenient for the business of managing money. It is primarily personal. It is quiet. By contrast, the appeal of the explicit is clear. Explicit conviction furnishes the comfort of knowability and modeled outcomes. It projects the legitimacy of diligence and precision. It is thought to be reliably manufactured via "repeatable process." It is clever and self assured.

Quality

I mentioned that implicit conviction "comes from something deeper than the cause and effect we perceive in the unfolding of events." What exactly is this deeper-something? My first attempt to answer this question happened spontaneously, over a decade ago: "Some companies have a soul," I found myself saying to a friend over lunch, "others are just going through the motions." I was expressing a dim recognition of something unusually alive about a company I'd recently visited. I continued to experience the same thing with other companies and started using the terms "quality" and "mission driven." In different situations, new ways of describing the deeper-something would come up, each illuminating it in a new way.

At the same time, no way of saying it captures the thing itself: the deeper-something cannot, I'm convinced, ultimately be defined. Any terms meant to capture it are sure to fall short and therefore feel cliche once familiar. Nonetheless, because literal communication necessitates choosing a word, I will use "Quality" (capitalized to distinguish it from the ordinary sense of the term) to indicate the deeper-something on which implicit conviction is based. Using "Quality" in this way is consistent with my prior writing and pays homage to the work of Robert Pirsig, which was a formative influence.

Analysis plays an important but limited role in detecting Quality. For example, the following is a selection of (neither necessary nor sufficient) indicators that I have found to be suggestive of Quality in companies:

- "Wow" customer experiences
- Mission to solve an important problem
- Domain mastery (the best at what they do)
- First-principles-based thinking and invention
- Unlimited ambition combined with no-nonsense realism
- Overcapitalized balance sheet
- Founder mentality (life's work).

While carefully looking for indicators like these is helpful, I think it would be a misstep to attempt to systematize the search, constructing a Grand Unified Theory of Quality and attendant comprehensive processes for finding and evaluating it. Quality emerges from the complexity of the system *in action*; it is in the *how* rather than the *what.* Thus, when Quality is broken down into parts and analyzed, its essence is lost. This explains why analysis alone has trouble discerning the authentic from the artificial. Moreover, Quality frozen in a theory or process cannot be recognized in sufficiently new contexts, such as in a company that is novel to one's experience or in the same company as it evolves (they always do!).

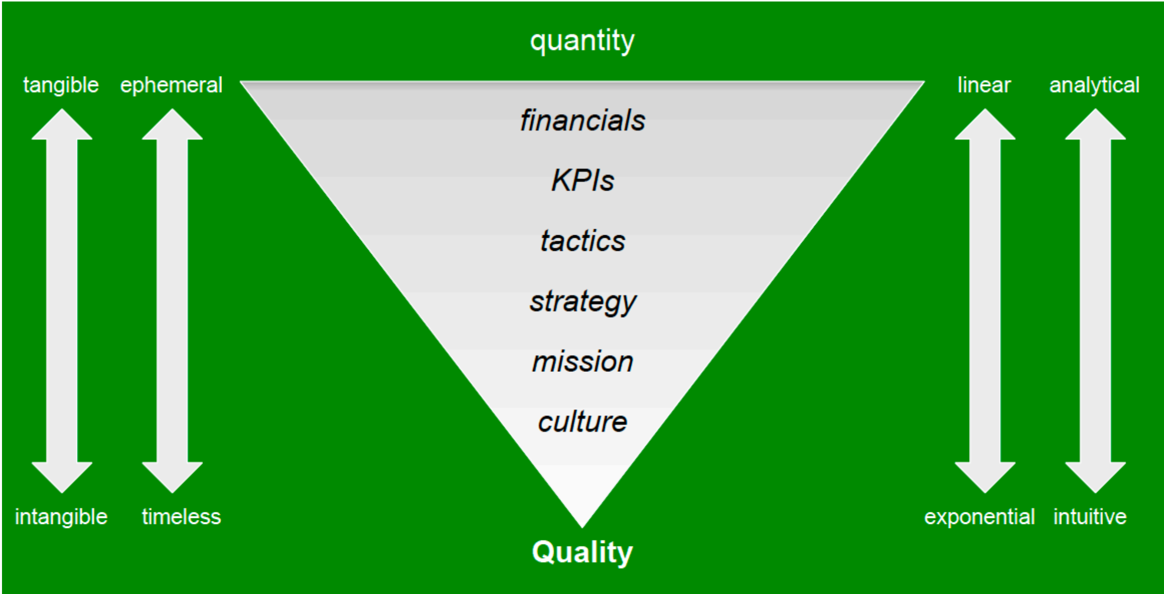
So where does that leave us? With intuition. Well-honed intuition does what analysis cannot by perceiving Quality directly, as opposed to through an intellectual process. What I suspect is happening in the direct perception of Quality is subconscious pattern recognition, based upon a dynamic, holistic experience of the thing in question. Of course, the ability to intuitively recognize patterns in a specific domain must be earned through experience and feedback; indeed, I have found that the value of my own intuition has grown (starting at zero) over many years. Interestingly, I also find that experiencing Quality in any one domain (e.g., music or meditation, to use examples that are dear to me) can be helpful for recognizing it in other domains (including business) because Quality's nature is universal, even as its manifestations are necessarily particular.

I believe that the analytical vantage point and the intuitive vantage point are profoundly complementary, together providing a far deeper and more complete picture than either on its own. My process for getting to know companies involves endlessly iterating between the two. Using two lenses instead of one tends ultimately to winnow out investment options, narrowing the field to companies that pass both tests, so to speak. While many people are distrustful of intuition (especially in the investment profession), I tend to think that more tools are better if used properly. Even those who would like to cut out intuition altogether generally concede that doing so borders on the impossible. It might be, in fact, actually impossible: There are

experiments suggesting that acts of will register subconsciously *prior to* registering consciously, which if true would seem to undermine the notion of investing (or doing anything) on a wholly calculated basis. It strikes me that intuition is a fundamental dimension of the mind, and it is likely healthier and more effective to tame and utilize it than to suppress or ignore it.

While in theory the notion of Quality might appear rather philosophical and idealistic, in practice it could not be more pragmatic. One can think of Quality as simply the highest-leverage input into a system. For illustrative purposes we could envision a continuum of layers starting with a company's high-level outputs: financial figures and key performance metrics (KPIs). These outputs can be thought of as being produced from the processes and procedures employed to run the business day to day, which we might call "tactics." Tactics are informed by what the company defines as its plans and objectives, "strategy." Strategy, in turn, is embedded in what the company experiences as its purpose and animating force, its "mission." And where does the mission come from? It comes from the company's most fundamental beliefs, behaviors, and values, typically referred to as "culture." Deeper layers are where the leverage is. If one wants to effect meaningful, lasting change, tweaking quantitative parameters will go only so far. The way to transform a company is to alter its culture because changes at that level cascade throughout the system—an exponential effect. The further down we go, the closer we come to what matters most over the long term: Quality.

In talking about these layers, I do not mean to posit rigid categories or unidirectional causation, neither of which would be valid. The complexity inherent in any company cannot even begin to be captured in words or in a schematic like the one below. My aim is merely to paint a stylized picture of what Quality is to the system. We start at the surface with the things we observe each day and tend to quantify, the stuff of newspaper articles and analyst notes: tangible, ephemeral, linear, analytical. As we go deeper, the nature of things changes, approaching the intangible, timeless, exponential, intuitive. Each layer grows out of those below. Or to look at it another way, each layer sets the conditions for those above.



Over the past year I spent time with the CEO of a company that has become one of my favorite illustrations of the leverage found in deeper layers. It is a small company that operates

manufactured housing communities in a handful of US states. The residents of such communities are typically struggling to cover life's necessities and face a shortage of low-income housing throughout the country. The manufactured housing landscape has many operators that lack the timeframe and/or the resources to amply invest in their communities. By contrast, this company operates with permanent capital and an infinite horizon. "Our decisions are not affected by the need to cash out investors, close a fund, attract new investment, whatever," its CEO explains. "We operate our business under the premise that it can be profitable to offer our customers a square deal."

Since its founding in 2008, the company has acquired just shy of 50 manufactured housing communities, nearly all in its first decade, as pricing then soared beyond its disciplined valuation criteria. Luckily, there is plenty to do in the absence of deals—namely improving living conditions, often starting from a difficult situation. A distressed community might take five to seven years to reach passable conditions and over a decade to become exemplary. Outwardly the work looks rather straightforward, if demanding. It begins with remediation: removing abandoned structures, conducting deferred maintenance, complying with local code, enforcing resident screening and community rules. Then come upgrades like curbs and gutters, entrance and street signs, flower beds, and so forth. Eventually, as the community gains momentum and increases occupancy, larger investments are made, such as newly paved roads and brand new homes. A ghost-town becomes a neighborhood, and financial gains follow in the form of reduced maintenance costs coupled with growing rents and land values.

But is turning around a community simply a matter of ticking off a checklist of tangible improvements? If only it were so straightforward! Without the buy-in of the people involved, even top-notch physical surroundings give way to missed rent, neglect, littering, or worse. "It can take years to bring a community up to standard, a week to reverse it," warns the CEO. "When you backslide, the rest of the community sees that the rules are negotiable" and a vicious cycle can ensue. The real foundation is put down on a human level. "Step number one is getting trained professionals committed to our vision in place." It takes special determination and empathy to throw oneself into the mission, but thankless it is not. "It's fulfilling work to provide a human necessity in a way that I'm proud to tell my family." Only employees who *care* get the job done, and when the people running the place care, it seeps into the community at large. Residents "recognize the improvement and choose to stay longer, pay a fair price, act as good neighbors, and tell their friends. Increased customer commitment affords better and more rewarding careers for our people." A flywheel takes shape, and the best communities develop their own norms and come to police themselves. The enduring transformation is cultural.

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