“I have a proposition...”

By Shaun Heelan

Exclusively for

Ben Graham Center’s 6th European Value Investing Conference

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I BET YOU THAT I CAN BEAT ANY OPPONENT YOU CHOOSE AT PING-PONG

Rules:

- Standard Table
- We Play In This Room – In 3 Months
- We Play With Identical Paddles
- I Choose The Paddles, BUT

To Make It Fair

- Your Player Has 1st Choice on Paddle

ANY TAKERS?

What Are You Thinking?

- Can You Really Pick Anyone To Play?
- This Is Absurd?
- Too Good To Be True?

MEET AMARILLO SLIM

A Legendary Proposition Better

“IT'S YOUR CHOICE OF PADDLES, SON”

A relaxed Slim moseyed over to the vending machine, put in two dimes, and pulled out two 8oz Coca-Cola bottles.

A FRAMING WE ALWAYS HOLD IN MIND

"We regard investing as an arrogant act; an investor who buys is effectively saying that he or she knows more than the seller, and the same or more than the other prospective buyers."

Seth Klarman, 1996 Letter to Investors

A NUDGE TO HELP CLARIFYING YOUR THINKING

Why Does Someone Win Or Lose in A Proposition?

It is often NOT down to what you think it might be:

IQ	Slim's adversaries were very smart
Knowledge	Slim's adversaries were very knowledgeable about him, and about betting
Experience	Slim's adversaries were just as experienced as he was
Skill	Slim may have had more skill than his adversaries, but clearly had less than their ringer

His adversaries were sure THEY had the information edge

THEY KNEW SLIM'S TRICK!

Slim didn't proposition them. They propositioned HIM.

"It ain't what you don't know that gets you in trouble. It's what you know for sure that just ain't so."

Mark Twain

THE TWIST

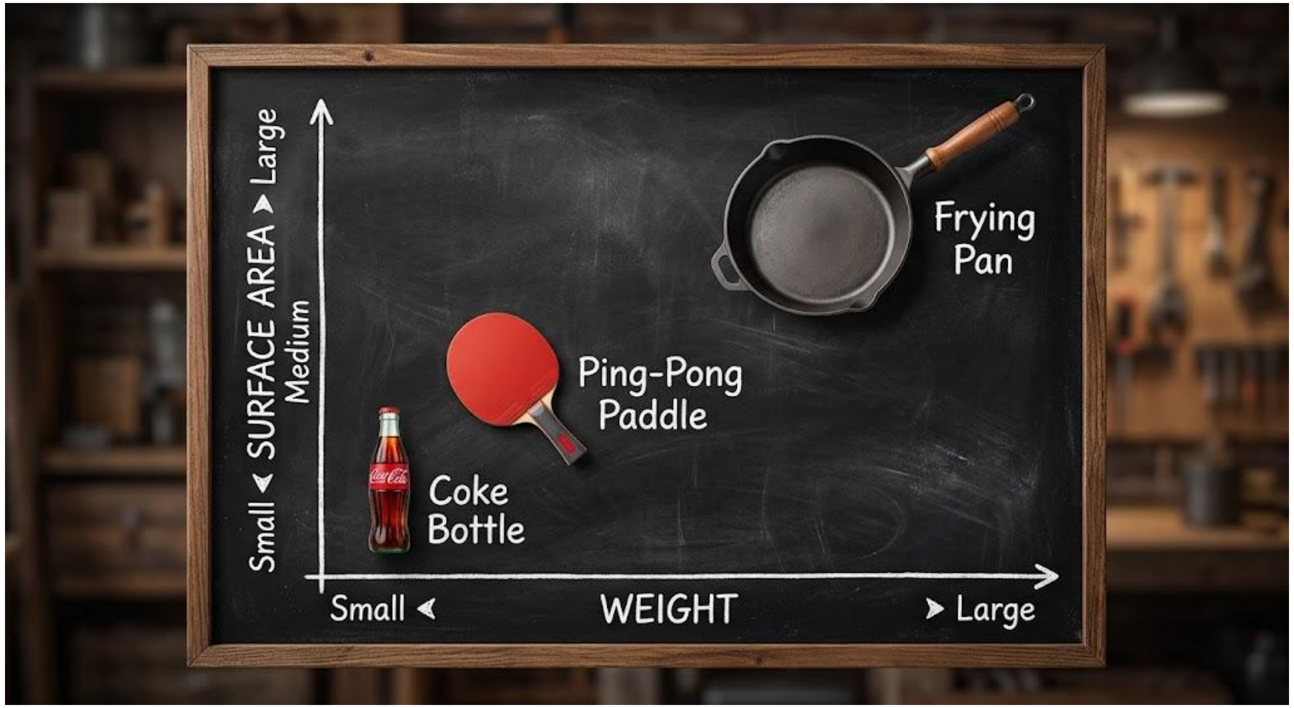
Their World Champion Practiced With the Biggest Frying Pan They Could Find!

"Rowing Harder Doesn't Help If The Boat Is Headed In the Wrong Direction."

Kenichi Ohmae

THE TWIST

Their World Champion Practiced With the Biggest Frying Pan They Could Find!



"Rowing Harder Doesn't Help If The Boat Is Headed In the Wrong Direction."

Kenichi Ohmae

BAD INFORMATION IS WORSE THAN NO INFORMATION

When you ASSUME, you make an

ASS out of U and ME

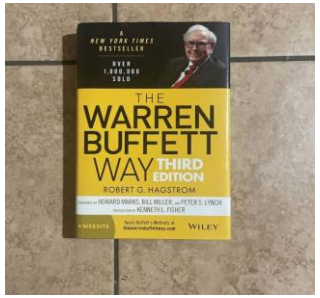
ONE WAY TO IMPROVE DECISION MAKING

Clearly delineate and distinguish between, and **never confuse one for another**

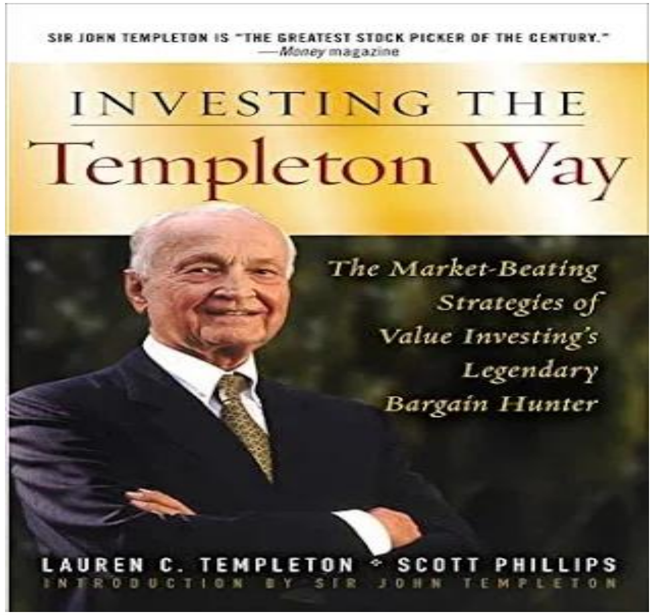
FACT: the paddle would be a frying pan. That was, of course, only ever an assumption.

INVESTORS AND BETTORS

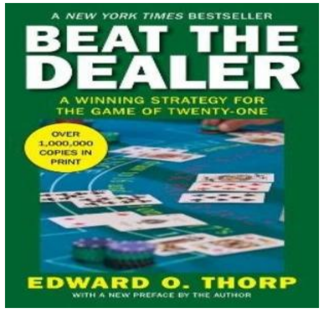
The Track



Poker



Blackjack



THE CRITICAL VALUE OF WARREN BUFFETT'S TWO RULES

1. Never lose money.

2. Never forget Rule No. 1.

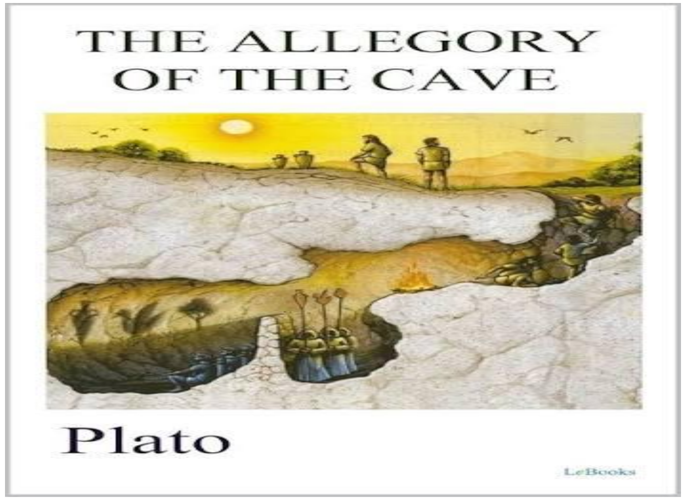
WHEN WE ARE TEMPTED WITH A GREAT YEARNING...

We see the cheese and pay no attention to the trap.

WHEN INVESTING, IF WE AREN'T CAREFUL, WE ARE THE PREY

HOW DO PREDATORS BAIT US AS INVESTORS?

THE NUMBERS	THE NARRATIVE



We can be taken in by either even when we know better

HOW WE CAN GET TAKEN BY THE NUMBERS

THE NUMBERS

Financial figures and ratios are subject to judgement in production and analysis.

They are manipulable, and

We often see what we want to see.

Prey

Hunter

THREE QUICK EXAMPLES

VALEANT PHARMACEUTICALS

SUBPRIME / ABS CDO'S

BERNIE MADOFF

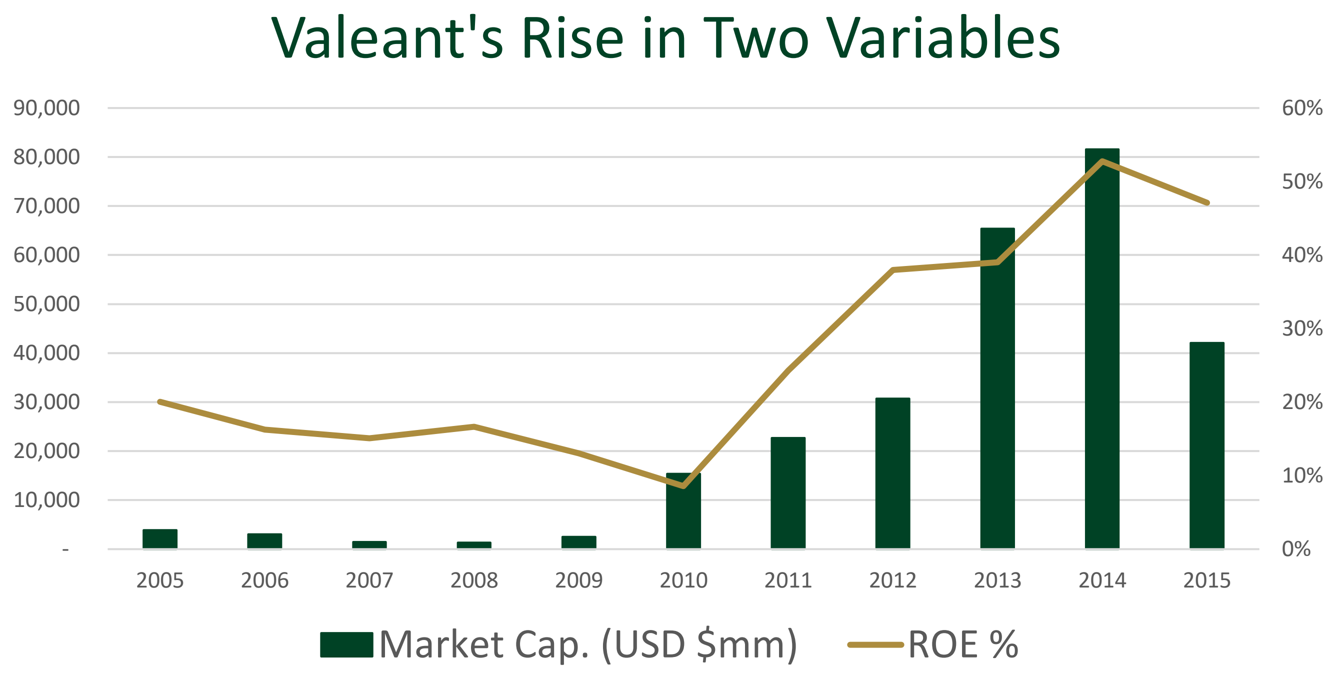
"There are three kinds of lies: lies, damned lies, and statistics."

Mark Twain

#1: VALEANT PHARMACEUTICALS

VALEANT PHARMACEUTICALS	High Growth, High ROE (45%) / ROIC, Long Track Record of (seemingly) excellent M&A, Long Runway Ahead

Valeant felt like the holy grail for growth investors who favoured quality – measured by ROIC



#2: SUBPRIME / ABS CDO’s

SUBPRIME / ABS CDO’S

High Yields, Reasonable Default Rates: Both dropping over time, even as the market expanded

***Ponzi Like**

ABS CDO’s felt like the holy grail for bond investors / financial institutions, offering BB Yields for AAA credit rating.

This meant a fraction of the capital required and incredible ROEs for banks and insurance companies.

Mortgage Borrowers never had it so good: 100% LTV, NINJA Loans

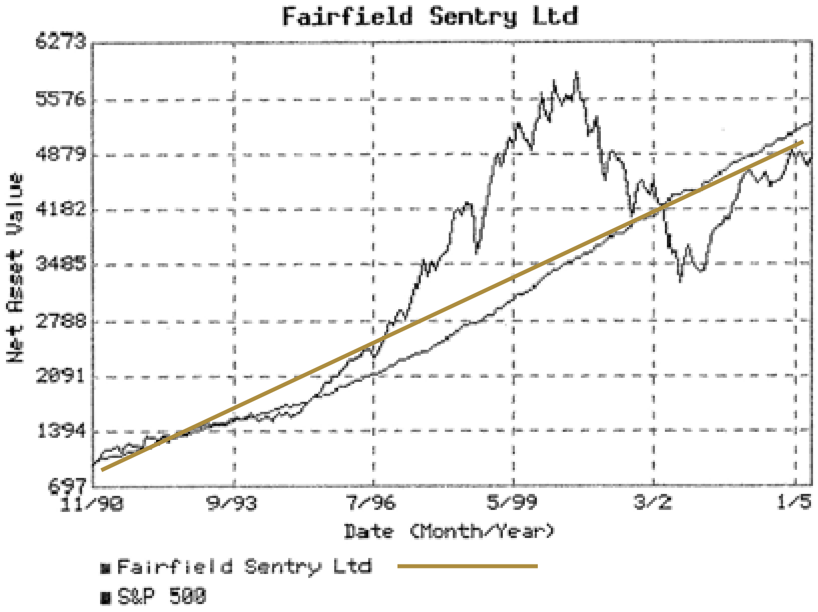
#3: BERNIE MADOFF

BERNIE MADOFF	Steady 10 to 12% p.a. Returns, Low Volatility, No Losing Quarters or Years, over 20 Years

***Ponzi**

Ed Thorp discovered it, checking the trade tickets vs. options volumes in the early 90's

Felt like the holy grail for funds of funds and certain wealthy individuals. Equity like returns, with little to no volatility. The invest and forget dream scenario with a seasoned wizard of finance



SUMMARY OF OUR THREE QUICK EXAMPLES

Think like an underwriter: "How can I get hurt here?"

THE PROBLEM OF JUST RELYING ON THE NUMBERS – 20 YEARS IN STRUCTURED PRODUCTS LEAVES YOU CYNICAL

"What gets measured gets managed."

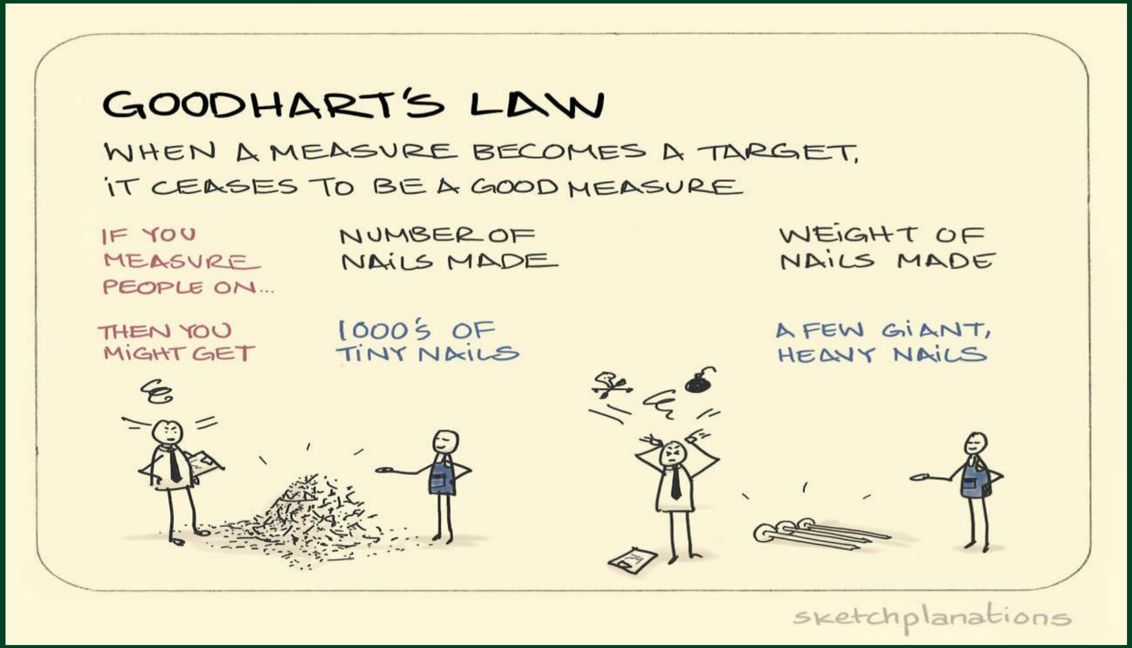
Peter Drucker

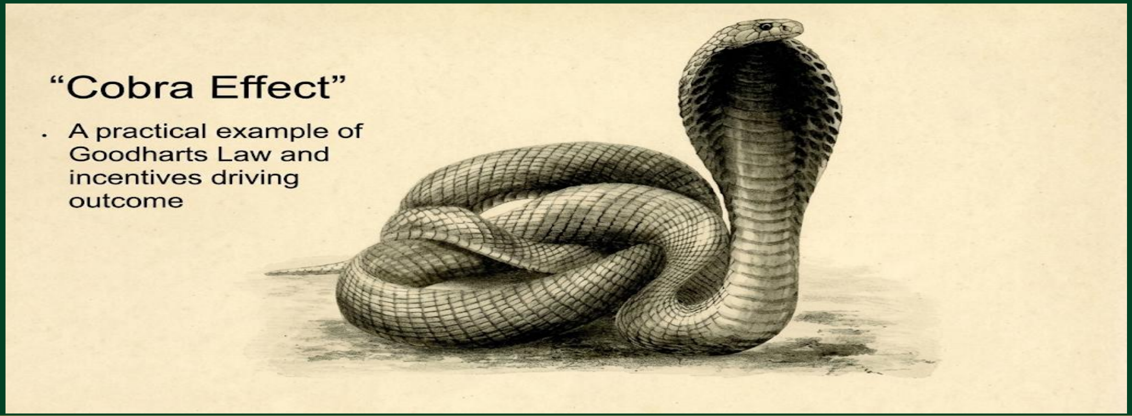
"When a measure becomes a target, it ceases to be a good measure."

Goodhart's Law

"What gets measured gets managed… gets manipulated."

Anonymous





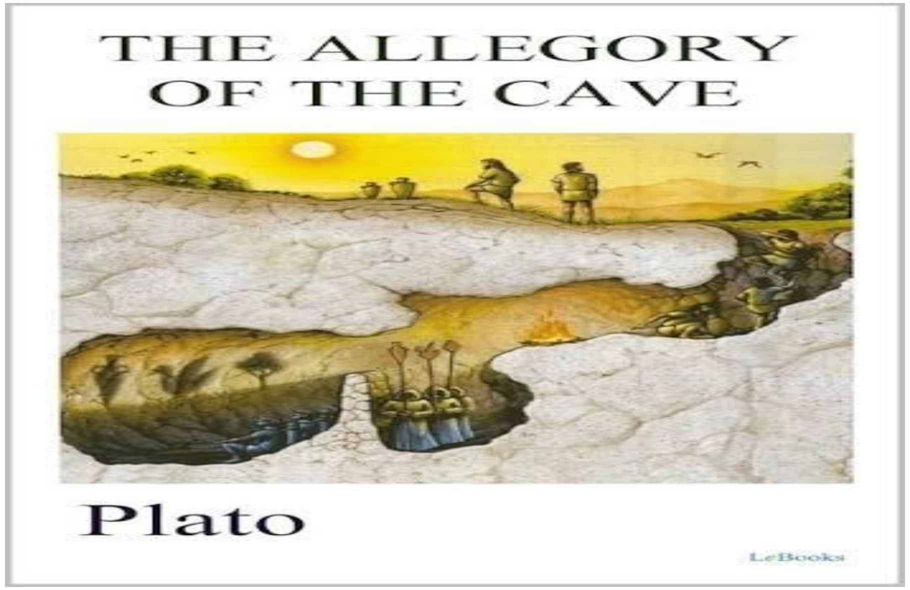
HOW WE CAN GET TAKEN BY THE NARRATIVE

THE NARRATIVE

Long before we had numbers, we had stories.

Numbers convince.

Stories seduce.

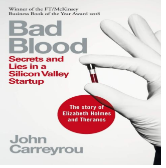


"After nourishment, shelter and companionship, stories are the thing we need most in the world." -Philip Pullman

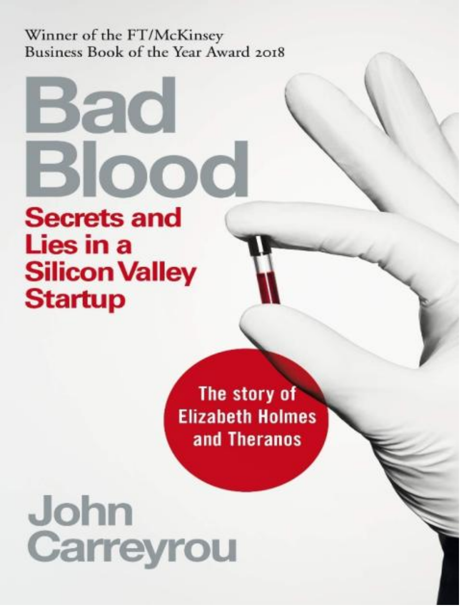
SOMETIMES THE NARRATIVE IS ENOUGH

We all want heroes. **Stories seduce**.

THERANOS / ELIZABETH HOLMES



Revolutionizing Healthcare one drop of blood at a time



SAME THREE EXAMPLES: FRAMED BY NARRATIVE

Numbers convince. **Stories seduce**.

VALEANT PHARMACEUTICALS	**Fast and Exciting: A Brilliant, Visionary CEO with a Long Runway to grow**
SUBPRIME / ABS CDO’S	**Safe and Reliable: “Safe as Houses”, Traditional Wisdom Said You Can’t Lose**
BERNIE MADOFF	**The Rolls-Royce: The Best Off All Worlds: Exclusive, Respected, and Seasoned**

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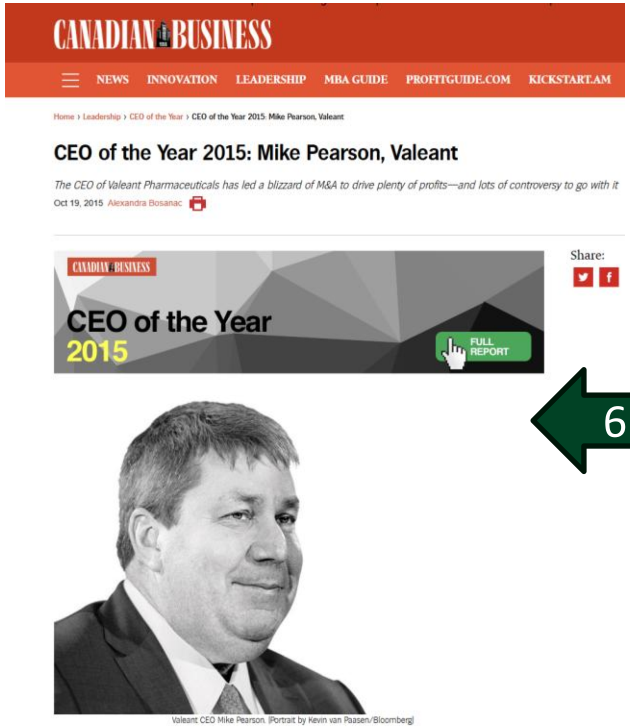
CANADIAN BUSINESS

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Home › Leadership › CEO of the Year › CEO of the Year 2015: Mike Pearson, Valeant

CEO of the Year 2015: Mike Pearson, Valeant

The CEO of Valeant Pharmaceuticals has led a blizzard of M&A to drive plenty of profits—and lots of controversy to go with it

Oct 19, 2015 Alexandra Bosanac

Share:

CANADIAN BUSINESS CEO of the Year 2015 FULL REPORT

Valeant CEO Mike Pearson. (Portrait by Kevin van Paasen/Bloomberg)

6 Months

Prescription for Disaster

IN LESS THAN A YEAR, VALEANT PHARMACEUTICALS HAS LOST 87% OF ITS VALUE–SOME $80 BILLION–AMID ACCUSATIONS OF MISMANAGEMENT AND FINANCIAL SHENANIGANS. THE INSIDE STORY REVEALS A PRESSURE COOKER THAT WAS BUILT TO EXPLODE.

NATHAN VARDI AND ANTOINE GARA

SAME THREE EXAMPLES: FRAMED BY NARRATIVE

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SUBPRIME / ABS CDO'S

Safe and Reliable: "Safe as Houses", Traditional Wisdom Said You Can't Lose

"Traditional wisdom: Long on tradition, short on wisdom."

Warren Buffett

63 Months

SAME THREE EXAMPLES: FRAMED BY NARRATIVE

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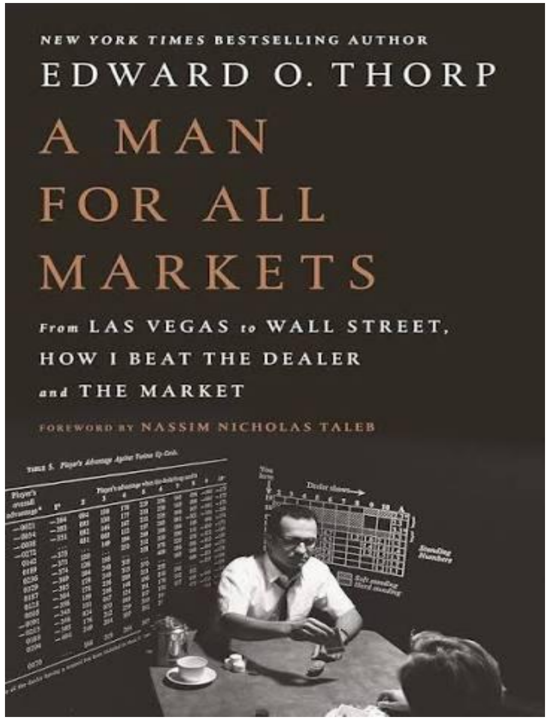
BERNIE MADOFF

The Rolls-Royce: The Best Off All Worlds: Exclusive, Respected, and Seasoned



17 Years

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We often see what we want to see.

THE NARRATIVE

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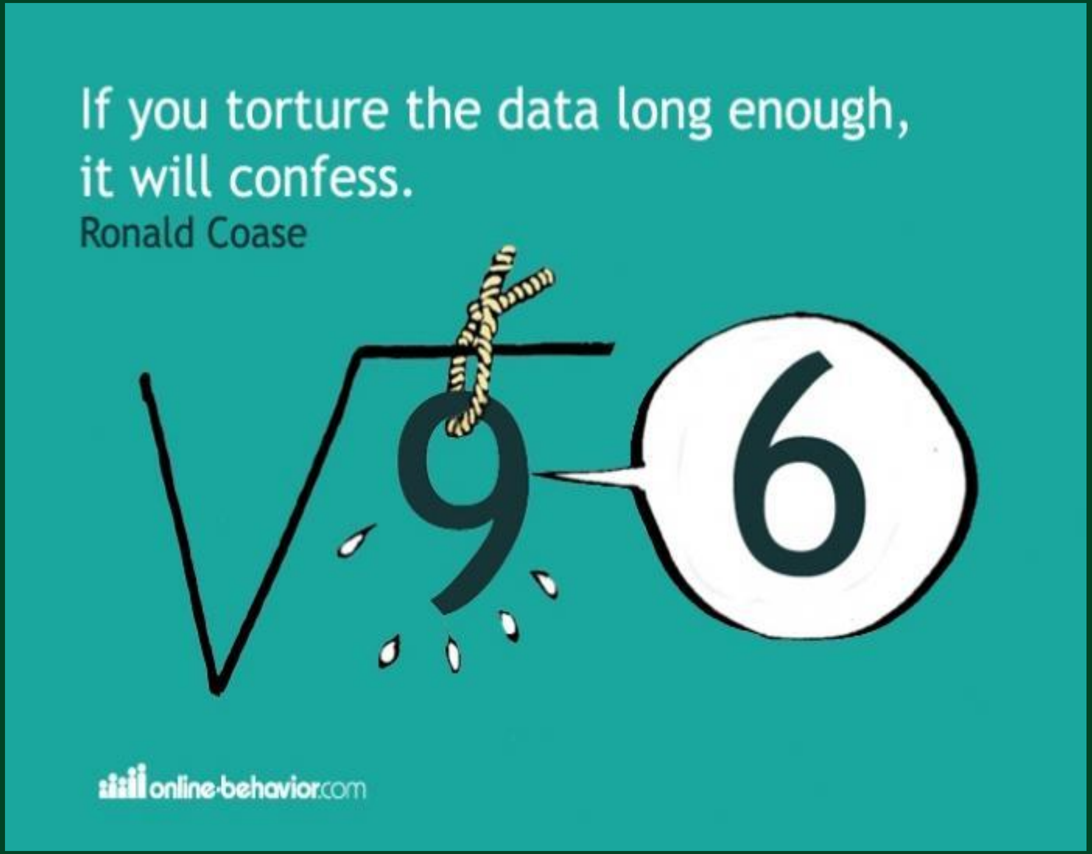
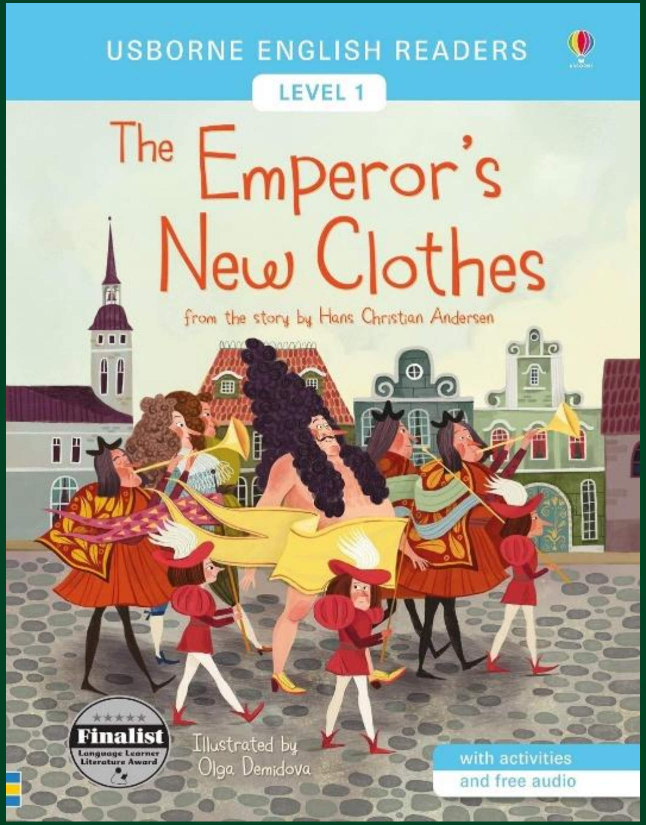
IT'S NOT A LACK OF DATA: IT'S ASKING THE WRONG QUESTIONS



"There's no question that the what the human being is best at doing is interpreting all new information so that their prior conclusions remain intact."

Charlie Munger

IT'S ASKING THE WRONG QUESTIONS... & IGNORING INCENTIVES



Useful Questions To Ask

- **Are We Analysing The Data Or Torturing It?**
- **What Is The Incentive Of The Person Selling This?**

ONE BIG ADVANTAGE WE HAVE OVER THE MOUSE

Unlike Slim's counterparties, we can usually reverse our decision

Am I behaving like the monkey with his hand in the jar?

IT'S OK TO LET GO

SOME LESSONS FROM THE PARABLE OF SLIM

THINK LIKE AN UNDERWRITER

- Remember Warren Buffett's two rules
- Keep in mind... You may be the prey
- Think about how you might be baited
- Work Smarter, Not Harder.

SOME TIPS TO HELP AVOID TAKING A ‘SLIM AMARILLO’ PROPOSITION

REMEMBER: **BAD INFORMATION IS WORSE THAN NO INFORMATION**

DELINEATE YOUR DATA

Separate your:

- Facts,
- Assumptions, and
- Opinions

Try not to mistake one for another, and

Update them as you discover what worked, and what didn't

ASK USEFUL QUESTIONS

Are we analysing the data or torturing it?

What are the incentives for the people on the other side?

Am I behaving like the monkey with his hand in the jar?

IT’S OK TO LET GO!

THANK YOU

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