Astronomers, Astronauts and Styles of Investing

by Mohnish Pabrai

One of my favorite parts of the film, *Jurassic Park III,* is when the lead actor Dr. Alan Grant (Sam Neill) is having the following conversation with the adventurous eleven-year old Eric Kirby (Trevor Morgan):

Alan: *…I have a theory that there are two kinds of boys – those that want to be astronomers and those that want to be astronauts. The astronomer, the paleontologist, gets to study these amazing things from a place of complete safety.*

Eric: *But you never get to go into space.*

Alan: *Yes. It's the difference between imagining and seeing.*

One might think of investment managers as astronomers and CEOs as astronauts. The two roles are radically different with distinct personality traits. Like astronomers, investment managers tend to be introverted, skeptical and very analytical. CEOs, like astronauts, are the exact opposite – typically being extroverts, optimists and well, leaders.

A subset of CEOs is that of entrepreneurs. And the classical definition of an entrepreneur is an individual who pursues opportunity without regard to the resources currently controlled. That sounds like a very different person than one might expect an analytical investment manager to be.

The essence of a good investment manager is one who studies a given business and extrapolates the future cash flows that the business is likely to generate over the next several years. Based on the cash flow and asset assessment they can then arrive at their expected rate of return if they bought a fraction of that business at a given price.

Working with the Unpredictable

When I ran a small IT services business in the 1990s, it had strong recurring revenues – yet I couldn't accurately forecast cash flow for even the next few quarters. Small changes in the customer base or losing/hiring a few key employees could create massive swings in cash flow. And I have yet to meet a CEO who can look me in the eye and provide a precise forecast of the cash flows their business will produce over the next several years.

It seems very odd that "astronomers" looking at these businesses from a great distance can come up with these precise cash-flow forecasts for the future when the CEOs who've been running the place for years on end can't do the same thing. Why is that?

I believe the answer lies in the way they each look at the world. CEOs understand their businesses are extremely nonlinear and that their future performance is affected by myriad internal and external factors. In most businesses, many of these factors are hard to quantify and nearly impossible to forecast. Also, entrepreneurs and CEOs are usually operating with incomplete datasets. They have some information at their disposal and they implicitly make assumptions about the missing information and execute. And they tweak their execution as more data becomes available. It's a continuous, unending process with constant tweaking and experimentation.

Investment managers on the other hand look at the business from a distance and have a perfect view of the past. Based on the past and other trend data they tend to build linear models of the business for the future. If a business has grown yearly sales consistently at a consistent 10-15% clip, its models are likely to assume a 10-15% growth rate for the next few years.

A Meeting of the Minds

When the linear and non-linear thinkers speak to each other, the exchange can be quite funny. On many a conference call, analysts will ask questions related to expected growth rates or cash flows for the next few quarters or years. From the analysts' perspective, CEOs appear to be stonewalling when they sidestep these questions and start listing all the nonlinear factors that make analysts' forecasts difficult.

With companies that provide earnings guidance, I've found two things to be true. Either they suggest numbers based on the most pessimistic view of their business or engage in accounting games to make the numbers. As Buffett succinctly points out, *"Companies that fixate on making the numbers are likely to make up the numbers".* And being optimists as a group, sometimes their most pessimistic view ends up being too optimistic and then we get "revised lowered earnings guidance."

Neither the CEO nor the investment manager has an accurate view of the future and both are likely to be off-center on the future prospects of a given business. I believe that the best astronomers are ones who are also comfortable being an astronaut and the best astronauts are ones who enjoy astronomy.

Or as Warren Buffett puts it:

I am a better investor because I am a businessman;
and I am a better businessman because I am an investor.

With his amazing 53-year investment track record, Buffett represents the pinnacle of investing prowess. At the same time he's repeatedly demonstrated his strong CEO and leadership skills going back more than 60 years. Buffett is not only comfortable playing the role of both an astronaut and an astronomer, he's exceptional at both.

It is a contradiction to be both an astronomer and an astronaut. Nonetheless, the best investment managers are ones who've run a business or two in the past and the best CEOs are ones who understand the intricacies of capital allocation, return on equity and investment choices as fund managers intrinsically do.

More than 80% of fund managers lag the indices. I believe one of the big reasons is their inability to see the world through Berkshire Hathaway Vice Chairman Charlie Munger's latticework of mental models – which would clearly show the nonlinear, messy nature of the future.

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