THE IDIOT FACTOR: WHO'S MINDING THE CORPORATE STORE?

By Marcus W. Robins

Is it possible the CEO of your favorite investment is a dolt and blissfully unaware of it? A look at how it can happen, and how to evaluate the competence of corporate managers.

Which company would you rather invest in? The one with a tall, tanned, supremely confident CEO? Or the one led by a fingernail-biting nebbish who seems a bit worried about his company's future?

Recent research suggests that you might be much better off with the latter. Confidence is no sign of competence, according to an article in the "Journal of Personality and Social Psychology." Instead, incompetent people are more likely to overestimate their true abilities.

"Not only do they reach erroneous conclusions and make unfortunate choices, but their incompetence robs them of the ability to realize it," Justin Kruger and David Dunning, both professors of psychology at Cornell University, write in "Unskilled and Unaware of It" in the journal's December 1999 issue.

AN UPSIDE-DOWN WORLD

For example, students who did the worst on a test of logical ability, with an average performance at the 12th percentile, believed they had scored at the 62nd percentile and that their reasoning abilities should rank at the 68th percentile. Meanwhile, the top performers, who tested at the 86th percentile, on average, estimated their test results at the 68th percentile and their reasoning ability at the 74th percentile.

This test and others seem to indicate that the Peter Principle may be true: People rise to the level of their incompetence, and it's possible that the CEO of your favorite investment is a dolt and blissfully unaware of it.

The research has sparked scores of tongue-in-cheek newspaper stories that share a common "Dilbert was right!" tilt. Columnist Bob Goldman wrote, "As far as I'm concerned, this is the Rosetta stone of business life. ...We now know why in businesses all around the globe, dim, dull, truly incompetent people rise to the top."

The potential for comedy here—the study itself has three pretty good jokes in it—presents the risk that we'll overlook some useful information while we laugh about every pointy-headed boss we've ever known. The laughter may betray that these findings are uncomfortable facts. Usually, when faced with uncomfortable facts, human nature responds by alternately asserting that they simply aren't true, or maintaining that, if true, they can't be allowed to affect how we do business.

In one sense, the insights from the recent research are nothing new: In the fourth century B.C., according to legend, the Oracle at Delphi proclaimed Socrates the wisest man in Greece because, unlike other Greeks, "He knows the extent of his own ignorance."

Thomas Jefferson once said, "He who knows best knows how little he knows."

And more than a hundred years ago, Charles Darwin wrote, "Ignorance more frequently begets confidence than does knowledge."

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IGNORANCE BECOMES BLISS

How is it possible that a poor manager may be convinced he or she is a good one?

The researchers put it this way: The skills that enable one to *make* a good business decision are the same skills necessary to *recognize* a good business decision. Managers who are prone to making bad decisions, therefore, often can't recognize it. If they knew what a mistake looked like, they wouldn't have made it in the first place. The good speller knows when she has made a mistake or is unsure of a word; the poor speller may have no such insight.

But surely, you may ask, by the time someone is appointed CEO of a publicly traded company, he or she has been tested and proven competent a thousand times over?

True enough. Although there are plenty of examples of a person being proven in one area (say engineering or plant management), and then being asked to take on the sometimes very different challenges presented by the CEO's role and failing because he lacked the necessary skills and knowledge. Besides, the point for an investor is not whether a CEO is an above-average businessperson—most undoubtedly are—but whether he or she is an above-average CEO.

Mathematics tells us that 50% of CEOs must be below average, but research as early as 1977 has established that a majority of business managers view themselves as more able than the typical manager. It's also significant that the test subjects in the recent research were all Cornell undergraduates—all presumably had met the university's stringent entrance requirements, posted high SAT scores and had outstanding high school records. But still, the students in the bottom quartile, even if only relatively incompetent compared to the others, still demonstrated the gross overconfidence common to incompetents everywhere. There's no reason to think that, given a large enough sample, you couldn't take the top quarter of the Cornell subjects, find a test sufficient to spread their results on a spectrum, and find the same outcome of overconfidence at the bottom of the chart and underconfidence at the top. And there's no reason to think you couldn't do the same with the bottom quarter of the Cornell subjects.

IMMUNE TO THE FACTS

There's another puzzle: How is it that incompetents, including incompetent CEOs, fail through life experiences to learn that they are unskilled?

One might think that the pressure-cooker atmosphere at the top of American corporate life would soon have all chief executives examining themselves closely in the mirror or doing twice-weekly sessions with a shrink, given querulous boards of directors, prickly stockholders, and ornery Wall Street analysts.

Kruger and Dunning propose several reasons incompetents sail on despite negative feedback. One is that people seldom actually receive negative feedback about their skills and abilities from others in everyday life, a fact supported by three decades of psychological research. People are polite about such things generally, and telling the boss he's an idiot is still particularly frowned upon.

Second, even if people receive negative feedback that points to a lack of skill, they commonly attribute the failure to some other factor, such as bad luck or someone else's mistake. That deep insight was established by separate studies in 1977 and 1983.

Finally, incompetents seem unable to take advantage of a particular kind of feedback that Kruger and Dunning call "social comparison." They do poorly at seeing the decisions others make, accurately assessing how competent those decisions are, and then revising their view of their own competence by comparison.

The two researchers established that finding with a fascinating final phase to their recent work. They brought back some of the subjects who had been through the first tests, handed them a packet of the test papers to review, and then asked them once again how they thought they did on the exam. The top performers, seeing the kinds of answers their classmates gave, could quickly figure out they'd done better than average and were able to revise their estimates much closer to their actual performance. The bottom-quartile performers, on the other hand, looked over the papers and failed to gain any insight into their own performance.

"If anything," the researchers observed, "bottom-quartile participants tended to raise their already inflated self-estimates, although not to a significant degree."

The implication is that you could hand a below-average CEO a stack of balance sheets, for instance, that should show him that he's being outperformed by competitors, and he might just emerge with a more profound belief that he's doing a pretty fair job.

CONFIDENCE VS. COMPETENCE

The research thoroughly trashes the idea that confidence is a good predictor of competence and substitutes another idea that might work better: The competent are good at recognizing competence in others, while the incompetent are not.

This finding helps explain why poor CEOs tend to amplify the effect of their own incompetence by surrounding themselves with incompetents. It also opens the gateway for a fresh line of questioning that might help investors find the top CEOs:

- First, quit relying on confidence as a sign of ability. Remember the ancient Taoist saying, "If a

man says he knows the Tao [the way], he does not know the Tao. If a man says he does not know the Tao, he may know the Tao."

- Second, throw out all those old questions that turn on confidence: "How do things look for the second quarter?" "What's your feeling about sales to retailers next year?" And discount the responses that speak of confidence: "We're confident our sales force will turn things around;" "We predict we'll increase our market share to 25% next year;" "I feel our team is just so outstanding we're bound to expand revenues as well as anyone in our market." Give a CEO extra points every time he or she says, "I don't know." The more a CEO honestly realizes and admits the bounds of his knowledge, the better.
- Finally, pose questions that ask a CEO to judge the competence of others: "Who are three business people you respect most and why?" "How would you rank the competition?" "This competitor has lost market share; what mistakes did it make?" "What did you learn from its troubles?"

If you get insightful, intelligent answers to those questions, and perhaps spy some chewed fingernails or a furrowed brow, that, the Cornell research says, is the man or woman to bet on.

SIZING UP MANAGEMENT

Much of the recent Cornell research was validation for my own longtime approach of avoiding management pomposity and arrogance in favor of candor, pragmatism and experience in the school of hard knocks.

How, then, can you evaluate management? Here are some important touchstones:

- *Hubris or Humility?* Hubris—defined as arrogant pride or unreasonable confidence—is always a bad sign. The most dangerous CEO is one who doesn't know what he doesn't know. The best own up to their shortcomings and constantly work to overcome them. As one sage put it, to know that you fall short in some area "would already be to remedy a good portion of the offense."
- *Vision.* A competent business leader must have a vision and be able to articulate it to others. If she can't tell you the story and get you excited about it, she probably can't do it for her own people either. Moreover, the best leaders are like mother bears about defending the vision and keeping it focused. Here, humility can go too far—the best CEOs fight for their vision and never, ever give up.
- *Realism.* There are a few managers who are so "miscalibrated," to use the Cornell terminology, that they chronically make mistakes in judging themselves or the marketplace. But for every "natural" incompetent, there are a dozen who've made themselves that way. Anyone who's developed the habit of self-deception is not a good candidate with whom to invest. It's one thing to be optimistic in a way that gives confidence and energy to your team, it's quite another to ignore signs of danger in the foolish faith that "things will turn out all right."
- *The Parking Lot Principle.* When you make an on-site visit to a candidate company, you not only get a chance to test the CEO's handshake and ability to hold eye contact, you get to scope out the parking lot. You do not want to find that executives have taken the funds provided by the IPO and your kind share purchases and poured the money into the latest Mercedes S-Class land jet. As you find small things, so will you find large things: You want management that believes its job has just begun when the money flows in, not that it is done.
- *The M&M Principle.* Is the office entrance laden with marble and mahogany? Worse, are they predominant in areas where officers gather but the customer will never see? Outside of a few businesses, such as high-end banking that need to convey solidity, the presence of marble and mahogany is like the presence of late-model Ferraris in the parking lot: It shows that management is not careful enough in seeking solid returns for every penny of the other people's money that makes up its capital.
- *ROE, ROE, ROE.* Subjective measures of management performance are important, but most investors also long for an objective measure. The best candidate is return on equity, or ROE. In essence, it shows how successful management has been in using company resources to produce profits. But because part of the formula requires you to plug in pre tax profits, ROE is meaningless for early-stage companies that don't have profits. Also, ROE tends to fluctuate quarter-to-quarter or year-to-year. For example, ROE in large companies used to run in the middle single-digits, but over the past few years, the average has been closer to 20%. ROE only really tells its tale effectively when you view it over several years of history and in relation to industry and market averages. By then, of course, it may be old news, and less useful for finding market-beating opportunities.
- *Scan the Proxy.* This document, which management must file each year with the SEC, can raise a red flag. It provides a list of senior executives and a description of the board members' backgrounds that can make it easier to determine whether the board or management is packed with someone's cronies. The compensation section can also make for some enlightening reading. For example, one com-

pany we cover, Vari-L (Nasdaq: VARL) paid out $1.1 million to a former officer, director, shareholder, and employee of the company who also happened to be the wife of the chairman.

- *Check the Hometown News.* Another great place to do some digging is the Web site of the local paper for the company's hometown. By running a search for the company name or officers' names you might be able to dig up some information that didn't hit CNBC. One good place to find the nation's newspapers is the American Journalism Review's NewsLink site at ajr.newslink.org. We did a recent search on Neon Systems (Nasdaq: NESY) at the San Diego Union Tribune's site, for example, and found that its chairman had landed in hot water for giving a city councilwoman 350 low-priced shares in NESY's IPO which she flipped for a big profit. The same day, she also voted to continue studying a new stadium for the city, a stadium that would house the chairman's baseball team. Uh-oh.

The final word is that gauging management strength remains one of the most important things in investing, and one of the most difficult to do well. ❖