Checklists not only save lives, they can protect investors from overconfidence

Dear Reader,

Complexity and a higher rate of mistakes go hand in hand. The higher the complexity, the more difficult it becomes to remain systematic in our thinking. Biases and shortcuts take over, resulting in poor decision making. Industries such as healthcare and aviation have been able to overcome the human brain's inability to deal with complexity by introducing checklists. In investing the use of checklists is relatively novel, but we believe it can be just as useful in the stride to make fewer mistakes. This letter will discuss the history of checklists as well as our approach to using a checklist.

THE INVESTMENT CHECKLIST

Checklists have their origins in the aviation industry, with the introduction of the B-17 bomber in the 1930s. During the testing of the B-17 bomber there were frequent crashes. The US Air Force found human error to be the reason for most of these crashes and deemed the plane to be too complex for one man to fly. Boeing, the company responsible for the airplane, faced bankruptcy if the project failed. To solve this life-or-death issue Boeing came up with four different checklists to be used when piloting the plane (Takeoff, Flight, Landing and After Landing).

The introduction of these lists during further testing caused the incident rate to drop to zero. Outside of war, the B-17 has one of the best flight safety track records. The success of the B-17 bomber prompted checklists to become widely-used in the commercial airline industry. This has helped the airline industry to become by far the safest means of travel in the world. **Seeing the success of checklists in aviation, numerous healthcare professionals also started to push the use of checklists into their field.**

LISTS SAVE LIVES

One of these men, Professor Atul Gawande of Harvard Medical, struggled with the high level of unnecessary deaths in hospitals and as a result literally wrote the book on checklists: **The Checklist Manifesto**. One of the earliest introductions of checklists into the realm of healthcare was in the intensive care unit. High infection rates caused by human error led to thousands of deaths annually. To reduce the infection rate a 5-point checklist was introduced. This was done as the investigative team realised hospital personnel (both doctors and nurses) made routine mistakes over and over again. For example, personnel often did not wash their hands or forgot to put sterile drapes over the entire patient. These routine errors were put in the checklists to halt their repetition. In hospitals where this simple checklist was introduced and adhered to, the infection rate dropped to close to zero, savings thousands of lives. In both healthcare and aviation, checklists have been shown to be proven means of reducing unforced errors.

As we mentioned above, the reason checklists are effective is because our brains were not designed for systematic work. Humans evolved in an environment where it did not pay to think systematically, but where survival depended instead upon fast reactions: if you faced a threat, the 'flight' mechanism was triggered and without thinking, you ran.

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THE CHECKLIST BENEFIT: USE IT OR LOSE IT

Humans are also emotional beings. We suffer from overconfidence, which leads us to believe we are more capable of assessing situations than we truly are. In investing, we also take short-cuts and suffer from behavioural biases, just as in our earlier examples from healthcare and aviation. We therefore believe our profession can benefit just as much from checklists as those and other industries have.

Our approach to checklists is to focus on the past mistakes of our team, as well as those of other well-known investors. By bringing awareness to past errors you reduce the likelihood of them recurring. Nota bene: One of the biggest pitfalls of a checklist is to have one but not use it. If you don't use it as a standard "check the box" exercise, results will be poor. To prevent this pitfall we have kept our checklist short (6 questions) and have made sure it is a group-wide process.

We have recently implemented this checklist in our investment process. Two questions from our checklist are discussed below.

DON'T UNDERESTIMATE LEVERAGE AND THE CAPITAL CYCLE

One of the questions on our checklist is "how leveraged is the company?". Over the course of our history. we have often underestimated both the financial as well as operational leverage of a company. While debt may seem high and manageable during prosperous times, it is less so when the business enters a downturn. One case in which we underestimated the leverage was that of the UK grocer Tesco. Rapid organic and inorganic growth had led to an increase in financial debt. Retailers also have a high degree of operational leverage given the high fixed costs in the business (rents and store employees); a downturn in the business, due to increased competition, and combined with more debt resulted in a strong decrease in profitability. This eventually resulted in a cut in the dividend and a poor total return on our investment. We believe we could have avoided this mistake by thinking more explicitly about the leverage in the business.

Another theme we believe has been the cause of many mistakes in the investment world is the lack of appreciation for capital cycles. Investors as well as sell-side analysts tend to spend the majority of time thinking about demand, whereas supply is often a much more important factor in predicting industry profitability. We have made the same mistakes in the past. An example of this is our investment in Transocean, the deep-sea oil driller. Transocean was generating high returns on capital in a market that was benefiting from high capital expenditures from its clients. The strong returns attracted new investments from both incumbents (including Transocean) as well as new competitors. This wave of new capacity resulted in oversupply, which lowered earnings and resulted in a steep drop of the share price. **To prevent this mistake from happening again, we have added the following question to our checklist: “Where are we in the capital cycle?”.**

Checklists help people to reduce mistakes in complex environments. They force us to be systematic in a way that our brain is not designed to be. In healthcare and aviation it has resulted in fewer accidents and complications. In investing we believe it reduces the amount of unforced errors and improves our long term performance.’

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