



ELM RIDGE

“A Future for Agency Capitalism”

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“Graham and Dodd investors are people who place a very high value on having the last laugh. In exchange for the privilege, they have missed out on a lot of laughs in between.”

– Michael Lewis

“A healthy male adult bore consumes each year one and a half times his own weight in other people’s patience.”

–John Updike

Sheetal and I were on the phone a couple weeks ago as major stat came out with a hotter-than-expected inflation reading, with the S&P moving more than 100 points as the number scrolled across our screen. I was awed by the speed of the interpretation: “Must be the machines.” Of course, within a few seconds, the markets then reversed by double that amount: “What the...” “Different machines,” Sheetal guessed. And we went back to work.

So, as we explained in more detail last quarter, we’re just waiting to see if valuation to will rear its head once again. And as the market begins to grasp that its hopes for low 3s long-term treasuries may not pan out, we might be inching closer to that day.

But this piece will skip my thoughts on the current market forces. I have bigger fish to fry.

A Future of Agency Capitalism

“On this team, we’re all united in a common goal: to keep my job.”

–Lou Holtz

“Idealism is what precedes experience; cynicism is what follows.”

–David Wolf

Before I get into it, a disclaimer is in order. I want to sketch out a set of incentives that I think will drive a particular outcome. I am not blaming anyone. I do recognize that if I wasn’t of the AARP demo and was actually trying to build an institutional investing business, we would be playing right along. And there is no way I’d be writing what follows.

I was finishing listening to George Packer’s, *The Unwinding: An Inner History of the New America*, just as Boeing jumped back into the news on a regular basis, and those two events combined to drive some very dark thoughts. The former illustrates the decline of American institutions, told through the stories of real people, and I can’t do it justice here (but highly recommend it). As for Boeing, it seems that I’m watching the possible collapse of an American icon, one that I have followed for 30+ years (I have models starting in ’86, “shot the root”¹ with production workers in a dumpy bar and in a former incarnation even managed money for their pension plan). We watched, at

¹ A shot of Jägermeister dropped in a mug full of beer.

first from afar, as problems with the short-term fix for the 37 MAX (stretching the fuselage and using heavier more powerful engines, thus avoiding the cost of designing a new wing) may have produced the instability behind a couple of high-profile crashes. As the Street continued to reflect their clients' support (as in the footnote below.² Note that we value sell-side notes as much for their reflection of what their clients believe as for any analysis they may contain), we took a closer look – figuring that that stock market pressures had produced more business shortcuts than were currently visible, and that these would impact the company for a very long time to come. If I thought the problem would stop with the 37 MAX (ignoring issues with the 87 and some high-profile defense programs), or just Boeing, I might be more sanguine about our future. But I'm not. So, here's my initial two cents on where agency capitalism might be headed.

When I entered this racket at Sanford Bernstein, almost 40 years ago, I would visit with CEOs who would regularly remind me that they were stewards of the company and its stakeholders, with its long-term future in mind. While I might ask about some options that could boost profitability, they would habitually respond that they had to consider the impact way down the road, along with many more things than what us narrowly focused greedy Wall Street guys might desire. I still remember staring at one good ole boy's spanking new leather soles, as he kicked his feet up on the desk, while he droned on and on about whoknowswhat, recognizing that even though I represented a 10% voting interest in his company, I was well down his list of things he cared about.³

Well (maybe thanks to CNBC) times have changed. The enormous pile of riches that we will grant a CEO for maximizing short-term stock prices has soared to the point where they are only too happy to accommodate the Street (whose voice is multiplied by the enormous stake of passive investors following the momentum that they create). Stakeholders are not going to make it to *Mad Money*. Let's lay out the logic.

Investor & Management Incentives ...

1. Most capital, save Warren Buffet's and a few others, is entrusted to professional agents to deploy.
2. These agents are evaluated according to their historical record and are given a limited leash to reproduce successful results. They are incited to keep companies from investing in any non-story-of-the-day project whose return might not show promise within the allotted time frame – although they may want to sell a story that the company is making these moves (so they can sell out to whoever buys their shpiel).
3. These agents are usually hired by professional allocators with the same set of incentives.
4. If agents think a company may be pursuing a strategy that will result in problems down the road, they+ have the incentive to sell and get out quietly, rather than cause a ruckus that will both hurt the stock price and bring their judgment into question. (Anecdote in the footnotes.⁴)
5. Non-professionals, who don't really have access to data that would allow them to establish any fair valuation targets (unless I have managed to avoid speaking to the only ones that do), are also going to focus

² As Boeing just announced some more short-term cash hits from their recent problems, I'm reading a note from an Industrial Trading Strategist noting that "most of our conversations about BA with investors usually sound like 'it's \$150 to the downside and eventually ~\$300-350 to the upside', but the question is when to (re)enter, not 'where'. Today's comments should not be a surprise and likely aid the process of finding a floor." And, indeed, the stock shot up nearly \$5 on the news.

³ The next time I visited him, I came armed with a bunch of figures I put together showing that his outsized capex had indeed improved his profit position vs the competition and he answered every question directly and with his feet under his desk. By the way, he ended up selling his company at a hefty premium, rewarding both of us.

⁴ I remember, at a former firm, an analyst reviewing one of our holdings' recent results saw that their receivables had blown up and did not get a satisfactory response as to why. We promptly sold what had been one of our largest and most successful holdings. Three weeks later, a scandal broke, and I think some of the execs were criminally charged. Our marketing team wanted to brag about our deft moves in our presentation deck. I argued against it on the ground that we were 3 weeks away from being hoodwinked ourselves.

on short-term price movements as reinforcement that they are doing the right thing. Cap-weighted passive vehicles mimic the same phenomenon.

6. As a side note, those who might call attention to the unsustainability of current trends are going to come off as pompous \$#!&heads. I, for one, would have no friends, nor should I, if it wasn't for liquor, sports and power tools.
7. Management has learned the wisdom of meeting their investors' expectations. They have a choice: a) exercise oodles of stock options if they can goose short-term performance; or b) get fired/face a proxy fight. As I've droned on before, CEOs like Citigroup's Chuck Prince had to dance to the music, or their shareholders would have replaced them with someone who could really step. (Note that there are a handful or so of execs who have achieved Exalted Status, having developed such a cult-like following that they are given the freedom to maximize long-term results – that is, if they expect to be around that long, and if they so choose. But these are exceptions, not the rule.) As Sheetal just noted, you would never get a current CEO to ask "What were you thinking?" about why his stock was trading at 10 times revenue anymore, as a tech favorite did some twenty years ago.⁵ He'd get fired.

Drive Decisions that Risk Drastic Consequences

As I have probably already discussed too many times (such that it made its way into our characterization of our basic letter template some 10 years ago), the "I'll-be-Gone-You'll-be-Gone" (IBGYBG)⁶ nature of the market, leaves most participants with an incentive to, in effect, sell insurance/cut off the tails when making decisions; the costs of falling behind are more immediate than those of going down with the ship when everyone is in the same boat. There are many tools/gimmicks that can maximize short-term returns, most of which are actively supported by their agent investors.

8. They can extort monopoly rents wherever possible. While companies should seek to maximize profits, if they raise prices too high, they will encourage new entrants who can thrive under their pricing umbrella. (See Marlboro Friday.⁷)
9. They can cut R&D and/or marketing that does not have immediate payoffs. (Most consumer-facing companies can report whatever they want at the expense of future growth.)
10. They can cut skilled labor in a pinch and have their customers suffer the repercussions when they need to hire them back.
11. They can cut back on safety (cigarettes, Oxycontin, instant blood tests or what might be the case with a "full self-drive" solution that uses cheaper cameras v LiDAR.) What's the harm? Note that these make for some excellent documentaries.
12. Their supporters might encourage them to use perfectly legitimate gimmicks to better fit the then current requirements for the Good Housekeeping Seal of Investment Approval⁸ (asset-light compounders at present). They can get their agents to pay employees with options and claim that is not really an expense. They can compensate other parties to advance funds on their receivables or hold off on collecting payables. When calculating free cash flow, they can treat acquired capex and R&D as if their compounders got them for free – unlike the exact same activities that would normally be undertaken in-house. These usually come at some cost, often masking hidden leverage.

⁵ <https://medium.com/@Bentan1/what-were-you-thinking-fea15ec6c09d>

⁶ As discussed by Jonathan Knee in *The Accidental Investment Banker*, 2006, where bankers sign off on deals with the potential for trouble figuring that they will not be around when the stuff hits the fan.

⁷ https://en.wikipedia.org/wiki/Marlboro_Friday. I remember this one vividly.

⁸ I don't know how many of you remember the commercials touting the Good Housekeeping Seal of Approval. But if you too are an old geezer, who cut school to watch *The Beverly Hillbillies*, you know what I'm talking about.

13. Most significantly, and they usually resort to this after the cookie jar is well drained, they can further goose their returns by adding leverage. In fact, most accounting gimmicks (substituting rent for ownership, paying third parties to hold inventory and receivables, continued acquisition activity, etc.) help disguise this risk. Indeed, running close to the edge does maximize profits, but stumbles can be fatal (for the companies and the ultimate owners of capital that is, not the IGBYBG driven types who chose this step). So, after two decades of declining rates, serial acquirors are once again admired, as the Compounder Bros don't remember the Nifty Fifty Crash in 73-74,⁹ 1990-92 LBO Bust,¹⁰ and 2000-03 market downturn blow-ups, when such previous titans of the market like Harold Geneen, Robert Campeau, Jack Welch, Dennis Koslowski and Maurice Greenberg drowned the Bros' predecessors (please feel free to look up each one). And this points to what I think is the most important consequence of all.
14. As the Road to Riches Part 1/2/3/4 inspires more and more imitators and hucksters, resulting blow-ups tend to happen in waves (as in the three periods above in addition to the 08-09 financial meltdown) – usually when the economy or markets turn sour. It's not just a one- or two-off thing, particularly since so many of the popular investments are marching to the beat of the same incentives/drummer. The ultimate investors get wiped out. Thousands might lose their jobs at once. And as the public suffers, the agents who drove the issue will try and play a new game of musical chairs. (*The Unwinding* tells this all too well.) And all of you (and your alma maters and pension funds) who bought wholesale into privates as a way to avoid confronting unwanted volatility, can try and get at the cash behind those reported returns to make up for that loss. (Some of those firms on the right side of the Big Short faced the same or even higher withdrawals than those who had lost their clients capital, since these few firms could actually pay them back.) Good luck.

As a consumer, investor, or employee, I would not necessarily feel comfortable that Adam Smith's invisible hand is working to the degree it might have a few centuries ago.

Our Government Can't and Won't Protect Us

I've listened to friends argue that "the government" should have protected them from the Great Financial Crisis in 2008, and in the next sentence talk about the need to rein in the Big State. Now there's a great job description, wait around until after we need you and then get blamed for what you weren't around for. I should stop right there (but of course I won't).

15. Regulators face a skewed set of interests and incentives. They are expected to prevent future harm that appears to have a diffuse effect spread over thousands of people not paying them any attention. But their tools would produce visible costs to those most affected by their decisions. And these are the folks who monitor and interact with them much more frequently.
16. Their efforts rarely produce an immediate visible benefit, but the costs are much more obvious. Imagine if a federal official in 2006 announced that they were going to make it much harder to get mortgages. Never mind the developers; A&E ("Flip This House") would have raised a ruckus.
17. Given that the job incurs such opprobrium, top regulators often get hired away by those they regulate. Do they really want to make enemies?
18. Regulation always involves a tradeoff between some cost and a desired outcome. Just look at what works for good ("good" referring to their skill in getting elected, not legislating) political discourse and you'll see that the general public has little interest in nuance and subtlety. Any apparently unjust outcome will be

⁹ <https://economics-files.pomona.edu/garysmith/papers/Nifty50/Nifty50.html> , <https://bridgeway.com/perspectives/party-like-its-1972-what-can-the-nifty-fifty-teach-us-about-todays-market/>

¹⁰ [https://en.wikipedia.org/wiki/Private_equity_in_the_1980s#LBO_bust_\(1990_to_1992\)](https://en.wikipedia.org/wiki/Private_equity_in_the_1980s#LBO_bust_(1990_to_1992)),
https://en.wikipedia.org/wiki/Private_equity_in_the_1990s

portrayed as a much more statistically significant event than it is. Politics is a business too. A politician's job is to get elected. We make it difficult to vote. Anger is the best way to get someone to the polls.

19. As a result, regulators are afraid to set rules until after the thing they were charged with preventing happens. After that, the pendulum swings way too hard the other way and the costs borne by those being regulated will escalate until their excesses get them torn down and the cycle repeats. It's only a matter of time before Boeing faces 10x the regulatory requirements than it currently does. Then, a few years after Airbus kicks its butt, the FAA will give them the keys back to the castle once again.

I'm sure there are holes in some of this (and please let me know), but I don't see a happy ending. The Corporate Unwinding will repeat. Products will endanger consumers (anyone have an idea of how to prevent the harmful effects of social media, or false "facts" promoted by those who know that an emotive story is way more profitable than a logical one?). Companies built over decades will get wiped out in months. Some people will get priced out the ability to stay alive (insulin?) and others will lose their lives to unsafe products. The public will lose their shirts at semi-regular intervals in various investment schemes. And when they do, some politicians will learn to capitalize on their hatred and fleece them even worse. But I don't see a better alternative.

I should have stayed in academia, describing a problem with not a clue as to an effective solution.

Caveat Emptor.

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Past performance should not be construed as an indicator of future performance. Inception is January 2000.

(a) The performance figures are estimates and unaudited. (b) All returns presented are calculated on a time weighted, total return basis (include all dividends, interest, accrued income, realized and unrealized gains and losses and commissions). Gross Returns do not reflect the deduction of a 1.5% management fee, applicable fund expenses, or a 20% performance allocation. Net Returns include dividends, net interest, and reflect the deduction of a 1.5% management fee plus applicable fund expenses; they are also net of a 20% performance allocation, if applicable; (c) These returns are not GIPS compliant. These returns are not AIMR compliant as they represent only the performance of the Series A, Class 1 shares. Individual investor returns may vary due to several factors, which include but are not limited to: the timing of subscriptions and redemptions; differences in fee structures; individual investor account high water marks, and differences in tax treatment. Because of certain governmental regulations, not all accounts are New Issue eligible. New Issues contributed approximately 9.6% gross to the performance figures presented for the year 2000, 0.6% gross for the year 2001, 0.09% gross for the year 2002, 0.48% gross for the year 2003, 0.47% gross for the year 2004, 0.30% gross for the year 2005, 0.17% gross for the year 2006, 0.24% gross for the year 2007, 0.03% gross for the year 2008, 0.01% gross for the year 2009, 0.03% gross for the year 2010, 0.05% gross for the year 2011, 0.00% gross for the year 2012; 0.05% gross for the year 2013; 0.05% gross for 2014; 0.01% gross for 2015 and 0.00% thereafter; (e) All performance figures are before-tax returns. Actual after-tax returns depend on an investor's individual tax situation and may differ from those above. (f) All historical performance and exposure statistics reported in this letter prior to October 1, 2001 refer to Elm Ridge Value Partners, L.P., a 3(c)1 limited partnership. (g) All S&P 500 performance percentages are shown with dividends reinvested. The S&P 500 has not been selected to represent an appropriate benchmark to compare Elm Ridge Management's performance, but rather is disclosed to allow for comparison of Elm Ridge Management's performance to that of a well-known and widely recognized index and is not intended to imply that the fund's portfolio is comparable to this index either in composition or elementary risk. The S&P 500 Index is a market-capitalization weighted index containing the 500 most widely held companies chosen with respect to market size, liquidity, and industry. The index is calculated on a total return basis with dividends reinvested. (h) The Form 13F that is filed on a quarterly basis by Elm Ridge contains the required details concerning our portfolio.

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Cumulative and annualized returns are shown. Cumulative returns represent the amount, including all interest or dividends and capital gains received on an investment over a period, usually expressed as a percentage of the amount invested. Annualized returns represent the increase in value of an investment, expressed as a percentage per year. Contribution figures are estimated and may not sum due to rounding and compounding effects. Estimated Gross Long and Short Contributions are calculated independently by compounding the respective monthly returns. This material has been prepared or is distributed solely for informational purposes only and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy.