KAIZEN INTERVIEWS

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WILL THORNDIKE INTERVIEW – 2016

It is a pleasure to interview Will Thorndike, author of *"The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success"*. Will is an investor and co-founded the private equity firm Housatonic Partners[1] in 1994. He researched extensively the outsider CEOs in the book with a team of Harvard Business School (HBS) students, conducting over one hundred interviews and analysing over a thousand years of company data. Will, welcome.

Will Thorndike (WT): Thank you Connor.

Connor Grindlay (CG): The first question we'd be interested in is, what was the motivation for writing the book? I've read *Market Wizards*[2] and *The Money Masters*[3] and those authors wrote their books as much to report on great investors, as to learn about investing themselves. Can you talk about why you wrote the book and what you learned?

WT: The book grew organically out of a talk that I gave about 10 years ago at a conference that we host bi-annually for our CEOs - the people who run our portfolio companies. (I work in the private equity industry.) I raised my hand and said that I'd give one of the talks at that conference, and then I had to figure out what I was going to talk about. I had read about a CEO who very successfully ran a conglomerate in the 1960's and 70's called Teledyne, and the CEO was a guy named Henry Singleton, who is one of the CEOs profiled in the book. I needed to gain access to the Baker library at the Harvard Business School to do the research – which is the great repository of financial information and public company financial information here in the States – and we had a Harvard Business School student working for us that summer who was excellent and was also a tennis player - which will make sense in a minute. I asked him if he wanted to do an independent study in his second year, to do a "deep dive" on Singleton and

1 http://www.housatonicpartners.com.
2 Various books by author Jack D. Schwager.
3 *The Money Masters* by John Train (1980).

Teledyne and he told me that he would love to do that but had unfortunately just agreed to another independent study but that his doubles partner was looking for a project and so he connected me with his doubles partner, a guy named Aleem Choudhry. Aleem, who agreed to do the project, was a Phi Beta Kappa in Physics from Stanford and turned out to be a very talented guy.

Aleem and I did a full year project for which he got an independent study full year credit in his second year at HBS. In the first semester we did a detailed analytical dive on Teledyne and all of the comparable companies – the 60s era conglomerates. We then produced a pretty detailed piece of analysis which was the output of that work and then we shared that analysis in the second semester and then interviewed all of the people who were still alive who had anything to do with Teledyne. Singleton, unfortunately, was deceased, but everybody else in the top management team was still alive, also board members, employees, competitors, analysts, bankers, lawyers, etc. So we did a very broad interview piece and as I was writing up the findings from that project Aleem came to me and said 'if you want to do another one of these next year, I know a really talented guy[4] in the class behind me who's looking for an independent study'.

The project had been much more intellectually stimulating than I had imagined, so I leapt at the opportunity to do another one and that student was a Phi Beta in Chemistry from Harvard. So, I happened into this very talented group of HBS MBA students who helped me with the research and provided access to the Baker Library. So the project sort of grew organically out of that series of collaborations, one per year, and after the 4th year it became clear that there might be a book project. Then after about the 6th one it became clear that there was this much stronger than anticipated pattern. It made it quite a bit different than the *Money Masters*, which is a great book, and had been something of a model for this but it evolved differently.

CG: In the book you talk about 2 tests for selecting an Outsider – that someone had meaningfully outperformed the index and also their peers. When did you come up with that rule and how did you begin to find other potential candidates?

WT: That's a good question Connor. It began with that second chapter, John Gilligan ended up working with me on the Capital Cities[5] chapter, and we were looking for CEOs who'd fit 2 patterns. They had to have better performance relative to the S&P than Jack Welch – that was the absolute test, which was a high bar – and then, more importantly, they had to meaningfully outperform their peer group. So, on average, they outperformed the S&P by twenty-fold over their 10 years as CEO and the peer group by seven-fold.

For that second task, I think the best analogy is duplicate bridge, an advanced form of bridge in which a group of teams of two is divided into tables of 4 (people), the tables are dealt the exact same cards in the exact same sequence and at the end of the evening the team with the most points wins and so it's designed to be a pretty pure test of skill. I think over long periods of time within an industry, it is like duplicate bridge, so if one company meaningfully outperforms their peer group that's worthy of study and all these CEOs had to meet those 2 tasks and fit that pattern.

[4] A guy named John Gilligan who was studying Chemistry at Harvard.

[5] American media company Capital Cities Communications (a.k.a., "CapCities"), which became Capital Cities/ABC Inc, and whose successor is Disney-ABC Television Group.

CG: That's interesting, because clearly, if you're in a growth industry, you can grow faster than the index but the difference relative to your peers in an industry is critical for measuring real skill.

WT: Exactly.

CG: At the core of the book you have identified those characteristics that turn up very frequently, but the most important one is the CEO's ability to act as the capital allocator. If we think about CEOs today, maybe you can talk about the reasons why you think many of the CEOs are poorly equipped, or are insufficiently experienced, to make capital allocation decisions.

WT: CEOs come from a variety of backgrounds and they come from a variety of functional areas so they could come up through marketing, or through operations, or through finance, or any number of paths to the top within a corporation and CEOs tend to bring with them, into the CEO suite, their learning from whatever their respective experience or track was into the office. Capital allocation, which tends to be one of the primary areas of commonality across the eight (CEOs in the book), really is a set of skills that is more closely associated with investing than managing. So, if you look at the skills you need to be effective in allocating capital, it's very similar to the skill set you would need to manage either a public market portfolio or a private equity portfolio. It's more similar to that, than it is to the skills you would associate with running a business and managing employees and creating a vision and so forth. It´s just different from the norm that a lot of people expect as the relevant skill set they would need for leading an organisation.

In addition to that, there is a deep-rooted tendency among CEOs to do 2 things that can cloud their capital allocation abilities. One is to imitate capital allocation patterns that peers are employing; something that Buffett refers to as the institutional imperative; and the second is to rely on experts to help with these kinds of decisions. So experts could be internal or external. Internal experts would be the CFO and finance team. External experts would be investment bankers, consultants, and so forth. The pattern among the 8 CEOs (in the book) is that they did not delegate major capital allocation decisions. They involved insiders. They didn't involve consultants or bankers. But they themselves were intimately involved in doing the analytical work and then making those decisions. They did not delegate that.

CG: Can those skills be learned? One of the things that's fascinating for me, is to understand whether the DNA of the outsider CEO flows through to their successors. As the outsiders CEOs departed, did the successor CEO have the same record of success? Or is it like a game of chess where these CEOs – for example Singleton or Murphy – go into the industry, consolidate it, lever-up, buy back stock opportunistically, cut costs, decentralize and then at some point they exit as they've played the game optimally to its conclusion. They retire, sell the assets or move on. Since, in that sector or company, the game has been played out it becomes very difficult for the successor to replicate the opportunity. I´m really interested in (1) can the skills be learned; and (2) is there any evidence of successor CEOs continuing to carry the torch?

WT: That's a good question. So, the short answer is that I believe the skills can be learned. The actual analytical work around these decisions, as with investing, is not complicated analysis. It's not high-level math, as you well know. Really the key learning relates to a mindset, a commitment to analytics, and to a data-oriented approach to these decisions.

So the extreme example in the book is Katharine Graham, who turned out to be an exceptional capital allocator, but really she had virtually no experience as a CEO or as a capital allocator before she took the helm of the Washington Post Company after her husband tragically committed suicide in 1963. She turned out to be a very effective allocator because she had identified a mentor, who was at that time unknown, in Buffett and then she had the sense to listen to him and learn from him over the last 20 years of her tenure, and she was an extremely effective capital allocator, far and away the best allocator in the publicly traded newspaper industry in that period of time and she started from a dead standing start. So I do think the skills can be learned.

I think you asked a very good question though, because, it's easy to oversimplify the ideas in the book. So an example of that is that the book has been translated into Japanese and a guy I know told me that the subtitles translate as *"don´t pay dividends, buy back your stock*". A dramatic over simplification of the ideas in the book and basically I think the key message in the book is that the way to address capital allocation is to analytically look at the 5 alternatives you have as a CEO for allocating capital. So, that's investing in your existing operations, buying another company, paying dividends, paying down debt or repurchasing shares. Those are the only 5 things you can do with capital. So, looking analytically at those and continually calculating risk-adjusted returns across them and being analytical and rational in doing that and processing the most current data, then choosing the one with the highest risk-adjusted returns. If the returns from the highest one are not high enough, then not doing anything - that basic approach is very powerful. And it means that sometimes you're going to repurchase your shares, but 95% of the time you're not going to touch your shares because the returns aren't interesting.

In the 5% window, when your share price is 'compellingly' cheap, you buy a lot of it. You don't buy a little each quarter. And similarly with acquisitions, you don't do lots of acquisitions; you do occasional large acquisitions when they're truly compelling, and where there is a significant margin of safety and so forth. So what that leads to, is you see in the best of these CEOs, an extreme example like Singleton, they show great range. Singleton built Teledyne and in the 1960s he was an extremely effective issuer of his shares at very high PE multiples and used that currency, i.e. his stock, which was inexpensive because it traded at a high PE, to buy a lot of companies, 130 companies. But when his PE fell dramatically, at the end of the decade, along with all the conglomerate stocks, he fired his business development team, and stopped buying companies. He never bought another company and he proceeded to optimize his businesses and then he turned around and repurchased shares when the PE was in single digits, so he showed range. He was able to do different things and that's hard to do.

A lot of CEOs have one very specific system. I think the best CEOs have some flexibility stemming from pragmatism, and there are examples within the book of successful succession. The best example being General Dynamics, where you had a series of CEOs across the period spanning the book starting with Bill Anders, who was an astronaut, and ending with a former lawyer named Nick Chabraja who had an exceptional combined record but actually they were very different in how they allocated capital. Anders was divesting assets, paying large special dividends structured in a way that made them tax free and buying back a lot of stock. Chabraja was an active acquirer, an occasional share repurchaser, and for the largest acquisition he did – to buy Gulfstream – he actually used stock as the primary currency. So, at different points in time, different options made sense. So they showed some range.

CG: I guess if Tom Murphy worked for Tom Murphy he would probably learn very quickly, but then want to do it himself elsewhere. You see that many of the Tiger Cubs[6]have been incredibly successful because they have learned the DNA of the flagship, but then leave because they can't run the show. I'm wondering whether there were any people you followed who worked at executive level in these companies, figured out they wouldn't be the ultimate capital allocator, left went on to do great things themselves. Did you come across any like that?

WT: Over here in the States (I don't know if there's an equivalent in Australia) they do this thing with great football coaches and they will show their family tree. So they'll show, over 20 years, where their assistants left to become coaches – in college or at the NFL level. It's very interesting to see the spread of influence and the case of Capital Cities is a good one. If you look at the Capital Cities diaspora, one of the top executives went to the west coast and ran a private media conglomerate owned by the family that controlled one of the San Francisco newspapers *The Examiner* and totally turned that around. Another one ran the Pulitzer newspaper business after they left Capital Cities, and another formed a very successful TV broadcasting company. To this day, the current CEO of Disney, Bob Iger, is a Capital Cities alum. He is still in active contact with Tom Murphy who is 91 years old. They still talk regularly.

CG: That is fascinating and it's logical because success does leave clues and employees in the field of influence could carry on with that successful pattern. You talk in the book about foxes and hedgehogs and the opportunistic nature of these CEO allocators. They didn't seem to have the quarterly or yearly capital markets day and say 'we're going to do this' and if something better came along, fear changing plans. Many current CEOs would be criticised for changing their 3 or 5 year plan and possibly ousted. It seems that a lot of these CEOs were, at heart, very opportunistic and they'd wait. There was no pressure to act but when they did, they made very big bets. So could you just talk about the differences between the foxes and the hedgehogs? I love that in the book.

WT: This analogy, it goes back to an essay that Leo Tolstoy wrote[7]. The basic idea is that there are 2 types of intelligence. There's the hedgehog, which knows one thing, but knows it deeply. And there's the fox, which knows many things, a sort of breadth of knowledge. I think the traditional preference, as it relates to CEOs, has been for hedgehogs. Jim Collins likes hedgehogs. I couldn't have more respect for Jim Collins - he was a professor of mine at business school. He's an amazingly talented guy. There are obvious benefits that come from being a hedgehog – a specialization, expertise, learning curve effects and all kinds of benefits. But if you look at the pattern of these 8 CEOs, one of the most interesting findings in the book is that all 8 were first time CEOs; a very surprising finding. Two of them had MBAs, four of them had engineering degrees, they came from a pretty wide variety of backgrounds, but they had an unusual personality type. If you were going to describe them, you wouldn't use the traditional CEO-type adjectives like charismatic, visionary and strategic. Instead, you'd use some other adjectives like pragmatic, flexible, cool, agnostic, analytical, opportunistic, humble, frugal, etc. As a group they didn't relish the outward-facing part of the CEO role. They were more introverted analytical types by nature, optimizers. So they didn't have the depth of experience,

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[6] Tiger Management Corp., also known as "The Tiger Fund" was a hedge fund founded by Julian Robertson in around 1980. In 2000, after closing the Tiger Fund, Robertson used his own capital, experience and infrastructure to seed many up and coming hedge fund managers in return for a stake in their fund management companies ("Tiger Seeds"). Those managers became known as "Tiger Cubs".

[7] '*The Hedgehog and the Fox'* was an essay written by Isaiah Berlin but which seeks to define Tolstoy as either hedgehog or fox.

didn't have the Malcolm Gladwell 10,000 hours[8]. They were more foxes, they had a breadth of experience that brought with it freshness of perspective which turned out to help them, when combined with their analytical bent, in developing differentiating approaches and metrics. It ended up creating significant long-term value for their shareholders.

CG: You mentioned that 4 of the 8 were engineers – why do you think that was? As you know, in investing there's a tendency to overcomplicate financial models – when I've been on the buy side, you get the sell side models which are 10 Meg excel models with 30-40 tabs and full of circular reference errors, because they're so complicated. Yet Murphy and Buffett often did things in their head and distilled them into something very simple. As an engineer myself, at university we were taught to distil everything to its simplest form. Were you surprised that 4 of the8 (50%) were engineers?

WT: I think it's consistent with what I described about personality types. This group were rational optimizers as opposed to strategic visionaries. Engineering is all about optimization. It's all about maximizing throughput for given input, so the mindset is very consistent with that. They did tend to have, collectively, this genius for simplification so they were very good at reducing – after a lot of work and thought – their approach to their businesses to key economic variables that could be translated to their teams.

It was very common across these groups to have single one-page sheets that were used to evaluate potential acquisitions. I don't know if you've read the book 'Thinking fast and slow' by Daniel Kahneman, but basically, there are 2 ways that the human mind processes things. You have system one, which is pretty close to purely instinctual where it quickly uses rules of thumb to arrive at decisions quickly, and it's really effective about 90% of the time. System two requires some pondering and reflection to arrive at the answer. But a lot of us get stuck in, or use, system one most of the time because it's easier and it works most of the time. One of the findings from Kahneman's research is that to get from system one to system two it often takes a simple sort of trigger, and these one-pagers were very effective in doing that for people who worked in these outsider companies. An example would be in John Malone's TCI[9] when they were actively acquiring other cable businesses. He required that for every acquisition after the 1st year of operation under TCI's ownership, that the purchase price to cash flow at the end of year one, be 5 times or lower. There were about 3 levers that needed to be pulled to get it down to 5 times from whatever it was on a trailing basis, and those could be captured on a single piece of paper. It's very powerful.

One of the contemporary analogues of these 8 is a company called Transdigm[10] and if you talk to the CEO there, Nick Howley, he will show you a single page analysis they use for all their acquisitions that would triangulate to an internal rate of return. So it would often translate into a differentiated set of metrics that they would use to describe their business to investors and to the sell side.

CG: That's fascinating, and the patterns that didn't make the list, or occurred maybe 70% of the time? I'm also interested in the personal goals, or drivers, for those outsiders. They might have had a shared goal that got them up every morning and created focus.

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[8] See chapter 2 of *'Outliers: The Story of Success'* by Malcolm Gladwell, published by Little, Brown and Company (2008).
[9] Tele-Communications Inc.
[10] Transdigm Group Inc (NYSE: TDG).

This is a much more difficult thing to quantify, but were there any things that didn't quite make the list?

WT: Let's see… Things that didn't quite make the list… There are some personal characteristics. But people always ask a bunch of seemingly superficial questions about the personalities that are kind of interesting. So politically, more Republicans than Democrats, but more Democrats than you'd usually find in a sample of public company CEOs. Depending how you counted it, I think it's 5 and 3, or maybe 6 and 2. All of them married to their first wife, and a lot of them living in their original house. Personal patterns, very frugal, certainly in their business lives and usually in their personal lives as well. That sort of Buffett model holds much more widely. There are more teetotallers in the group than you'd expect. A number of them enjoyed analytically oriented card games – bridge, poker. I think some of the interesting stuff on the pattern side falls outside of the quantitative capital allocation.

Something we haven't talked about that's a very strong pattern across the book is a preference for decentralised organisational structures. What I would characterise as extreme decentralised organisational structures. Henry Singleton with 20 people in corporate and 40,000 employees. Buffett's probably the extreme with 25 in corporate and 250,000 employees. Capital Cities, TCI, and these companies they all had a commitment to dehydrated or anorexic corporate staffing. So highly differentiated from their peers.

CG: Onto controversy. Unconventional thinking, with the benefit of 5 or 10 years of enormous success and hindsight is always held up as the way to do things – think Steve Jobs and his comeback. But at the time, unconventional thinking is, of course, *unconventional* and people don't like it; they reject it and are critical.

WT: Absolutely.

CG: I think of Valeant[11] today with Mike Pearson, and I was going to ask you who you think are the outsiders of today and whether Pearson is one of them. He's engaged in enormous controversy at the moment, but I was wondering, looking back, were those 8 CEOs quite controversial in their day?

WT: That's a very good question. The short answer is that most of them faced significant controversies and extended periods where they underperformed their peers. If you look at long-term stock charts the data is overwhelming, but if you take shorter periods of time, it's much more volatile. Some of the characteristics are almost designed to annoy Wall Street (primarily the sell side). A focus on tax minimisation is one of the commonalities across the group, so if you're focused on minimising tax, very often, over time, that correlates with complexity in your corporate structure – creating new entities, spinning things off etc.. Then, you take that complexity and marry it to financial leverage and virtually all of them (the one exception being Buffett) used financial leverage generally quite liberally over time, and finally, a disdain for investor relations, a reluctance to spend a lot of time speaking to Wall Street analysts or the business press.

So, those are the 3 common characteristics across the 8. Those 3 things mean that it's often true that things are hard to understand, and so the market often penalises that package of attributes, particularly in downturns. So you would think that proven capital allocation ability would trade at a premium, but in fact if you look at the data it systematically often trades at a

[11] Valeant Pharmaceuticals (VRX).

discount to peers and that's true as recently as 2008/09 for all of John Malone's entities, and there are many of them now. You can go back and trace where all of those traded for extended periods of time from late '08 to the end of '09 and it's really remarkable that you can track that versus the peer group for those respective entities, they traded at a significant discount. If you look back even further than that with Malone, to the time that he was running TCI in the 70s and 80s, he was massively controversial for aggressive pricing practices and high levels of leverage and people really didn't understand what he was doing. It was so revolutionary and he got a lot of negative media attention culminating in Al Gore, the vice president, referring to him as Darth Vadar. There's a lot of press and that sort of controversy across this group, and often they would use those periods of controversy to repurchase shares.

CG: I was trying to understand why some of those companies' share prices and stocks became so cheap at certain periods, particularly in downturns, despite stellar historical capital allocation, but it seems that these were fantastic periods to buy into the companies as an investor. They suffered enormous under-performance for a while but then, over the long term, the charts are fantastic. Key to understand is that the share price charts of these companies don't go from bottom left to top right in a straight line – they have a lot of zigzags.

WT: That's exactly right. I have a chart in my office of Teledyne versus the 'comparables' and it's just unbelievable how much volatility there is and you just look at the swings but the overall numbers are extraordinary.

CG: Classically we're all taught that volatility equals risk. Well maybe it doesn't. That's the whole point; the share price moving around doesn't necessarily mean there's more risk in the business. But that's a whole different topic. So I just want to hear a bit more about you, maybe tell us about Housatonic Partners and the kind of investments you have. I'm guessing that you have a very curious mind, you love to back an outsider, perhaps even in the private equity space early. Do tell us a bit about the firm and some of the holdings and things you're excited about and do you have any outsiders in the wings?

WT: So our firm is in the private equity industry as I mentioned and we focus on growing recurring revenue businesses. So our exclusive focus would be growing recurring asset light businesses and smaller transactions. So we're focussed on a part of the market where we believe there is still some inefficiency and some ability to source transactions outside of competitive processes.

We have a preference – it predates the book – for backing really talented younger managers. 35 to 40 year olds who have a prior history of success, prior P & L management experience, but their first real opportunity to own equity. We tend to hold things for longer periods of time so we can benefit from the younger CEOs as they hit their stride in running these businesses. The business model we like is designed to generate free cash flow, have very low cap ex and working capital requirements. So in capital allocation, the first step is to have capital to allocate and those businesses are designed to, on a recurring basis, provide capital for management teams to allocate and we try to be helpful in working with them to optimize the capital allocation over our holding period. It's a different situation in private equity investment because you either have control of those decisions outright or you have negative control, the ability to block them. We often do try to repurchase shares from other owners over time so we try to do a modified version of stock repurchases across our companies

So those are the characteristics we have. We've had the good fortune of backing over the years a couple of executives who came out of Capital Cities – who were imprinted with that ethos – and they did an excellent job for us in a couple of industries. We're no longer invested with them, but they did a great job for us. We have lots of CEOs who would fit this profile well, and they would generally be earlier in their careers. We believe that part of our franchise is this exceptionally talented group of younger CEOs. Many of them have ties to top US business schools, but by no means all of them. That work is a core part of our business.

CG: That's interesting, and now one last question. If we imagine there was a successor to an outsider CEO, who is brought into the CEO's office for the last meeting. What pearls of wisdom do you think each of those CEOs would pass on to their successor, condensing of all their accumulated knowledge into a sentence or two?

WT: The first thing that comes to mind is a great story about a note that each of the last 5 US presidents has left in the top drawer of the desk in the oval office on the day they leave their office for their successor. And it's a single line that says: "don't let the turkeys get you down". I think (it's obviously tongue in cheek) something like that would be along the lines of what these CEOs would pass on to those behind them, meaning don't let the day-to-day sniping from investors, Wall Street analysts, and the business press deter you from focussing on what really matters which is the creation of as much long term value per share as possible. That's really what they were all solving for. It turns out that's a hard thing to stay focussed on day-to-day when the world is as volatile as it is, particularly these days in the age of social media, twitter, Jim Cramer[12] and so forth.

CG: Thank you for your time Will.

Important note

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[12] American television personality, former hedge fund manger, and best-selling author. He is the host of CNBC's Mad Money and co-founder of TheStreet Inc.