

## To Trust or Not To Trust, That is the Question

By Mariko Gordon

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**I've been thinking a lot about trust lately, because I have a friend who just got "Madoffed."**

She'd known her advisor for years. Their kids had grown up together. **Then one day he ups and dies and she's told to expect an orderly liquidation.** A few days later and the memorial service is now for family only. A few more days and another email, this one saying that the local securities commission has been contacted for "guidance" and that they are trying to "locate" assets.

**She's probably wiped out.**

**And do you know, this beautiful person writes to me and says:** "People rarely do things out of ill intent. Mostly, they make a decision, and then another without recognizing the pattern they're weaving. Expediency can feel as urgent as necessity, and before they know it, they're in a mire from which they don't know how to extricate themselves except by going in deeper - which takes them further away from the safe shore of their own souls."

We see a new level of distrust in our industry post-Madoff. Makes perfect sense. Clients are asking for more insurance coverage on our part, and **there's more interest in our compliance processes than ever.**

Our individual willingness to trust others would appear to be an ineffable thing. Hard to measure. Hard to differentiate among people. And certainly hard to see how it impacts one's financial success.

**Indeed, I would have thought my tendency to trust (or not) and my pocketbook were two separate things.** Until I stumbled upon a paper titled "[The Right Amount of Trust](#)." After wading through a thicket of formulae like this one -  $\log(Y_{ic}) = \sum_j \alpha_j \text{Trust}_{jic} + BX_{ic} + \delta C + \eta R + \epsilon_{ic}$  - the upshot is that **the "wrong" amount of trust (more on what that means in a minute) can cost a person, over a lifetime, as much as they would have lost by foregoing college.**



Whoa. Based on [U.S. Census Bureau estimates](#), that's comparable to \$900,000 in lifetime earnings.

**But that's only the half of it.**

After I'd wrapped my head around the "trust price tag," I had to get over the next hurdle: **The right amount of trust, according to this research, is at the top of a bell curve.** Too much and you get taken; too little and you miss opportunities.

**Too much:** "Highly trustworthy individuals think others are like them and tend to form beliefs that are too optimistic, causing them to assume too much social risk, to be cheated more often and ultimately perform less well than those who happen to have a trustworthiness level close to the mean of the population."

**Too little:** "...the low trustworthiness types form beliefs that are too conservative and thereby avoid being cheated but give up profitable opportunities too often and, consequently, underperform."

**As professional stockpickers, we're challenged on a daily basis to separate truth from fairytale.** And while there's certainly a level of cynicism required for success, life doesn't always unfold perfectly.

Companies don't always make their guidance or whatever estimate the Street has extrapolated down to the last penny. In that circumstance, whether or not you trust management is the difference between buying more stock or puking up what you already own.

**Call me naive, but I tend to give managements the benefit of the doubt until proven otherwise.**

We once owned a company whose lawyers had put stock option repricing language in the proxy, and everyone went nuts. For technical reasons it was too late to change the proxy, and if the option plan were defeated, no one at the company would receive any options at all for an entire year. Management promised they would fix it after the vote, and we believed them. They'd always been straight up with us. The stock option plan was approved, and yes, management did strike the repricing language immediately.

**Sometimes, the horror with which the Street regards an earnings miss - especially if it's followed a dog and pony show or, God forbid, an analyst day - is an investment opportunity.** One of our companies had the temerity to whiff earnings three weeks after an analyst day; the loathing and accusations of lying, venality, and other grave character defects this provoked was kind of



amusing, except for the whacking the stock took as a result.

It turns out that a piece of very high-margin, short-tailed, very economically sensitive and very back-end-loaded business (and when I say very back-end-loaded, I mean like in the last week of the quarter) fell off a cliff. That was the cause of the whiff, not that management was stocked with pathological liars who enjoyed misleading and humiliating the Street. **We bought more stock - call it the "trust arbitrage opportunity" - and it was the right thing to do.**

**Likewise, there are some managements whose stock I will not buy**, no matter how big the I-don't-trust-the-leadership discount is. Life is too short to wonder when the next skeevy shoe will drop.

**So what's the right level of trust?** As with most of life's big questions, it depends. One thing seems clear from the research, however. **The defiant, macho, dorsal fin stance of aggressive distrust that seems to be the default starting point of investors** may result in leaving money on the table, as profitable opportunities requiring a little trust may be overlooked.

Until next time, here's wishing you a 2010 "close to the safe shore of your soul."

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