All you need is love!

by Mohnish Pabrai
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When one looks at the stock performance of Southwest Airlines, Dell or Walmart over the last 5 years or since their respective IPOs, the charts are very impressive. In the last 5 years, Dell is up nearly 600%, Walmart is up 400% while Southwest is up over 300%. All three have trounced the S&P 500 which has gone up a modest 50% in the last 5 years.

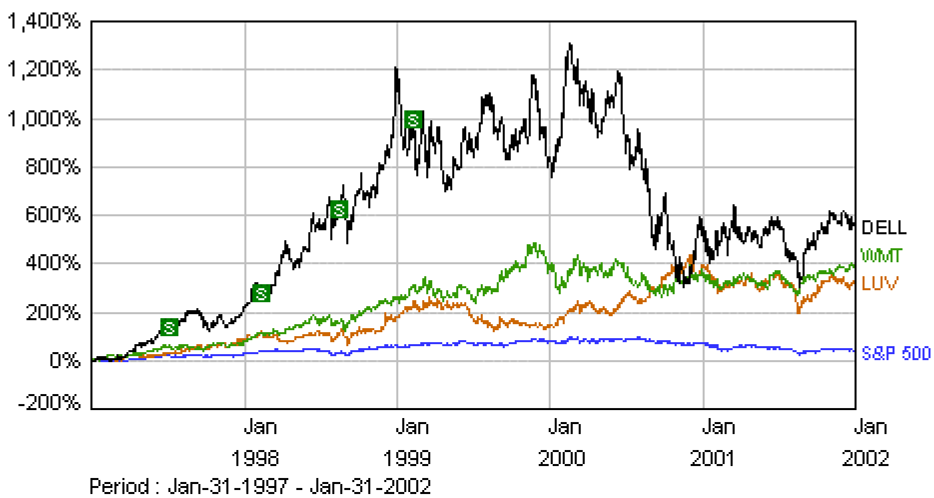

Figure 1: The performance of Dell, Southwest Airlines and Walmart vs. The S&P 500 Index over the last 5 years.

All three are in very challenging industries - where its tough to earn a double digit return on equity, yet they've delivered returns manifold the S&P 500 average. Let's take a look at Dell. Selling PCs is a very tough business. You're essentially selling a commodity where price is a big driver. How has Dell performed relative to its peers like Gateway and Compaq? Not only have Compaq and Gateway both lagged Dell's stock performance and the S&P 500, both have netted investors a negative return over the same period.

Figure 2: The Stock Performance of Dell vs. Gateway and Compaq over the last 5 years.

The contrast in performance between Walmart, Sears and K Mart is especially stark. Retailing is a tough way to make a buck. Of all industries, trade secrets are virtually non-existent – it is among the most transparent industries. To understand Walmart's strategies etc., its competitors can just walk through their stores. All the data one would care to know – pricing, product lines, merchandising strategy is publicly available. Yet, while K Mart has decimated all shareholder value with its recent bankruptcy filing and Sears is simply treading water, Walmart has delivered spectacular returns to shareholders.

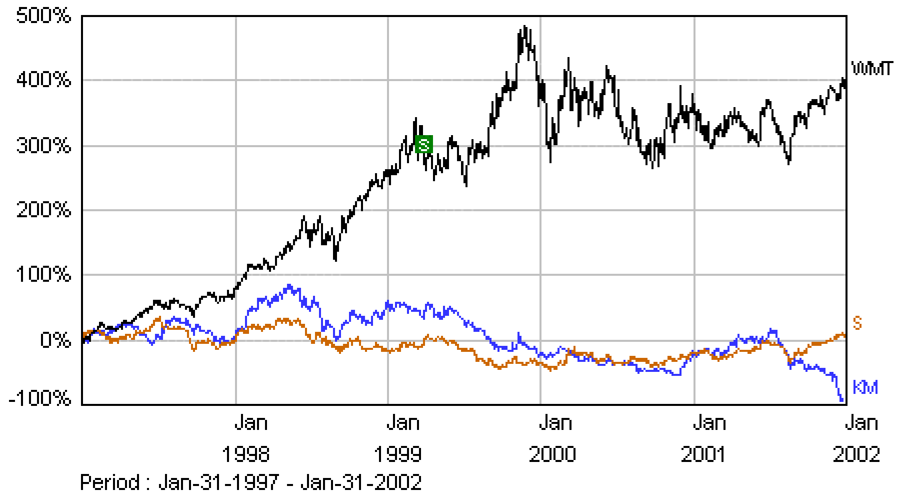

Figure 3: The Stock Performance of Walmart vs. Sears and K-Mart over the last 5 years.

Warren Buffett jokes that if he ever gets the urge to buy an airline stock, he dials an 800 number to reach Airlines Anonymous to talk him off his delusion. After living through the gyrations of his US Air investment, he learnt his lesson and will probably never buy an airline stock again. The basic economics of the business are very bad. You have organized labor that believes a pilot making $300K/year is underpaid and can strike to end your entire revenue stream. Add to that high fixed costs of the airplanes and finally pricing that is determined by the moves of your dumbest competitor who's only trying to recover marginal costs. Not only have Delta and United not earned a dime for their shareholders in the last 5 years, they've proceeded to lose some of the principal as well. But why has Southwest more than tripled investor returns. Indeed, Mr. Buffett should note that had an investor invested an equal amount in Berkshire Hathaway and Southwest Airlines in 1990, he would have made a stunning 15 times his original investment with Berkshire Hathaway – but Southwest would have given him more than 29 times the money he put in over the last 12 years. So much for airlines being a crappy investment!

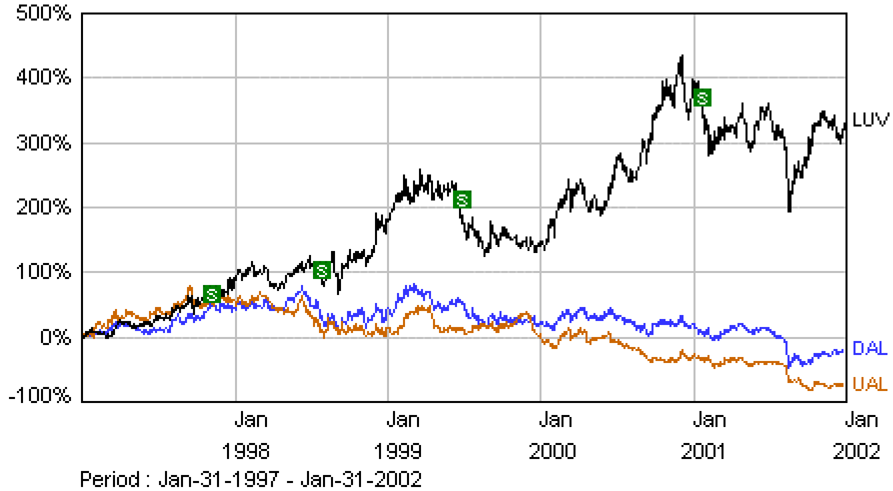

Figure 2: The Stock Performance of Southwest Airlines vs. United Airlines and Delta Airlines over the last 5 years.

How does one explain the wide outperformance of Southwest, Dell and Walmart vs. their competitors. It isn't their strategy since Gateway and Dell have both embraced the direct model since inception. Similarly K Mart has access to all of Walmart's best practices and has emulated them. Also United's Shuttle in California was an exact replica of Southwest's model of going point to point, turning planes around rapidly and flying only Boeing 737s – except that United lost tens of millions in the endeavor and folded its California Shuttle operations.

There are three unrelated books I read recently that provide deep insights into why some companies thrive in difficult industries – even after the driver (CEO) is gone and others are unable to even survive with identical strategies. The books are *Power vs. Force by David Hawkins*, *Matsushita Leadership by John Kotter* and *Good to Great by Tim Collins.* All three are exceptional and provide many of the answers.

It is impossible for me to present a summary of these three great works in a few paragraphs. I'd strongly recommend that the reader delve into all three books and the answers behind the differences in performance will become self-evident. It turns out that critical factors in driving shareholder value rest on certain traits in the CEO. Walton and Kellerher share several common traits – They include:

1. The complete lack of an ego.
2. The singular focus on the truth. They do not send "messages" to shareholders, employees or customers. They speak core truths that they deeply believe in. None would ever even think of "delivering a tailored message". This is a very critical characteristic and the definition of truth is very broad and deep.
3. They are deeply in love with their company and stakeholders. Their primary motivation comes from this dear love. The company is their temple.
4. They are highly capable and energetic individuals.

The combination of lack of ego, love, truth and capability is a potent one. Leaders that possess these rare traits will deliver astounding results. These conclusions are counter-intuitive. When boards look for CEOs, they look for marquee names – which implies high-ego leaders like Al Dunlap, Carly Fiorina etc. High-ego CEOs may do well during their tenure, but their companies inevitably fall apart after they leave. On the other hand, Walton, Kellerher and Buffett have built companies that will endure and do well for decades after the CEO leaves. As Buffett says of Berkshire Hathaway, "It's been lovingly created" or "I have no interest in selling it – even if I were offered five times what it's worth". You can easily gauge the extent of truth, love and ego in a given leader by reading their communication to stakeholders or evaluating their actions.

A good example are the recent television ads for Dell and Gateway. Both feature people. In the case of Dell, it's this likeable young, nerdy guy. In the case of Gateway, it's Ted

Waitte, the founder/CEO of Gateway. When Waitte left Gateway, it fell apart (sign of a high-ego CEO). When he returned, he puts himself in the TV ads! This, in my opinion, is again high-ego. He believes he is the White Knight that is alone capable of saving Gateway. Dell has never left his business despite tremendous wealth. Waitte moved the HQ of Gateway to San Diego from South Dakota and subsequently left Gateway to "pursue other interests". The message is clear – Dell *loves* Dell while Waitte *likes* Gateway and wants to pursue other passions.

A very gainful exercise for the investor would be to characterize the personality traits of the CEO before making an investment. If you can buy a great business well below its intrinsic value and its run by a very low ego, totally truthful, high capability CEO who is deeply in love with his business, back up the truck. Otherwise, keep on driving.

Mohnish Pabrai is the Managing Partner of Pabrai Investment Funds. He can be reached at mohnish@corp.siliconindia.com