"Confirmation bias (the tendency that influences all of us to put more faith in information that agrees with what we already believe) is probably the single biggest problem in business because even the most sophisticated people get it wrong." – Chip Heath, Decisive: How to Make Better Choices in Life and Work

In a 2013 Forbes article, Warren Buffett acknowledged that even his decisions could be swayed by confirmation bias, referring to it as a "brain bug". At the 2013 Berkshire Hathaway annual meeting in Omaha, Buffett invited hedge fund trader Doug Kass to participate. Kass was a critic of Buffett and his investment style and was shorting Berkshire Hathaway stock. Inviting a vocal critic who is short-selling the firm's stock to participate in an annual meeting is unprecedented. These events are usually scripted or at least tightly controlled by management, and controversy is rarely welcome. However, Warren Buffett sought out opposition to his ideas as a challenge to his way of thinking. F. Scott Fitzgerald famously quoted, "The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function."

In the book Deep Survival: Who Lives, Who Dies, and Why, Laurence Gonzales stresses the fact that those who endure the wilderness without provisions are the ones who can best adapt their mental models to changing elements and avoid taking the easy road of following others. In the world of investment management, we might not be talking about life and death situations as one might face in the wilderness but being able to adapt and avoid the influence of other opinions can be critical for our business, for us as investors and for companies in our portfolios.

To avoid looking like a fool, investors may spend too much time trying to convince themselves that they have the right answer instead of looking for facts to prove that their conclusions are wrong. This has been proven by the Wason Rule Discovery Test. This study aims to demonstrate that most people do not proceed optimally in testing hypothesis. Instead of trying to falsify a hypothesis, people more often attempt to confirm the hypothesis. People tend to favor information that confirms their preconceptions independently of the information's truthfulness or falsity.

Even when investors have the facts in front of them, they may still find it difficult to look for opposing arguments to their current assumptions. The desire to always be right and avoid the embarrassment of being wrong is a powerful emotion that can be difficult to avoid.

We humbly strive to review all arguments for a thesis, but that does not guarantee all investment decisions work out as we expect. We use situations where our thesis has broken or failed to materialize as expected to try and avoid making the same mistake twice.

Even when stocks in our portfolios are moving higher, we are on the lookout for risks and honor the dissent among investment team members to encourage more in-depth discussions.

There are always going to be environments when critics of our process question what we are doing. We tend to enjoy those times because that can mean that we are doing something unique. We recognize the challenges associated with confirmation bias and remain diligent in our attempt to avoid that behavior. We look for the same characteristic in the management teams of the stocks we follow.

What Has Not Been Working:

Recently there has been data highlighting the poor performance for value stocks leading some to question when we might expect this to change. Whether the discussion is about growth disciplines vs. value disciplines or active vs. passive investment vehicles, there may be a place and time for each discipline. There may be times in history (such as the past 10 years) where the market-weighted indices (S&P 500 and Russell Indices) perform well due to the strong performance of the heavily weighted underlying securities. However, there is no guarantee that the most heavily weighed securities will continue to be the top performers in the future. Additionally, there may be a time when value strategies again outperform growth. This shift between growth and value can be caused as businesses evolve and economic conditions change.

We have noticed that transformational acquisitions can be a strategy shift among businesses that requires our attention. The motivation to grow does not always benefit the investor but may help the acquiring management team. Warren Buffett has said in the past, "I've observed that many acquisition hungry managers were apparently mesmerized by their childhood reading of the story about the frog-kissing princess. Remembering her success, they pay dearly for the right to kiss the corporate toads, expecting wondrous transfigurations. Unfortunately, we have observed many kisses but very few miracles."

<u>Current Environment:</u>
The first quarter of 2019 proved to be a sharp contrast to the end of 2018. Stocks rebounded in 2019 as concerns over China, and the global economy faded. While this news might seem old, the data indicates that the challenges remain.

At the beginning of March, the Financial Times reported that China had its steepest year-on-year decline in exports in three years. With no clear end in sight to Beijing's trade dispute with the U.S., the world's second-largest economy may continue to suffer.

Leveraged loans also remain a concern. Companies have been amassing cheap loans (thanks to low interest rates) and loosening lending standards. In the U.S., non-financial corporate debt is now a higher share of gross domestic product than before the 2008 financial crisis.

Interest rates also remain in focus as yields over the last 12 months have gone from a peak of 3.2% on November 8, 2018 for the U.S. 10-year Treasury to 2.4% at the end of March. The U.S. Fed is letting its Treasury security portfolio shrink through run-offs, so the Fed is no longer a buyer. The policy shift by the U.S. central bank has raised fears over the outlook for the U.S. economy.

<u>Conclusion:</u>
We remain aware of the volatility in the markets and are mindful of current stock valuations. While it could be frustrating to watch the news and see asset prices fluctuate we usually get excited as the likelihood of identifying mispriced securities can increase. We remain patient and focus on businesses that generate consistent free cash flows and prudently deploy capital in the best interest of shareholders.

We thank you for your support and look forward to discussing the second quarter with you in July.