When Intelligence Fails Miserably

In 2001, Enron was the 7th largest company by revenue (close to $50 billion) before declaring the largest bankruptcy in the U.S. (at that time).

Fortune magazine named it "the most innovative company" six years running from 1995-2000, right before they blew up.

They were also named the 7th "most admired" company in 2001, the year they declared bankruptcy.

Company management overstated profits by roughly $600 million while assets were overstated by $24 billion through the use of mark-to-market accounting shenanigans.

Enron employees lost an estimated $850 million from money invested in the company's stock (which made up more than 60% of the assets in the company's retirement plan).

As the stock fell from $90 or so down to around $4 (and eventually zero) half of the Wall Street analysts covering the company still rated the stock a 'strong buy' or 'buy.'

Nine months before they collapsed, Enron was compared to Hollywood it girls Jennifer Lopez and Kate Hudson because "Wall Street was virtually drooling over the stock."

It's been nearly two decades but the Enron saga remains one of the craziest business stories I've ever heard. In their book, The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron, Bethany McLean and Peter Elkind profile the biggest players in the Enron scandal.

This description from the book of former Enron CEO Jeffrey Skilling was very telling in terms of one of the many reasons things went off the rails:

When people describe Skilling they don't just use the word "smart"; they use phrases like "incandescently brilliant" or "the smartest person I ever met." Skilling in the late 1980s wasn't a physically striking man -- he was smallish, a little pudgy, and balding -- but his mental agility was breathtaking. He could process information and conceptualize new ideas with blazing speed. He could instantly simplify complex issues into a sparkling, compelling image. And he presented his ideas with a certainty that bordered on arrogance and brooked no dissent. He used his brainpower not just to persuade but to intimidate.

Without question, Skillings formidable intelligence had a lot to do with turning Enron into a company that was successful -- at least for a while. But he also had qualities that were disastrous for someone running a big company. for all his brilliance, Skilling had dangerous blind spots. His management skills were appalling, in large part because he didn't understand people. He expected

people to behave according to the imperative of pure logic, but of course, nobody does that (including, it should be said, Skilling himself).

While reading about the combination of intelligence, overconfidence, and hubris at Enron, I was immediately reminded of the story of Long-Term Capital Management. Long-Term Capital was John Meriweather's hedge fund that went through a similarly spectacular fall from grace.

They were loaded with brilliant people as well, including Nobel Prize-winning economists Robert Merton and Myron Scholes along with a huge collection of PhDs and experienced traders. This passage from Roger Lowenstein's book, When Genius Failed: The Rise and Fall of Long-Term Capital Management (even the titles sound alike), about a client letter sent by Meriweather to the firm's clients was eerily similar to Enron in many ways:

Just as a handbook of poker might tell you that the odds of drawing an inside straight were 8.51 percent, the professors calculated that Long-Term would lose at least 5 percent of its money 12 percent of the time (that is, in 12 of every hundred years). The letter went on to state the precise odds of the fund's losing at least 10 percent, as well as 15 percent and 20 percent.

Of course, Long-Term could jigger the odds by changing certain assumptions; thus the letter contained not just one column of numbers but multiple columns, like a page from the Daily Racing Form. The point was, Long-Term predicted the odds with precision. It was as if the professors had some secret knowledge of an altered view of the world, for no ordinary investor would hazard such forecasts.

Now here's McLean and Elkind again on Skilling:

What thrilled Skilling, always, was the intellectual purity of an idea, not the translation of that idea into reality.

And this was the take from Michael Lewis in the aftermath of Long-Term Capital's downfall:

For nearly 15 years, Meriweather and the young professors had been engaged in an experiment to determine how far human reason alone could take them. They failed to appreciate that their fabulous success had made them, quite unquestionably, part of the experiment. No longer were they the creatures of higher reason who could remain detached and aloof. They were the lab rats lost in the maze.

I've read both of these books in the past year or so and the similarities run deep.

A few thoughts on this:

Too much intelligence can be dangerous. Being the most intelligent person in the room (or

assuming you are) is often the most dangerous place to be. It can leave you susceptible to over-thinking things and becoming overconfident in your own abilities. And when others around you assume intelligence is the be-all, end-all, no one else holds you accountable for your decisions. Unchecked intelligence is the worst kind because you begin to assume you're unstoppable.

Emotional intelligence is underrated. By all accounts, Enron and Long-Term Capital were both filled with highly intelligent people. But each organization lacked common sense, self-awareness, and humility. All the brainpower in the world doesn't matter much if you don't have the correct temperament to corral it in a thoughtful manner. Talent is usually overrated in the business world while people skills are highly underrated.

It's easier to fool yourself with complexity. Complexity in business and investing makes it easier to game your own system. Enron and Long-Term Capital were run by extremely bright people who tried to implement complicated processes to run their business activities. And these complexities allowed everyone within the organizations to be fooled by randomness or turn a blind eye to what was going on.

It led them to take risks they probably didn't understand. And it made it much easier to fool the outside world because people would like to believe they're intelligent enough to understand complex businesses and investment strategies. So no one stops to question why things are done a certain way because they don't want to look stupid.

Risk is always there even when you don't see it. It doesn't matter where you are on the intelligence spectrum -- we're all forced to deal with an uncertain future. I think this fact bothers the smartest-people-in-the-room types. This is why people constantly make predictions about the future, even though no one has a clue what's going to happen. It gives us an illusion of control in the face of an uncomfortable feeling of helplessness.

Long-Term Capital's Merton said after the fund's failure, "In a strict sense, there wasn't any risk -- if the world had behaved as it did in the past."

If only it were that easy.

Further Reading:
Experts on an Earlier Version of the World

Now here's what I've been reading lately:

- Should young investors use valuations to time the market? (Irrelevant Investor)
- 96-year-old secretary quietly amasses millions and then gives it all away (NY Times)
- Peacetime/Wartime CEO (a16z)
- How will bond ETFs fair in a market crash (ETF.com)

- Why winners keep winning (Dollars and Data)
- Avoiding single points of failure (Collaborative Fund)
- Why doing more leaves more potential for error (AAII)
- Check me out on the Canadian Couch Potato podcast with Dan Bortolotti (CCP)