Dear Investor:

This month’s letter is about moral hazard and its application to markets, politics, and life generally. When it was first used in the fire insurance industry during the 19th century, the term moral hazard referred to the risk of insuring bad characters. People who were labeled as dishonest were typically denied insurance, and contracts that were thought to create a temptation to cheat were generally not written. Nowadays, the term refers less to moral considerations and focuses more on economic incentives and conflicts.

Moral hazard took on this modern meaning during the 1970s, after economists Kenneth Arrow and Joseph Stiglitz explained it in terms of the principal-agent problem. According to that framework, moral hazard results from information asymmetry and conflicts of interest between principals and their agents. The payment of a tip offers a good example of this theory in action. A waiter (the agent) is incentivized by the prospect of a good tip to provide great service to his customer (the principal). In the hope of maximizing his tip, however, the waiter might offer free drinks, thereby cutting into the restaurant’s profits. In this particular case, the tip itself becomes a moral hazard to the waiter, who is motivated to act in his own best interest, even when it goes against the interest of his other principal, the restaurant owner.

From public policy to sports to business management, evidence of moral hazard is not hard to find. In a 2012 paper, the General Aviation Revitalization Act of 1994 was cited as the main reason for a reduction in the number of accidents involving old, privately owned aircraft. According to this research, the limitation of manufacturer’s liability incentivized the owners of such aircraft to exercise greater caution than before the law was changed. Conversely, a recent Washington Post editorial explains how the US National Flood Insurance Program (NFIP), which sells subsidized coverage against inundation for homes and businesses, continues to be a major source of moral hazard, as it encourages irresponsible construction in flood zones. Another study, published in the August 2003 issue of The Review of Economics and Statistics, analyzed the contracts of 1,873 NFL players between 1986 and 1995 and concluded that moral hazard caused professional players to play harder near the expirations of their contracts. This same breed of moral hazard crops up on Wall Street as bonus season approaches and at publicly owned corporations ahead of options grants.

While it is sometimes hard to spot, moral hazard is endemic among publicly owned corporations. This is because the interest of shareholders (the principals) is not always
aligned with those of the managers (the agents), and sometimes not even with those of the board of directors, whose responsibility is to police the agents. In light of the information asymmetry that exists, the misalignment of a CEO’s self-interest with those of owners often results in moral hazard. Earnings manipulation, excessive pay, ill-conceived acquisitions, and under-investment are just a few examples of what can happen when moral hazard gets the upper hand.

While conflict of interest is a common source of moral hazard, it is not the only context in which the concept applies. In a book titled *Snow Sense: A Guide to Evaluating Snow Avalanche Hazard*, avalanche expert Jill Fredston explains how more sophisticated avalanche safety gear can become a moral hazard. “If you let your gear make you feel safer,” she writes, “you are more likely to act in less safe ways that increase your chances of getting into trouble.” She also highlights the risk of hiking in big groups. “While we feel safer in herds, the reality is that big groups actually decrease our safety because it is difficult to communicate, make objective decisions, and follow safe travel procedures. The bigger the group, the more emboldened we are likely to be.”

Fredston also warns against the hazards inherent in becoming complacent about the status quo: “Because the snowpack is stable most of the time, it is common to travel to a particular spot in avalanche terrain repeatedly without seeing any avalanches. As a result, we get ‘positive reinforcement,’ that is, we begin to think of an area as safe. But if we visit that location often enough, sooner or later we will encounter unstable conditions.” Not surprisingly, her method for coping with this hazard requires a deep understanding of what causes an avalanche and incessant verification of the facts. As they say in pilot training, “safety is no accident.”

In his 2008 letter to shareholders, Warren Buffett echoed Fredton’s warning. “Clinging to cash equivalents or long-term government bonds at present yields,” he wrote, “is almost certainly a terrible policy if continued for long. Holders of these instruments, of course, have felt increasingly comfortable—in fact, almost smug—in following this policy as financial turmoil has mounted. They regard their judgment confirmed when they hear commentators proclaim ‘cash is king,’ even though that wonderful cash is earning close to nothing and will surely find its purchasing power eroded over time. Approval, though, is not the goal of investing. In fact, approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or a re-examination of conclusions formed earlier. Beware the investment activity that produces applause; the great moves are usually greeted by yawns.”

In conclusion, moral hazards run rampant throughout society and particularly in markets where information asymmetry and conflicts of interest exist. When we prospect for outstanding companies and managements, the question of moral hazard is an important consideration. Our approach to the problem is only slightly different from President Reagan’s: we verify closely before we trust, and then we verify again and again.

Best regards,

Victori Capital