# Assessing key person risk when investing

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Smart investment Management

When selecting a fund, the quality of the lead manager or managers is key, for obvious reasons. However, as well as the lead manager(s), we examine the investment team as a whole to ensure that we see adequate strength in depth. This is often to check that the process is not overly reliant on a single individual. However, there are exceptions, as certain fund managers have demonstrated such investment prowess that we want to be exposed to their undiluted ideas and specific style.

Fund managers apply much the same process when picking the individual companies in which they invest, as the senior managements' ability to generate positive returns for shareholders is a similarly key consideration. However, with an individual company, the situation is more complex. When a single person becomes so key to a company, this represents a heightened risk, as illness or death can radically reduce the prospects, and the share price, of the company. However, in some cases the profile of the individual can become part of the positive perception of the company and its products. As an example, many people would be able, if asked, to associate Bill Gates with Microsoft or the late Steve Jobs with Apple, if only because so many of us use the products of their companies. Furthermore, companies are aware of the downsides that come with relying on a single individual, whatever the benefits that person brings to the business, with Apple being a good example: whilst Steve Jobs was perceived as the saviour of the company that he founded when he returned in 1996, and was 'front and centre' of any subsequent product launches, Apple have successfully managed their way through his untimely death in 2011 to become the world's first $1tn market cap company.

Tesla is a newer company that has one such high profile character. It is, without doubt, a world-leading engineering company that has had a significant impact on the car industry by achieving distances for battery-powered vehicles previously considered impossible by the traditional car manufacturers, forcing the latter to accelerate their move into 'green vehicles'. However, whilst their engineering prowess cannot be questioned, whether or not Tesla represents an attractive investment is far less clear, with the company continuing to make losses at a significant rate and having come close to running out of cash on a number of occasions over the years. In spite of that, it maintains very high brand loyalty with its customers and has a market cap north of £50bn, higher than both Ford & General Motors (source: Yahoo Finance), with much of this success being linked to the profile of its flamboyant CEO, Elon Musk. He has a strong track record as an entrepreneur, having made much of his fortune through Paypal, and has been key in securing the funding required to get the company this far, often making up any shortfall himself. His public profile is not currently as high as Gates or Jobs but it is on the rise. However, the increase in publicity has not always helped Tesla's share price, as his recent behaviour has moved from that of the genius eccentric to looking rather self-destructive.

Questions first started to be asked in May when he dismissed questions from analysts during a conference call as "stupid" and "boring" before having a 20 minute conversation with a 25 year-old YouTuber. In July, he responded to claims by a British cave diver who had helped in the rescue of 12 boys from a cave system in Thailand that Musk's offer of a remote submarine to go into the cave complex was a PR stunt by referring to the diver as "pedo guy". After much criticism he withdrew the accusation and apologised but, in late August, re-ignited and escalated the row by questioning in an email to a journalist why the diver had not sued and calling the diver a "child rapist" (a law suit has now been filed). However, Musk's tweet in early August that he had secured the funding required to take Tesla private may yet prove to be a bigger problem in the long term for himself personally and/or Tesla as a company. He attempted belatedly to clarify that he was speaking in a personal capacity at the time and not as Tesla CEO. However, the withdrawal of the claim two weeks later has been followed by reports of several class-action law suits being filed by investors, presumably short-sellers, alleging that he manipulated Tesla's share price in order to generate large losses for them. In addition, the Securities & Exchange Commission (SEC) is looking into the same issue, although it remains to be seen how far they pursue the issue.

It remains to be seen whether any of the events above prove to be damaging to either Tesla or Elon Musk personally in the long term. However, the recent resignation of Tesla's Chief People Officer after one year in the job and its Chief Accounting Officer after just one month may prove to be an even greater sign of trouble, as it continues a pattern of high turnover in senior roles at Tesla. Without suitable checks and balances, and a healthy degree of challenge, even the most visionary leader can make poor decisions, and this is one of the main risks with either a company or fund that relies too much on a single individual.

In summary, if a fund manager invests in a company with increased key person risk that will be because they believe that the performance potential of the investment compensates for the additional risk, and selecting a fund with such elevated key person risk is very similar. Early investors in Tesla have certainly enjoyed very good returns, and Elon Musk has clearly played a key role in generating those returns (although after recent events some may be reassessing the risk/reward profile of the company going forwards). Similarly, if we believe that a fund manager can add genuine value, over and above the alternatives, and bearing in mind that the value of the holdings within their fund are not linked to their wellbeing in the same direct way as an individual company, we will invest in that fund.



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