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## Twenty lessons from Enron

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During the summer I read Bethany McLean's and Peter Elkind's book about Enron "*The smartest guys in the room*". I found it to be a gem of a book, with tons of lessons for investors - of what not to do... It's scary how a company (primarily management) can fool regulators, rating agencies, sell-side equity analysts and investors for such a long period. And how auditors – paid by the company – have short-term incentives to be part of the fraud (hopefully the fall of Arthur Andersen acts as a lesson, but I wouldn't bet on it considering human nature being what it is).

Enron was a darling at the time and the seventh largest company in the US. It had good business areas and bad business areas; the main issue was that management wanted the company to seem better than it was. Without whistleblowers and outstanding work from investigative journalists the fraud would likely have gone on even longer. For long-term investors whose style is to invest in companies with outstanding management teams the lessons from this scandal should act as a reminder..In my view, investors should act as if management is hiding the truth and do the detective work needed to understand if that hypothesis is correct. Here are twenty lessons from the book that may help you with that:

1. Always validate the accounting profits with the reported cash flows
2. Keep tabs on what management do and not what they say
3. Watch out for companies that are re-pricing options
4. Remember that Wall Street extrapolates the results of their darlings (which has met the quarterly forecasts over time)
5. Be wary of investing in companies which are dependent on debt without having stable cash flows
6. If a company puts too much emphasis on the next quarter – stay away!
7. If a company that obsess over their own stock price look elsewhere (Enron had monitors showing the current stock price – everywhere!)
8. Watch out for huge write downs amid management changes
9. If the company continually books non-recurring charges – they are recurring charges
10. Are you anchoring on valuations from sell-side analysts? Don't!
11. Don't mix the stock price performance with the performance of the underlying business
12. Don't rely on reports from rating agencies, sell-side analysts and auditors. Sometimes they are worth much less than zero.

13. Validate your analysis with that from short-sellers – *"invert always invert"*
14. Beware of company excesses – Why do you think Buffett called his jet *"The Indefensible"*?
15. That the employees are financially rewarded is not a clear sign of a good incentive structure – in fact it tells little about the rewards for the shareholders
16. Don't trust the predictions from management
17. If a text from a quarterly or annual report is impossible to understand – the company is probably hiding something
18. A cash flow statement is not the holy grail as it can also be tampered with – you need to understand how the cash flow is created.
19. Read stories about the company from investigative journalists – then re-evaluate your story
20. You are always susceptible to be fooled

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