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China and Wells Fargo Bank: ghost cities and ghost cross-sales . . . and the profound lesson for investors.

Zhengdong, China

Let's begin with the ending. There is a profound lesson for us in these 2 seemingly different subjects: China's so-called "Ghost Cities" and Wells Fargo's "Ghost Cross-Sales" scandal, which is making journalists happy this week, and politicians absolutely delighted, with the prospect of another bank scapegoat to publicly thrash for a long, long time to come.

The lesson is this: If we value our money, never believe the conventional wisdom . . . never, never and never again.

With every company we own or might buy, there is no alternative to the long, hard painstaking work of digging for the truth ourselves . . . or finding an investment manager who insists upon doing so. It's not that the "conventional wisdom" or "commonly accepted narrative" (as economist Brian Wesbury calls it) is always wrong . . . but the experience of almost 4 decades has taught us at Outlook that it's wrong a truly shocking percentage of the time.

Just before the Wells Fargo story broke this week, Outlook stumbled across one of those diamonds of reporting hidden among the mountains of rubble in the daily press. It was written by Wade Shepard, who has been traveling the world since 1999, writing (often from a business and economic perspective) about what he personally sees. What he personally saw in China, over the years, made him write a book called Ghost Cities of China. Beginning a few years ago, the financial and mainstream press announced their discovery of fabulous waste (and financial danger) in China: hundreds of square miles of whole cities and other civic projects sitting empty and unused: "ghost cities." In a flash, Wall Street's famous pundits, hedge fund types, short-sellers and others jumped on the bandwagon. The result was one of the deep, lasting anxieties which has plagued the stock market for the past few years: the "China's Impending Collapse" prediction.

Let us look at one brief passage from Mr. Shepard. He refers to a 2013 "60 Minutes" show, which focused on the giant "vacant" new city of Zhengdong, next to the 9 million-resident city of Zhengzhou in central China.

> *But 60 Minutes simplified the situation by simply calling the entirety of Zhengdong barren and deserted — they went for hype and got it, but rendered their report a work of fiction in the process. They went into skyscrapers full of businesses and then called them abandoned; they showed occupied high-rises and claimed nobody lives in them; they filmed in an abandoned mall but ignored the thriving one nearby; they filmed areas that are not even built yet and used it as an example of how people are not moving into the district. 60 Minutes did not find a ghost city in Zhengzhou, they created one.*
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> *By the time 60 Minutes arrived, Zhengdong's GDP was rising by 13.2% per year and had generated $1.22 billion in tax revenue the year before. 15 major banks, including HSBC, had their regional headquarters there, which were processing over 70% of deposits and 60% of all loans in Henan Province. On top of this, Zhengdong was home to 15 universities, which brought in 240,000 students and staff, as well as Foxconn's notorious 300,000 worker "Apple City." The place that 60 Minutes claimed to be uninhabited "for miles and miles and miles" actually had 2.5 million residents.*

In his book, Mr. Shepard looked hard, and with his own eyes, at many so-called "Ghost Cities" in China. In a nutshell, he found that throughout China's modern era, such cities have been built, sat fairly empty for periods of 1 to 5 years, then gradually filled with people and thriving businesses. He specifically looked at many of the "Ghost Cities" headlined from 2010 – 2013 . . . and found them now either rapidly filling, or already packed with people, and thriving. Finally, when he checked into several of the most famous journalistic "reports" of those years (with 60 Minutes a prime example, not surprisingly) he found that the "investigative reporting" behind them had been slipshod to an extreme degree, based on everything from satellite photos to prior stories by <u>other</u> journalists (who also hadn't looked for themselves or checked the facts very rigorously.)

To any student of history, this is not surprising in the least. Sensationalism works, and sells—because we are all inclined to fall for it, being only human. But human or not, when we put our investing hats on, <u>we must believe nothing</u> until we've looked for ourselves, regardless of the time and effort needed to do so. And that brings us, more briefly, to poor Wells Fargo Bank, which paid a few hundred million in fines to the government this week, to settle a case of fraudulent "cross-selling" within the Bank's own giant workforce.

The conventional wisdom within banking has been that Wells Fargo has been the Usain Bolt of cross-selling, for the past 20 years or so; that somehow this gigantic bank kept pulling off the management miracle of training and motivating its vast staff of fairly low-paid bankers and tellers to "cross-sell" <u>many</u> other bank products to existing customers. Wells Fargo's published "cross-sale ratios" seemed the stuff of Olympians, from the perspective of the rest of us plodding bank managers. Having actually "been there, and done that," here's Outlook's opinion of cross-selling (and managing staff required to cross-sell): "<u>Extremely</u> difficult . . . because most normal bank customers <u>don't want</u> to spend more of their time being "cross-sold" products which look like they'll add little or no extra value to their lives or financial affairs." Furthermore, we noticed, when desperate bank staff pushed too hard to make their cross-sale quotas, the direct result was irritated and alienated customers. People are not dumb. They know when somebody is targeting their wallets, more than their welfare.

Hence the conventional wisdom naming Wells Fargo an Olympic cross-selling organization brought a shrug from Outlook, back when it mattered. It didn't have the ring of truth or common sense . . . but that didn't stop hosts of bank bosses and bank analysts from lionizing Wells' amazing achievements. So this week's headline struck a chord, and reinforced that Golden Rule of Investing: "Don't believe the hype. Find out for yourself." It's a Rule which saves a lot of grief, and makes a lot of money.

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