

## Magellan – In The Know: Episode 39

### How should investors think about Israel and decision making?

#### Announcement (00:00):

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#### Host:

This is In The Know. A monthly investment podcast brought to you by Magellan Asset Management.

#### Michael Morell:

I think most importantly, from your perspective and your investor's perspective, I do not think under any circumstance that Iran will strike oil infrastructure in the Gulf. Why do I say that? I say that because that oil infrastructure is owned and operated by Sunni Arab governments who are Basically on Iran's side in this crisis. They're on the side of the Palestinians and Iran is not going to want to drive them in another direction.

#### Host:

That's Michael Morell, who knows a lot about geopolitical risks. He's a former Acting Director of the Central Intelligence Agency and has extraordinary insight into how to think about risks such as what is happening in the Middle East right now. Welcome to Magellan In the Know.

In this episode, Michael Morell is joined by Magellan Portfolio Manager and Head of Macro, Arvid Streimann, for a fascinating discussion about risks and how to deal with them. Together, they cover the globe, looking at Israel, Ukraine, and China before drawing parallels between managing geopolitical and investment risks. So if you're an investor interested in how to take chances sensibly, it's a conversation you need to listen to. First, here's a warm welcome from Arvid Streimann.

#### Arvid Streimann:

Hello and welcome to the latest episode of Magellan's In the Know. I'm Arvid Streimann, the Portfolio Manager and Head of Macro, and I'm delighted to have back on the podcast Michael Morell, the former Acting Director of the Central Intelligence Agency. Welcome back, Michael.

#### Michael Morell:

Arvid, it is great to be back on your podcast and always great to talk to you.

#### Arvid Streimann:

Yeah, likewise. And I think that we're going to have an interesting conversation today because I really wanted to talk about two things, and we usually talk about geopolitical happenings and goings on, but I remember once we had this really great conversation in private and I wanted to talk about a couple of things today. Firstly, some thoughts on what's happening around the world, and then that second piece,

the new piece, which is around how you think about risk, because as investors, we're thinking about risk all the time. So that's what I think is going to be interesting today.

**Michael Morell:**

Looking forward to the entire conversation.

**Arvid Streimann:**

Great. Great. Let's start on the geopolitical risk stuff, and we often talk about what's happening around the world, but I wanted to, for our listeners, give a little bit of background about why we're interested in geopolitical risk. As an investor, I think about geopolitical risk as a risk of a future demand or supply shock. And I think they're usually supply shocks that you're worried about, but generally when we're thinking about geopolitical risk, the issue for investors, putting aside the humanitarian costs which often come along with geopolitical risk, it's really around the risk of a negative supply shock. So today when we're talking about geopolitical risk, we might talk about three geographical areas being Israel, where of course there's been a lot of stuff happening recently, Ukraine, where there's been a lot of stuff happening in the past 18 months to two years, and then China and Taiwan where there's a lot of stuff going on and maybe continues to go on. How does that sound?

**Michael Morell:**

And hopefully something big won't happen there.

**Arvid Streimann:**

Yes, exactly. Exactly. So just to set the scene a little bit here, when we think about Israel from an investing perspective and through that lens of supply shocks, we're really thinking about oil here. But before we get onto oil, maybe the first question to you, Michael, and we can talk a little bit about is how you're thinking about these current conflict, potential scenarios and maybe some of the signposts to some of those scenarios if they were to occur.

**Michael Morell:**

Yeah. I'll start by saying that the key question is to what degree does this conflict go beyond Gaza? And with regard to that, I get more and more worried every day. And there was a step change for me, Arvid, last week when all of a sudden Shia militant groups across the region started attacking US facilities in Iraq and Syria, and in the case of the Houthis in Yemen, they actually attempted a missile strike on Israel that was intercepted by a US warship in the Red Sea. So why was that an inflexion point for me? And the answer is because that could not have happened in my view without an affirm Iranian decision that they wanted that to happen. All the groups did it at pretty much the same time and pretty much the same scope. And that really tells me that Iran either green-lighted it or actually encouraged it.

And if that's right, and I think it is, then it really says something important about the supreme leader in Iran's thinking about this, because he has heretofore been very cautious about his foreign policy and his national security policy. He was the one, for example, who stopped Iran's weaponization programme for nuclear weapons in 2003 and has not allowed it to start since. So he's been incredibly cautious. So this would be a pretty significant change for him to say to these proxies across the Middle East, let it go. But let me first start by saying it's an almost certainty that Israel will go into Gaza. It's an almost certainty that that will be an extraordinarily difficult military operation, that there will be a large number of Israeli lives lost, a large number of lives of Hamas fighters, and much more importantly, a large loss in life of women, children, and other civilian casualties.

Very large numbers. I think the other thing that's going to happen when Israel invades is you'll see a large barrage of rockets from Gaza into Israel, most of which will not reach the ground because they'll be intercepted by Israel's iron dome missile defence system. And I would imagine that those missiles that remain on the ground in Gaza won't last too long because they'll be taken out by Israeli airstrikes. Beyond, I think there's three significant risks, really, of the broadening of the war. The first is my expectation is that these Shia groups that have been attacking us in Iraq and Syria are going to cut loose with even more. Now, US facilities, the US Embassy in Baghdad and US military bases in Iraq and Syria are extraordinarily well protected. All of them have missile defence systems. They've been shooting down most of these missiles. But some will get through and some may even hit a target where it kills a group of Americans.

And this is the first place where I think you could see the US military getting involved. And I think there's two kind of scenarios. One is the attacks are so consistent and so large in number that we feel we need to strike those Shia militant targets in Iraq and Syria. Syria's fine, but if we strike them in Iraq, that could create real tension between the United States and the Iraqis because the Iraqis are not going to be happy with that. More importantly, if a number of US officials get killed on the ground by one of these missiles, we may find it necessary to strike Iran to try to reestablish deterrence with these Shia militia groups. Now, if that happens, Arvid, I would expect both the United States and Iran to be very, very cautious. We might do one strike, they might do one strike in return. Because I don't think either country wants a war.

And I think most importantly, from your perspective and your investor's perspective, I do not think under any circumstance that Iran will strike oil infrastructure in the Gulf. Why do I say that? I say that because that oil infrastructure is owned and operated by Sunni Arab governments who are basically on Iran's side in this crisis. They're on the side of the Palestinians and Iran is not going to want to drive them in another direction. So that's the Shia militant risk, which I think is almost certain to appear. And then you've got the risk of a second front in Northern Israel between Hezbollah and Israel. So a second war that Israel would be fighting. If you asked me a week ago, I'd say the probability of that happening was well under 50%, and now I'd put it much higher. I'd put it at 70, 80%.

I think there's 35, 40% chance that Israel starts that war to preempt what they believe is going to be a Hezbollah attack and be the first to strike, be the first to take out as many of their missiles and rockets, they have over 100,000, as possible. And I think there's a 35, 40% chance that Hezbollah starts to war to try to draw Israeli forces away from Gaza to be seen as supporting Hamas. So that's pretty high, right? Those are independent variables and when you add the two together, you get 70, 80%. Most of the people who study the Israeli military tell me that the Israelis would have a very hard time fighting two wars at once. One in Gaza and one in Southern Lebanon. And here's the second place where the US military could be affected. It wouldn't surprise me at all that in that situation where there's a two front war in Israel that the Israelis ask for our support, our military support.

**Arvid Streimann:**

And that's regardless of who fires the first bullet?

**Michael Morell:**

It's regardless of who starts it. And my guess would be it would be an easy yes for President Biden to conduct US airstrikes against Hezbollah targets in Lebanon. But I think it's also possible that the Israelis ask for US ground forces on the ground in Israel to prevent Hezbollah from actually invading Israel. Now, when somebody told me that this weekend, I said, "Geez, that sounds pretty significant." And they said to me, "If you were the US president and you were asked to put say 10,000 troops on the ground in Northern Israel to prevent a second Holocaust, would you?" And I said, "Of course I would." And so

that's possible that the US gets directly involved in this second war because Israel's going to have a hard time fighting both. So that's the second place where this could play out. And then the third is the West Bank.

Israel has spent the last seven to 10 days arresting Hamas operatives in the West Bank. They've arrested 450. They've conducted some airstrikes against Hamas targets. I think most of the Hamas guys will be rounded up by the time the ground invasion starts. But what's likely to happen in the West Bank is a popular uprising where normal folk come out into the streets and kids start throwing rocks at the Israeli military, people start attacking Israeli settlers with whatever weapons they can find, and the Israeli military has to respond. And so you have a second place where there are civilian casualties. Now, oil. So we took the Iran question off the table in terms of any effect on oil, but I think there's a scenario that most people aren't thinking about, and that scenario is the following. Arab leaders have to pay close attention to the views of their populations, which are strongly pro Palestinian. And that's why, quite frankly, they've taken the position they've taken over the last almost two weeks now.

So in a scenario, Arvid, where women and children are dying in very large numbers in Gaza and the Arab street in Saudi Arabia, in the Emirates, in Qatar, in Oman, and all of these places really starts to get angry. It is not impossible for me to think that those governments will feel the need to respond with really the only tool they have, which is oil. So I can imagine a scenario, as difficult as it is, a scenario where they say, "We're not going to sell oil to the United States or Western Europe or anybody who's supporting Israel." Now, you and I both know that that doesn't take oil off the market because they're still putting it out there to sell. They're just not selling it to their usual customers. And so the price effect of that is really transportation costs because you're now having to move oil from one place that's more expensive than from a place that used to be cheaper. But the other effect it has is fear and hoarding. And I think that fear and hoarding would drive up prices even more than the transportation costs would. So I could imagine in this kind of second Arab oil embargo as a result of the death of women and children in Gaza could have a fairly significant price effect for at least some period of time.

**Arvid Streimann:**

Yeah, it's possible to see. I agree about that. But I wanted to explore a couple of other ones as well. Let me throw these out here. Potential of stricter application of sanctions on Iranian oil exports, and secondly, perhaps the Iranians reducing the flow of tanker oil through the Strait of Hormuz, which is a choke point in the Persian Gulf.

**Michael Morell:**

I would put the second one in the same category as Iranian strikes against oil infrastructure. They're not going to want to anger their neighbours who again are on their side in this fight by stopping the flow of their oil. So I don't think that has a high likelihood, has a high probability of happening. In terms of the West tightening the sanctions on the export of Iranian oil, again, I think the United States does not want a war with Iran at this time. I don't think Israel wants a war with Iran at this time. I think the United States is doing everything it can to signal the Iranians that we don't want to fight them. They're not going to be attacked here. And so I don't think we'd want to do anything that increases the risk of them lashing out. So we'll see, but the US is doing everything it can to keep this fight focused on Gaza.

**Arvid Streimann:**

Another point here, you mentioned the unlikelihood of the Iranians interrupting the flow out of the Persian Gulf because they want to not annoy the Gulf states.

**Michael Morell:**

Curry favour. Yeah.

**Arvid Streimann:**

But if the Iranians were to do that, it would also annoy the Chinese and the Indians as well, which I presume they wouldn't like that as well.

**Michael Morell:**

The Chinese have taken a pretty strong position here. Have not taken Israel's side. They've taken the Palestinians' side because they are trying to play to the Arab street. Any chance they and Russia get to weaken US leadership in the world, that's the Chinese policy here. But at the same time, it's my understanding that the Chinese are cautioning the Iranians from doing anything that risks expanding this war. So saying perhaps not the right thing publicly, but saying the right thing privately to the Iranians, the Chinese are doing that. I mean, they don't want to see an increase in oil prices, right?

**Arvid Streimann:**

Yeah. Well, I was about to discuss, if we stand back here, it seems as though no one here is really interested in higher oil prices or restricting supply. And as the way you've described it, the most likely outcome here of a genuine supply change as opposed to a rising oil price because people are fearful would be because Arab governments want to show solidarity with the Palestinian people, which I'm sure they want to do if push comes to shove, but I don't think that they actually want to have a higher oil price driven by a negative supply shock. So in some sense, this might be a stable equilibrium, even though it's not an equilibrium that is guaranteed to stay in equilibrium.

**Michael Morell:**

And they would be doing this because politics is more important at the end of the day than economics, right?

**Arvid Streimann:**

Yes.

**Michael Morell:**

So this would not be something they wanted to do, and it absolutely would be the last resort for them to show solidarity with their street. So I agree with you 100%. They don't want to see higher oil prices either.

**Arvid Streimann:**

So now, if we're thinking about being an investor, I always say you've got to invest where you have conviction and if you don't have conviction, then maybe that's not the place to invest. Now, when you've just gone through that risk analysis, where would you say the lower parts and the higher parts of your conviction are or confidence levels are?

**Michael Morell:**

Yeah. As you know, CIA analysts make judgements and then they attach confidence levels to those judgments and those confidence levels are either low, medium, or high. And the confidence levels depend on how much of the picture you're seeing and the sourcing for those different pieces of the picture. Are

you confident in that sourcing or not? So if you were to say to me, what do I have high confidence in, I have high confidence in my judgement that Gaza is going to be a bloodbath for everyone involved, number one. I have high confidence that the Iranians do not want to get directly involved in this unless their hand is forced. I have high confidence that the US and Europe and the relevant countries in Asia, Australia are doing everything they can to keep this conflict in Gaza and keep it from spreading. I have low to medium confidence in my judgement about Northern Israel because I'm not talking directly to the people involved and I'm not seeing intelligence. I have low to medium confidence in the West Bank getting out of control as opposed to just riots and protests. And then I'd say I have high confidence that Shia militant groups will continue to fire rockets at US forces and US embassies in the Middle East.

**Arvid Streimann:**

Which is a real tinderbox. I think you did a good job of explaining that. There's a very strong deterrent reaction that would be required and probably some domestic political response as well.

**Michael Morell:**

Right. Exactly.

**Arvid Streimann:**

Okay. Maybe we'll move on to our second area, which is the Ukraine theatre, where here I don't think it's so much about oil directly. Of course there are some sanctions which were pushed onto the Russians as a consequence of what they did when they invaded Ukraine, but I think it's probably commodities more generally. I did see when I was travelling around shortages of sunflower oil, for instance. So my first question is how is what's happening in Israel going to impact what's happening in Ukraine?

**Michael Morell:**

Yeah, that's a great question. For the most part, there's not much overlap between the weapon systems that the US is providing to the Ukrainian military and what we will need to provide to the Israeli military. There's a little bit in the area of smart bombs, in the area of artillery, but not much. I think there's a bigger impact in terms of the focus that senior officials can give to the Ukraine problem. There's only 24 hours in a day. It's a finite resource. And believe me, when I was deputy director and all of my time was focused on Al-Qaeda, I couldn't focus it on, say, Russia and China.

I think that is a potential impact here. And then the other is the potential impact in the US Congress on its willingness to fund both Ukraine and Israel at the same time. There are already questions about whether America can afford to fund Ukraine even before the Middle East crisis, and now President Biden is asking them to fund both. So I think there could be pressure in Congress to cut back funding to Ukraine even more. So that's the potential impact that I see. No less desire on the part of the Biden administration to provide the support, but possibly less congressional support.

**Arvid Streimann:**

And does it make the Russian side more aggressive or this is independent of what they may be doing?

**Michael Morell:**

I think it's independent. The war is really grinding. Since the beginning of the counter-offensive, the Ukrainians have only regained 10% of what the Russians took since February of 2022. The Russians have tried a counteroffensive, I guess you would say, counteroffensive, and they were thoroughly defeated. Lost large number of men. Both sides are losing large numbers of soldiers. I think there's 80,000 or so Ukrainian soldiers have died in the counter offensive, 40,000 Russians. So this is grinding, and nobody really has an option to accelerate anything that they're doing, so they're kind of stuck where they are.

**Arvid Streimann:**

And so in this grinding outlook, if it was to continue, that seems to me as to be something that doesn't really change the existing supply or demand for commodities or these sorts of things that we talked about earlier. It's more of a status quo and what's happening in Israel doesn't really change it.

**Michael Morell:**

I agree 100% with that. I don't think there's going to be a change in the supply of commodities here in a significant way. I think the grinding, unfortunately, is going to continue I think at least through the presidential election a year from now. Putin is not going to even think about changing the status quo until he sees whether Donald Trump is reelected or not and takes the pressure off of him. And President Zelinsky has no intention of stopping his fight until he gains back every bit of territory. So I think this grinds on for another year with really no additional effect on commodity supply.

**Arvid Streimann:**

Yeah. Okay, great. And maybe we can turn to China and Taiwan where it's not really an agricultural, industrial or energy commodity supply shock that we're interested in here or thinking about. It's really manufactured goods, I would say. You've got semiconductors which are clearly having their supply or at least distribution around the world being interrupted, but there could be other things. Of course, China makes a lot of things and Taiwan makes the semiconductors. So question number one, how does what's happening in Israel and Ukraine impact what's happening in East Asia and particular Northeast Asia, China and Taiwan?

**Michael Morell:**

I don't think it does. I get asked this question a lot. I don't think it changes Xi's thinking about Taiwan. I think his strong preference remains a non-military solution to this problem because of the economic cost he would pay for a military solution. His goal remains to coerce Taiwan back into the fold, not have to use force to do it, number one. And number two, as you and I have talked before, China's not ready to conduct a military operation against Taiwan at a level of risk that's acceptable to Xi. Political risk that's acceptable. There's a number of things that he needs to do to be in a position to conduct a military operation at his preferred risk level, which is really low, because if he tries and fails, he loses his job. So I don't think anything changes.

By the way, just back up really quickly here, when he told his military to be prepared by 2027, he was basically saying he's not prepared today, just to drive that point home. So I don't think anything has changed on that front. What I think is changing, Arvid, is despite both the US and China wanting to reduce tensions and the number of meetings between senior officials that we've seen in recent months and the possible meeting between President Biden and President Xi next month at the Apex Summit in San Francisco, despite all of that, the fundamentals of the relationship are pretty much the same. In the midst of all of these diplomatic meetings, we continue to impose sanctions on high-end semiconductors, and the Chinese are responding in various ways. Mostly targeting US firms operating in China and going after companies where they're buying from American companies and they have an alternative source of supply. Micron was a great example, right?

Micron was selling them low end chips for which there's now a glut on the market. So by not buying from Micron, they hurt Micron, they hurt a US company, but they can still go get all the low end chips that they want. So that's where they are, but we keep upping the ante here in terms of sanctions and they're going to do the same. So I think they're going to focus on trying to hurt the United States and not the rest of the world in their response, but I think that's going to continue. I don't think that's going to be impacted by the Middle East, but I think it's going to continue.

**Arvid Streimann:**

Yeah. I wanted to explore that just a little bit more because we were talking earlier about some of the ramifications of what's happening in Israel, and I think there's really two buckets. Because you're saying that on the Chinese side, not much has really changed, but maybe there were two things that are changing on the Western or the US side. One is the amount of time that people have to think about China and deal with China because they're using that energy and time somewhere else. And secondly, the domestic politics, maybe the electorate is becoming fatigued about supporting foreign countries. We've seen that to some extent with Ukraine. There seems to be strong support for Israel, but I note that there are some people who think that the American government shouldn't be supporting Israel as much as they intend to, and perhaps that can flow into current and future support for Taiwan. So are those two things at risk, which is the time and the support?

**Michael Morell:**

I'm not sure because American politics at the moment is anti-China. It's really one of the few issues that both parties agree on. And I think in the election campaign over the next year, you're going to see both parties try to out anti-China the other. And so I think the decibel levels will be pretty high with regard to anti-China messages over the next year. Hopefully Xi doesn't feel he needs to respond to any of that and he'll understand what's happening. And so I don't think it's going to take a focus off China. I think that's going to remain, and I think that the tit-for-tat on sanctions, as I suggested, will continue, and that's going to keep the focus on China too. So I worry more about losing the focus on Ukraine than I do losing the focus on China.

**Arvid Streimann:**

Now, China supplies America with a lot of things. I like to say cheap T-shirts and things like that, but low-end manufacturers, but they also supply a bunch of other things. Rare earths, which is in the news quite a bit. And obviously there's mid to higher end manufacturers flowing the other way as well, which is to America and Europe. How do you think about China and its willingness to use that card or play that card?

**Michael Morell:**

Yeah. We just saw them respond to semiconductor sanctions by saying they're not exporting graphite to the United States. So they've now used that card for the first time. I do think that the way people should think about this is they'll be very cautious in taking steps that actually hurt the Chinese economy, particularly at this moment when the Chinese economy is struggling. So I think they're going to look for steps where they can cause pain for the US or a particular US company. And I think in most cases it'll be a particular US company. They're going to look for places where they can cause pain for the US and not cause pain for the Chinese economy. So I think people should look for the overlap of those two circles and where's that intersection? I think that's how you should probably analyse it.



**Arvid Streimann:**

Let's just say that US escalates towards China with some sort of trade sanction or restriction. Do you think that China's always going to match in some terms that escalation or introduce a real or genuine escalation?

**Michael Morell:**

Yeah, I think they'll match it. I don't think they'll escalate. Why do I say that? I say it because China is more dependent on trade than we are, and escalating for China is more risky than it is for the United States. Both in terms of exports as a share of your economy, and then where the two economies are from a health perspective, which is really unlikely to change over the next year, I think. So I think they'll be cautious in terms of escalating, and I think they'll just feel that it makes the most policy sense to match. Although look, politics matter there too, and Xi needs to pay attention to domestic opinion. So the more the US is aggressive with China, the more attitudes in China can change toward the United States. I know a little company in the United States that looks at what China is censoring at home, and one of the things they tend to censor is anti-US viewpoints among their own public because Xi doesn't want to lose control over US policy to his own public. And so I think you got to pay attention to if the US starts doing things that gets the attention of the Chinese public, then I think you got to worry a little bit more about China escalating.

**Arvid Streimann:**

Yeah. The nationalism piece is potentially a can of worms and uncontrollable.

**Michael Morell:**

Yes, absolutely.

**Arvid Streimann:**

Okay. I might move on to the second part of our conversation here, something new, where we're going to talk about managing risk. And in your successful CIA career, you obviously started on the analyst side, rose up through the analyst ranks, and there you were analysing national security risks. But what I think is really interesting in the parallel here towards what we do is that you didn't just analyse those risks, you had some partner or the CIA had some part in managing those risks. Because the parallel here is that as investors we're analysing investment risk, and we've done some analysing of investment risk earlier in the episode, but as an asset management firm, we also have to manage that risk. So I think what we do is fairly similar in some way. So I'm really interested in what you think are the main ways that you think about your approach to risk management.

**Michael Morell:**

Yeah. Let me say, in my career, 33 years, most of it on the analytic side, but the last seven or so really overseeing the entire agency, the agency takes two kinds of risk. One is an analytic risk in making judgments. So when we make a judgement, we're taking a risk. And we're taking a risk in that if we're wrong and the policymakers base a decision on our analytic judgement and we're wrong, we can have a significant impact on the interest of the United States. And the best example of that, of course, is being wrong about Iraq WMD, right? So you actually, on the analytic side, think about risk and how do you manage that risk? Well, first of all, you try to understand it, and I think the best way we try to understand it is what we talked about earlier in terms of capturing our level of confidence. That's really trying to understand the risk inherent in an analytic judgement.

So if you say high confidence, you better be right 95% of the time. When you say low confidence, it's probably okay to be right only 60% of the time. And policymakers understand that, you understand it. So in a sense, in capturing your confidence level, you're trying to quantify the risk you're taking. And you try to mitigate that risk by having in place a whole set of tools that analysts can use to make better judgements, make better confidence levels, try to do everything you can to be right rather than wrong. But you can't wait too long to make a judgement. You can't not take risk because then you'll never make a judgement and you won't be useful to policymakers. So there's that tension. Where I think the match is even greater to what investors do is on the operational side, where we're taking often enormous risk to the people who provide us information, they're putting their lives on the line, and then our own officers are taking enormous risk in meeting with our assets, our spies, the people providing us information.

If you don't take risk, you're not going to collect information. And so how do you manage that? You manage it by making sure that when somebody comes into your office and says ... This is the way I did it anyway. When somebody comes into your office and says, "We're thinking about this particular operation and we want to run this by you, or we actually need your approval according to the regulations," I want to make sure that I ask questions to make sure that they've thought through the risks and if they've identified a risk, that they've mitigated it to the extent that they can. And if I approve the operation based on the risk that they identified and the mitigation steps that they've convinced me that they're going to take, and if that risk appears, if it comes to the fore, if something bad happens, then I don't hold them responsible.

**Arvid Streimann:**

Yep. I agree 100%.

**Michael Morell:**

Interestingly, there is on the other thing that CIA does ... So CIA does analysis, CIA collects information clandestinely, conducts espionage. But then the other thing CIA does is something called covert action. So the first two things are designed to understand the world. Covert action is designed to change the world.

**Arvid Streimann:**

And the parallel for us is that's the risk management part as opposed to the analytical part.

**Michael Morell:**

Yes, exactly. Covert action is a presidential decision. And interestingly in the document that the president has to sign for a covert action to actually happen, there are three sections, and the first section is, here's the policy objective that the president is trying to achieve. This is him saying it because he signs the document. The second section are the authorities that he's giving to CIA, the things that the CIA can actually do to try to bring about that policy outcome. And the third section is a risk section where CIA is expected to outline all of the risks it sees involved in this covert action. And they can range from the reputation of the US government to the reputation of CIA, to the reputation of our allies, to the safety of our officers, the safety of our assets. Giving a green light to the world that doing this kind of thing is okay. It's one of the things that President Obama was deeply concerned about. The US doing something in the world and sending the message that this is okay. So those risks must be outlined in those documents. And so there's a lot of discussion about those risks at CIA. There's a lot of discussion about those risks at the policy level and then with the president before he signs that document.

**Arvid Streimann:**

Yeah, it's interesting. Actually it's more than interesting. I find that fascinating. A couple of comments from me on this is that as an investor, you can invest in something and it can go up or it can go down,

you can make money, you can lose money. And so really trying to manage the risk so you get more upside and less downside. Whereas I'm guessing from your perspective in what you were doing at the CIA, as an outsider, it seemed as though what you were really doing was trying to manage a lot of the downside and not so much as create the upside. Although some things that could create upside, I think it was really managing the downside. So what I'm saying is the payoff functions between what we were doing may have been slightly different, but the underneath I think is reasonably similar.

**Michael Morell:**

Yeah, yeah. No, I never thought of it the way you just said it, but you're exactly right. You're exactly right in terms of what we were trying to accomplish.

**Arvid Streimann:**

And here's what I think about when it comes to a risk event. On the analysis side, you can draw it out into some outcome tree and you can have a certain number of branches. And I'm with you, and I'm saying, if someone comes to me and something happens and the branch wasn't there, I think that's almost the worst thing you could possibly do. But once you've drawn the branches, you have to then sit there and go, okay, so what's the impact under all of these branches or the payoff or the outcome? That's the second thing. And then the third thing is to attribute some probabilities to all of those branches. And then the fourth thing, which I know you and I have great sympathy for, is to stand back once you've drawn that painting or picture and go, how much do I believe this? How much conviction do I have? And that I think people can visualise. I think it's a relatively simple framework. Of course, filling in the probabilities is probably the hard bit, right?

**Michael Morell:**

Yeah. And those probabilities change every day.

**Arvid Streimann:**

Totally.

**Michael Morell:**

Right. As you get more information. Just like I said I've become more concerned about the spread of the war in the Middle East the last few days. So it literally changes every day for both intelligence analysts and investors.

**Arvid Streimann:**

And I really like how you were giving probabilities earlier, by the way. That sort of floats my boat a little bit when you do that sort of stuff.

**Michael Morell:**

I know you now, Arvid. I know you.

**Arvid Streimann:**

Okay. So now that we've established how you were thinking about analysing and what I call managing risk or your actions, where do you think people generally underperform?

**Michael Morell:**

Yeah. One common pitfall is to not take enough risk. I've seen analysts not want to make a judgement . I've seen senior CIA officials not want to take risk on the operational side. I've seen myself not want to take risk on my investments. And I think that in all three cases, CIA would've been better off and I'd be better off financially if I had taken more risk. So I think there's a risk aversion that often gets in the way of taking the amount of risk you should take, or that would make sense if you had more information. That's one.

I think a second is what I call mere imaging. When you're looking at a situation and you don't have ... Particularly when you're looking ... Maybe this is more intelligence analysis than investing, but you'll tell me. When you're trying to think about what happens in the world, it's a combination of what other players do in the world with what the US does. And you have pretty good insight, not perfect into what the US does. You've got much less of a perfect insight into what a others do. And when you're trying to think through what others do, when you don't have information, there's a very strong tendency to mirror image and say, if I were President Xi, here's what I would do. And that is almost always wrong. That is almost always wrong. I've seen that over time. So that's another one I would highlight.

**Arvid Streimann:**

It's fascinating you say that because one thing that I always tell people is that when you're in a situation and you're trying to predict what someone's going to do ... And I've seen this loads of times. I used to be an economist. We're trying to pick what the RBA, the Reserve Bank of Australia, is trying to do. And people would often say, "Well, I would do this." And I always pick them up and say, "Hang on. You're not trying to tell people what you would do. You're actually trying to pick what that person's trying to do." So I have a lot of sympathy with what you just said.

**Michael Morell:**

Exactly, exactly.

**Arvid Streimann:**

And just on your first point, the not taking enough risk, I suspect you were saying not taking enough risk for a given level of confidence, right?

**Michael Morell:**

Yes, yes, yes, yes.

**Arvid Streimann:**

And there, I think you've hit the nail on the head. I see this quite a bit, and people have their biases. I don't blame anyone here. I think this is a human thing, this loss aversion. I think people don't really want to be wrong. So the upside in some sense is not quite as big as the downside if it was a 50-50 because they feel more hurt from a losing trade than a win from a winning trade.

**Michael Morell:**

One of the things I saw with CIA analysts is they would say, "Here's the likely outcome." And then they would write a red cell and say, "Here's an unlikely outcome." And those two things together would cover everything. And therefore, anything that happened, they could point to either the main judgement they made or the red cell that they wrote to protect themselves, which at the end of the day isn't helping anybody.

**Arvid Streimann:**

Yeah. Yeah. We say this a little bit. You go throughout my entire career, is that people don't want to be wrong, and so they'll put a laundry list out there. And I always say to them, "Hey, at the end of the day, no one gets 100% right." That's where I think this conviction really graduates your risk analysis and then informs the risk management. Hey, no one gets things 100% right. No one hits a hole in one every time they walk up to the tee, right?

**Michael Morell:**

Right.

**Arvid Streimann:**

It just doesn't happen. And so I think that that graduation is super important. Now, I wanted to ask you a question, and you kind of talked about it a little bit earlier in one of your responses. Let's just say you're in a situation where you have to make a decision right now, and you haven't gone through that entire process or my decision tree. How do you approach that particular scenario?

**Michael Morell:**

Yeah. I faced that scenario many times when I was deputy director and when I was acting director. And what I would do is I probably had maybe 15 minutes, 30 minutes, hour to make a decision. I would get the experts in the room, every single one of them, and I would start with the least senior person in the room and ask them what they think of the situation we find ourselves in and what they would recommend that I do, and then work my way up. I would start with the most junior so that their view was not influenced by the more senior person in the room. And during that process, I would ask a lot of questions, and then almost always out of that conversation would come a consensus that I agreed with. Most of the time. That's what I would do.

**Arvid Streimann:**

I find that fascinating. In particular, going from the junior person to the senior person in order to stop any potential persuasion of views, which I think is really important. We try to do a similar thing internally here as well. I think it's really important. And then the gaining of a consensus, obviously we face this type of issue in investment markets as well. I think you can gain a consensus, but if you're limited by time, I think you generally as a rule will have lower confidence. You can still get the consensus, you can still form the view, but that time element, I think the vector at which that impacts your analysis and therefore flows through to your risk management is really on a lower level of confidence.

**Michael Morell:**

Yes, I agree. I agree with you 100%. If you can get it, great. If you can't, you got to make a call.

**Arvid Streimann:**

But the one thing which shouldn't change here is that is what I believe is that the level of conviction or confidence required to make an action should be unchanged even though you may not have as much time, which influences the level of conviction that you can get in the analysis phase.

**Michael Morell:**

Yeah. Oftentimes you're faced, and at least in my business, you're faced with a decision that has only two bad outcomes, and you got to figure out which one is worse. There's no upside. There's just two options with both downsides. That happens a lot in the espionage business.

**Arvid Streimann:**

Yeah. I think another difference between what we're doing ... I know there's a lot of similarities. Another difference is that at the end of the day, you can measure how well we do by percentages. Okay, you made 10%, you lost 5%. Pick a number. Whereas your outcomes, you can't compare apples with oranges. So if there's one particular outcome, maybe it is something that involves civilian harm, and then there's something on the other side, which maybe is some change in geopolitical power. And weighing those up, it's not quite as cut and dry and saying it's a plus 5% or a minus 5%.

**Michael Morell:**

Yeah, that's exactly right. And I would add that, and I think this is one of the reasons why the risk aversion kicks in, is because when something bad happens, either analytically or operationally, everybody knows about it. It's front page news often. Whereas the good things that happen get hidden more and don't become big issues, which I think drives the risk aversion I talked about earlier.

**Arvid Streimann:**

Michael, I'm getting towards the end of the pod here. Any final thoughts on your career as a risk manager and risk analyst and what that might be a parallel to with respect to what we do?

**Michael Morell:**

Yeah. Here's what I would say is that I didn't know what I was doing from a risk management perspective in my job in the government until I was out of the government and I was actually sitting on a risk committee on a board. Did I really realise what I was doing and how I was managing risks pretty much exactly the same way as we were managing all sorts of different risks on the risk committee.

**Arvid Streimann:**

There is an underlying framework here, and I think sounds like the framework, if you get that right, then it doesn't matter how you apply it or what you apply it to. It's the same business.

**Michael Morell:**

I think that's exactly right.

**Arvid Streimann:**

Great. Well, it's been a pleasure talking to you as usual, Michael.

**Michael Morell:**

Likewise. Great to be with you Arvid. Thank you.

**Host:**

That was former acting CIA director Michael Morell in conversation with Magellan Portfolio Manager and Head of Macro, Arvid Streimann. We trust you've enjoyed this episode of Magellan In the Know. Join us in a month's time for the next episode. For more information on upcoming episodes, visit [magellangroup.com.au/podcast](http://magellangroup.com.au/podcast) where you can also sign up to receive our regular investment insights. Thanks for listening.

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