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Bait-and-switch warning: reading this week’s entry may create disappointment because the topic is not light and amusing, as with previous entries. (Unlike the “Flash Boy’s” entry, I have not found one excuse to use the F-bomb in this piece on integrity. I know that’s disappointing.)

Duly warned, I will jump in. Integrity is a core value of investment firms—as it should be—based on our extensive culture work in the industry. More firms claim to be practicing integrity than any of the other common values: excellence, client satisfaction, teamwork, accountability, etc.

Here’s the rub. Most investment professionals—including CEO’s—have not thought carefully about integrity beyond the general notion of “do the right thing.” The dirty little secret in the investment world is that most of us care more about markets and money than integrity. We can talk for hours about discounted cash flow, foreign exchange, DB and DC markets, and the like but our discussion of integrity is limited to, um, “do the right thing.” (And even if people agreed about what that meant, studies show that average people only follow through on 3 of 10 promises. Not a good score for integrity.)

Enter Werner Erhard (EST and Landmark Forum) and Michael Jensen (Harvard prof and founder of Social Science Research Network SSRN). In their new paper, “Putting Integrity into Finance: A Purely Positive Approach” they go into great depth and detail about the importance and definition of integrity. In the first place, they elevate integrity to a factor of production. In their view, integrity is a necessary ingredient to business success, as important as labor, capital or resources. This view opposes the more common one: “integrity exists as a virtue rather than as a necessary condition of performance.” They call integrity a necessary but NOT sufficient factor in creating long-run value maximization. A key term they use is “workability” which means “capable of producing the desired effect or result.” And the causal link in the paper is as follows: integrity => workability => performance => long-run value. In short, no integrity, no long-run value. The authors believe that their claim “long-run value maximization requires integrity” is a positive proposition that is testable and refutable. I would use simpler language: high integrity leads to high performance. And conversely, low integrity leads to poor performance. As evidence, author Jensen cites his experience at SSRN. They adopted strict adherence to integrity and the organization’s productivity rose 300%. FCG has indeed found this link to be accurate in our selection of the “Focus Elite” firms: strong leadership and healthy cultures leads to greater integrity which leads to greater success. (See our paper, “Linking Strong Culture to Investment Success” on the website: http://www.focuscgroup.com/files/9213/7028/4838/Linking_Strong_Culture_to_Success.pdf)

So, the first good thing about their paper is its practicality: integrity links to performance. To be clear, integrity is not sufficient to ensure long-run value. Successful firms must also “create and execute brilliant competitive, organizational, technological, and human strategies.”
Ok, so what is integrity? Beyond just “doing the right thing” how do we carefully define it? Here is their definition:

1. The person’s or other human entity’s (i.e. firm’s) word must be whole, complete, unbroken, sound, in perfect condition.
2. For the word of a person or other human entity (i.e. a firm) to be whole, complete, unbroken, sound, in perfect condition, they must keep their word, or when they will not be keeping their word, they must maintain their word as a whole, complete, etc. by honoring their word.

This definition hinges heavily on clarifying and understanding one’s “word.” Erhard and Jensen go into great detail about what exactly it means to honor one’s word, which is important because they say early on that integrity for a person/firm “is a matter of that person/firm’s WORD—nothing more and nothing less.” (This heavy emphasis on the “word” is almost Biblical: “In the beginning was the Word, and the Word was with God, and the Word was God.” Well, so be it...) And, here is what they mean by “word” which is the gist of their model: to be in integrity means to live by your word as defined below:

**Word-1:** What you said you would do or not do

**Word-2:** What you know to do or not to do

**Word-3:** What is expected of you by those with whom you desire a workable relationship (that is, their expectations that are in fact unexpressed requests of you), unless you have specifically declined this or that of those expectations

**Word-4:** What you say is so (your evidence for what you say is so, would satisfy your listener)

**Word-5:** What you stand for

**Word-6:** Moral, Ethical and Legal Standards of your country and profession

- The social moral standards, the group ethical standards and the governmental legal standards of right and wrong, good and bad behavior, in the society, groups and state in which one enjoys the benefits of membership are also part of one’s word (what one is expected to do) unless a) one has explicitly and publicly expressed an intention to not keep one or more of these standards, and b) one is willing to bear the costs of refusing to conform to these standards (the rules of the game one is in).

2. For a person or other human entity, **keeping your word** means you fulfill your commitments and promises in full and on time. (unlike our “3 out of 10 promises” cited earlier...😊)

3. For a person or other human entity, **honoring your word** means that you either:

- Keep your commitments and promises, and on time, or
• When you have failed (or expect to fail) to keep a commitment or promise on time, you honor your word by:

  o Acknowledging that failure as soon as you realize it, and saying by when you will now keep that word, or that you never will keep that word, and

  o Cleaning up any mess you created for those who were counting on you to keep your word (your commitments and promises) on time.

Ok, some of you are ready to stop reading (at best) or drink heavily (at worst) because all the high-falooting jargon is annoying. Understood. (The authors do apologize for the “slogging-through-mud” quality of the writing, but they believe it is necessary for a new understanding of integrity.) However, the authors are willing—thankfully—to put all this in plain English:

“Honoring your word means that you are honest and straightforward: This means nothing is hidden, no deception, no untruths, no violation of contracts or property rights, etc. And (as explained above) because your word also includes conforming to the rules of the games you are in (for example, ethical standards of the profession or organization you are in, and the moral standards of the society and legal standards of the government entity you are in). If you refuse to play by any of the rules of the games you are in, integrity requires you to make this refusal clear to all others and to willingly bear the costs of doing so. (Gandhi is an example.)”

Much of what Erhard and Jensen are saying is familiar to FCG clients: it’s our work on Candor and Accountability. Candor means to speak openly and honestly, not having hidden agendas or “withholds” (i.e. things strategically left unsaid). And accountability means making and keeping clear agreements, which includes cleaning up the broken agreements or “messes” as they put it. In this regard, FCG would align with their model of Integrity. And we have plenty of evidence to support their view that higher integrity leads to better team performance.

There are, however, some interesting additions and fine points that Erhard/Jensen include in their definitions of keeping one’s word.

**Word-1.** For example, the authors say if someone makes a request of you, then you must do one of four things: 1) accept, 2) decline 3) counter-offer, or 4) promise to respond later at a specific time. So, they are saying that requests made of me become my word unless I do one of the four things above. It is not acting with integrity to “duck” a request, such as, “Will you come to my meeting this afternoon?” Once the requested has landed with you, then integrity requires you to respond. Interestingly, the authors do NOT reverse this concept. If you make a request of someone else it does NOT become their word to you just because you voiced your request. The authors tie all of this rationale back into workability: my efforts to duck requests rather than deal with them cleanly will reduce workability of me and the team. However, for me to assume that MY requests of others have now become their word will likely reduce workability. Rather I should take responsibility for obtaining a response. I like this approach because it is
practical—looking at what leads to greater workability—and it rests on the notion of control: what is in my control and what is out of my control? I can control how I respond to people’s requests of me. I cannot control how others will respond to my requests of them. So, high integrity would look like taking responsibility for those things that are truly in your control.

**Word-2.** The logic behind this form of “Word” is that we know many things about work, colleagues, clients, processes, etc. and it is not ok to play dumb. For example, a colleague’s behavior may signal to you that his actions violate compliance requirements. For you to have this suspicion and not voice it is a case of “knowing what to do and doing nothing.” You can see how the authors’ view of integrity highlights the subtle forms of misbehavior: acts of omission.

**Word-3.** This one is about expectations. This one fascinates me because I routinely ask investment teams and their leaders to get clear about their expectations of each other in order to perform well. (i.e. better workability) Teams perform better when expectations are revealed and understood. I ask leaders to write down what they expect of their team, and team members to write down what they expect of their leader. The authors agree that workability will improve as expectations are dealt with. So, teams and leaders should reveal and discuss expectations, with the outcome being agreement on which expectations will become agreements (such as, “working from home is acceptable”) and which will not. Importantly, to remain in integrity a person must decline the expectations that s/he has no intention of aligning with. A highly workable team would clear up all these misunderstandings around expectations.

**Word-4.** This one is about what you allow people to believe. If I create a poorly designed incentive system—one in which staff members are tempted to game it, or it is simply unfair—then I am out of integrity. As the leader, I may be preaching fairness, teamwork, and transparency, but my comp and bonus plans don’t line up with my words. I allow people to believe that we operate in a meritocracy (where people are rewarded for their contributions), but in truth people are rewarded for longevity, special status (favoritism), mediocre results, etc. For investment firms that preach meritocracy, a quick test would be to publish everyone’s total comp for the year and see what the staff’s reaction would be! In the Focus Elite firms, the reaction would be relatively mild because they tend to practice transparency and few employees are misled in their beliefs about comp. But in many other asset management firms, the extreme opposite is true: employees would hit the ceiling if they knew what some of their co-workers were making.

**Word-5.** This one is also fascinating. The notion is that what you stand for is your word. The way you present yourself and behave creates expectations in others about who you are and what you stand for. To the degree that you are mis-aligned with what you stand for, you are out of integrity. An example of Word-5 in the investment world might be a leader who stands for “client satisfaction,” but allows the firm to offer products that clearly are not in the best interests of their clients.
Word-6. The authors also consider part of one’s word living by the moral, ethical and legal standards of society and the code of their profession. In the investment world, the code of the profession is best captured in the CFA standards, which all candidates must understand to pass the exam. Of course, one can express an intention NOT to live by certain ones but then they must accept the consequences.

To review briefly, the viewpoint of the authors is that integrity is not a moral issue around being a good guy/gal vs. being a sneaky rat. It’s a question of high performance: high integrity teams will perform better (higher “workability”) than low integrity teams. In the context of FCG’s work, this makes sense. Teams that practice high trust, respect and accountability perform better than “sloppy” teams.

On a practical level, I’ve already mentioned one exercise that FCG does with leaders and their teams: revealing expectations. Word-3 above provides a very useful way to increase workability on a team: get clarity and agreement around what is expected. One small cap PM that we work with expected her analysts to bring in one new investment idea each month, 12 for the year. In extreme frustration one day, she blurted out, “I just don’t understand what is so difficult about coming up with one new idea per month!” I asked her, “Have you made that expectation clear to your team?” Still upset, she responded, “They know that I need new ideas in the portfolio!”

“Yes, but have you specifically told them that you want one new idea per month?” I said. She thought about it for a second and shook her head, “No, not specifically.”

At the next investment meeting she made the request: one new idea per month. And since that time, several months ago, the team has responded with new ideas each month. In this way, integrity becomes a very practical matter.

Again, from a practical perspective look at Word-4 description above, about compensation. The authors believe that many of the incentive plans in the investment world are out-of-integrity. In their words, the plans lead to “unworkability and value destruction. And note that all this destructive behavior by human beings in the firm is motivated by the fact that this common bonus plan is out-of–integrity in its design as a system. Eliminating this counterproductive behavior [e.g. gaming the system, competing against your team mates] must start by eliminating the lack of integrity in the design of the compensation system. Asking the human beings operating in this badly designed system to change their behavior will fail unless and until the compensation system itself is redesigned to put it into integrity.”

Some time ago, FCG came to the same conclusion: that many incentive plans for asset managers are poorly designed. As a result, FCG began doing comp design for firms. Our approach is radically different from the big name comp firms in the industry. Instead of using a lot of shared industry data to show investment leaders how they SHOULD comp their staff, we start with the radically simple premise: intelligent professionals can design their own comp plans. (One leader responded in horror to this idea: “you are turning the keys over to the inmates!” You do have to wonder about his leadership style when he uses this metaphor.) In our experience of collaborating with the very professionals who are being
rewarded, we have NEVER seen the process fail. It usually requires two meetings, 2-3 hours each, and the plan is mostly done. And the integrity is intact because the team has thoroughly discussed the options and come to their own agreement about what constitutes a fair, transparent, competitive, and understandable (i.e. simple enough) plan. If the planning session starts to head in the direction of “out-of-integrity,” then invariably the team will self-police itself back into integrity. So far, it has never failed. And the beauty is that you achieve a high level of buy-in when the team signs off on it. No one complains at the end of the year when bonuses are paid.

Personally, since reading their paper, I can sense a renewed interest in living in integrity. The clarity of their definition of integrity—living by one’s word—has inspired me to be as transparent and clear as I can be with friends, family, colleagues and clients. And the reward is a very “clean” sense of personal integrity, which results in higher energy levels, and a very clear conscience. Things like hidden agendas and half-truths weigh us down. And cause lower performance levels.

Interesting, isn’t it? That an industry in which “integrity” is the number one value chosen on culture surveys has so much trouble behaving itself. Read the original article for yourself and let us know what you think. I give you my word, it’s worth it.