Culture as a Strategic Advantage for the Investment Firm

by **Jim Ware, CFA** and **Jim Dethmer**

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Introduction

Culture is at the heart of competitive strategy in the 21st century, so says a recent white paper from McKinsey & Company.[1] We agree. In the investment world, we have worked with hundreds of investment firms on vision, mission, values, and strategy. These same firms, when asked, "What are your core strengths?" typically list many of the following:

- Great people
- Superior processes
- Unique investment philosophy
- Work ethic
- Creativity
- Independence
- Owner mentality
- Leading edge systems (IT)
- Ethical/Trustworthy
- Experience

And while all of these are important to success, firm leaders are kidding themselves if they think that these factors give them a unique competitive advantage. We have yet to walk into the firm that says, "Our people are stupid and lazy, our processes are bad, and we have no integrity whatsoever!" Obviously, all firms think they are winners and will tell you about it at length over coffee. But the factors above do not constitute a competitive advantage.

We believe culture does represent a true edge. David Fisher, Chairman of Capital Group, put it succinctly when he said, "our only competitive advantage is culture."[2] Benefits of culture include the following:

- Attract and retain top talent.
- Hire for fit much more effectively.
- Orient new employees quickly into the culture.
- Promote and compensate based on values.
- Mentor and coach more effectively.
- Better weather the tough times.
- Improve decision making
- Create a stronger brand and better story for consultants and other external audiences.

Culture is defined as:

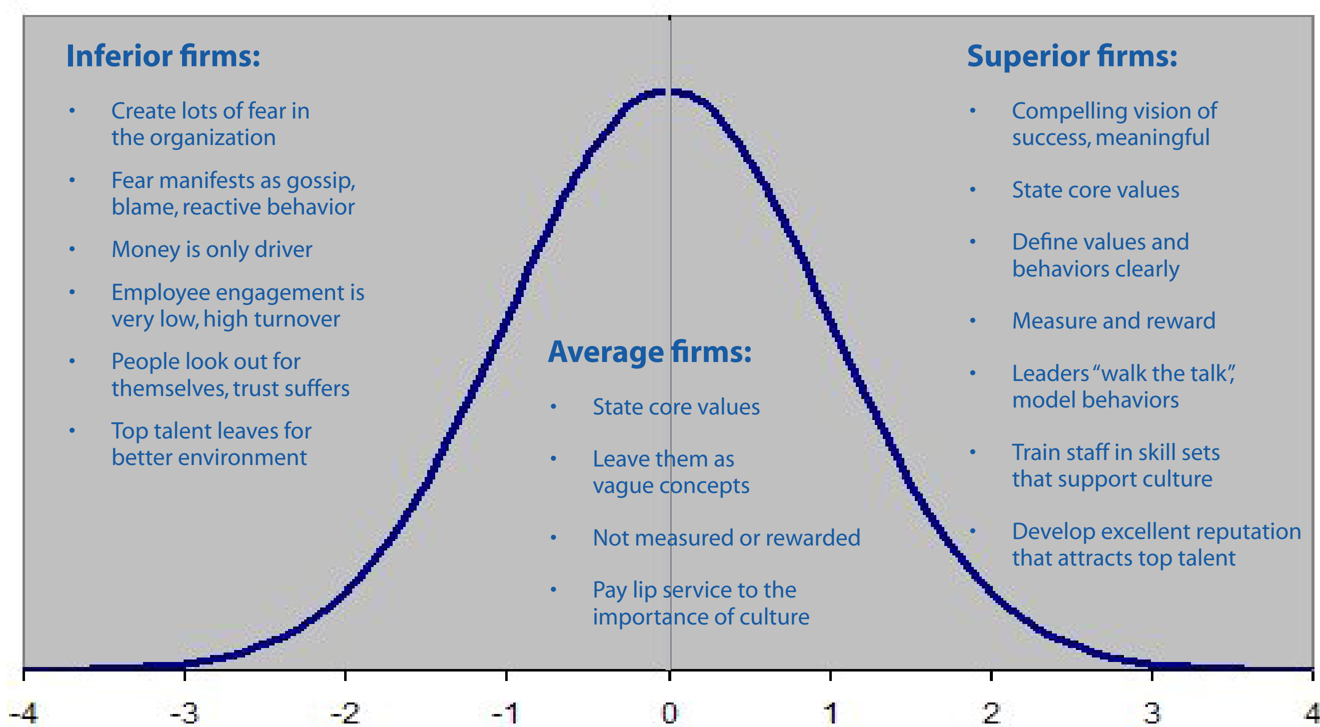
"The values, beliefs, and behaviors that would differentiate your firm from others."

Herb Kelleher, legendary CEO of Southwest Airlines, also understood the importance of culture and put it this way: "Competitors can buy tangible assets, but they can't buy culture."[3] In the investment industry, firms try to buy talent through liftouts and acquisitions but the success rate is poor. When big firms buy small, successful asset management firms and integrate them into the larger culture, the magic is nearly always lost. The smart firms like Old Mutual, AMG, Convergent Capital and others create strategies to acquire small asset management firms without disrupting their culture.

This paper examines what it means in the investment world to use culture as a strategic advantage.

Living in the Tail of the Distribution

Most firms are unable to live "in the tail of the distribution." That is, they fail to create a distinctive advantage in culture. The chart below shows the highlights of firms that are superior, average or inferior with regard to culture:



Most firms only achieve, at best, "average" scores for culture. They do not give the time and attention required to move to the tail of the distribution, to develop a true competitive advantage in culture. I am reminded of a time in my life when I was about 20 pounds overweight. I knew I should lose the weight. I paid lip service to the task. I occasionally ate healthy foods and exercised, but I clearly was not committed to the goal enough to make any real difference. I did not lose any weight. Many firms are like this. They know that having a strong performance culture is a good strategic goal. They talk about it, occasionally send around an article about it, perhaps have an offsite dedicated to it, but never fully commit to becoming a strong performance culture. (Note: I have since committed to physical fitness and lost the weight. Not by forcing myself but by continually asking myself, "what do I really want as an outcome?" Then designing a realistic plan, following it, weighing myself everyday, and getting support from others.)

Inevitably, one of two reasons explains the culture shortcoming: not enough pain, or not enough dream. Either the firm is not suffering enough—so the motivation to change is low—or they have not created a compelling vision of success. The latter motivates them to do the hard work of changing their behavior.

First Steps: create a reality map and look at what is true

As with any change effort, it begins with a solid look at the facts. Locate yourself and your firm. Where are you on the journey? What's true currently? What are the facts? What measurements can you create?

The following are pieces of a firm's reality map:

- Statement of purpose. Why do we exist? What is our mission?
- Vision of success. What does the picture of success look like in 3-5 years? (Make this as vivid as possible with specific results)
- Strategy. Can it be stated in 35 words or less, covering the objective, scope, and competitive advantage?[4]
- What are the key goals for the next 12 months?
- What are our core strengths? Weaknesses? These are internal to the firm.
- What are the external threats and opportunities?
- Do we have the right team members?
- How strong is our current culture? (Do employees know the core values? Do they rally around them, that is, live them?)
- How much "sludge" is in our firm? (Sludge is fear-based behavior: gossip, blame, complaining, etc.)
- What unconscious beliefs and behaviors are running the firm, such as: "I've put in my time, I'm entitled to spend the remainder of my career with good pay and bonuses, regardless of what I contribute."
- What are the key issues according to team members?
- What is the ownership structure?
- Are the structures of the firm optimally aligned with the strategic direction?

There are other elements of a good reality map, but these are some of the most important. Ideally, the senior team will collect this information via surveys,

documents, and interviews (best conducted by a neutral—read "confidential"—party). Jim Collins states that one of the characteristics of great firms and great leaders is their ability to look at the brutal truth and still remain positive and motivated. The truth for your firm may not be so brutal, but there are always blind spots. (The U.S. auto industry in 1972 believed that fuel would always be in abundance, that foreign imports would never amount to more than 15% of the market, and that Americans would buy a new car each year—so quality did not matter much. Can you say, "Denial?") Human nature being what it is, we have enormous talent for ignoring the truth. Further, most firms create—unconsciously—a reward system that favors bringing only good news to leaders. Therefore great leaders must work hard to get an accurate reality map, including all the good, the bad, and the ugly.

Creating a Strategic Culture: two pieces

Once the leadership is seeing reality fairly accurately and has created a truly compelling vision of success, then they are ready to address the culture issue: What kind of culture must we create to gain competitive advantage? Most investment firms use language like, "performance" or "accountable" to describe the desired culture. Some firms prefer "client-centric." Still others like "culture of excellence." Whatever name is chosen is not nearly as important as the purpose: to use culture as a means to achieve the vision of success.

The culture discussion contains two important pieces. First, in our work with investment firms over the last ten years, we can state with conviction that there is a preferred mindset and code of behaviors that create the optimal environment for knowledge work, any kind of knowledge work. In short, create an environment where people do their best thinking.

The second piece is investment related. There are additional cultural elements that will depend on your investment philosophy and process. They will also depend on the idiosyncrasies of your team. For example, which behavioral finance traps do you fall into most often? Culture can help the team make better investment decisions.

Performance Culture: the core behaviors

The map below shows the core behaviors of high performing investment teams. The elements are as follows:

Trust As the anti-dote to fear, trust is at the core of a high performing team. Unless there is a sufficient amount of trust in a team or firm, the other behaviors will not evolve. For example, in an environment with little trust, I will not feel safe being candid.

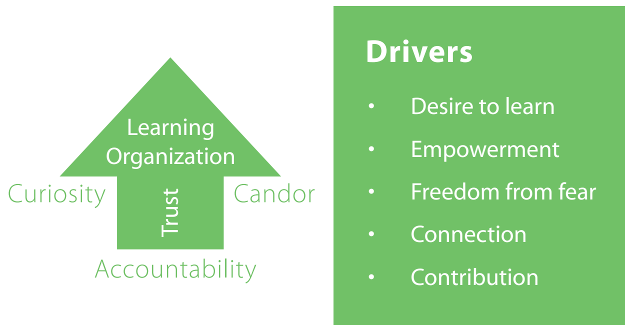
Curiosity Top teams have members who are open to feedback from all sources and who use it constructively. They develop the ability to wonder about how outcomes were created. They ask: how did I contribute? How can I do better? When they do become defensive, they know how to shift to a more open and receptive mindset.

Candor World class decisions can only come from teams where members are fully candid. Because no one sees reality fully or accurately, we must rely on one another to paint a more complete picture. Research shows that the ability to fully vet an idea contributes to the best decisions.

Accountability The gateway from "below the line" thinking to "above the line" is found in the act of "taking responsibility." This mindset believes that whatever occurs in my life, I will assume responsibility for it, not blame it on others or my bad luck.

Performance Culture: the core

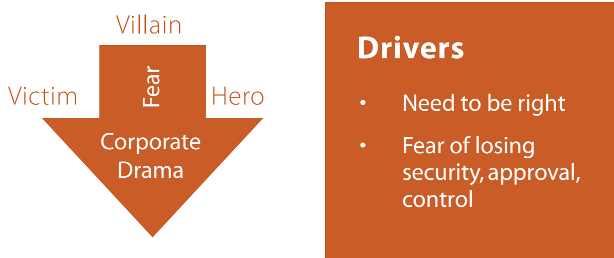
More Conscious Behavior: proactive



"By me" attitude. "I take responsibility for creating the outcomes in my life."

Key Mindset: Do I locate the power to change things inside myself or "out there"?

"To me" attitude: "I blame life and others for what happens to me. It's not my fault."



Less Conscious Behavior: reactive

The flipside of the performance culture ("above the line") occurs when fear is rampant in an organization. People are naturally fearful, as part of evolution we developed the fight or flight reaction. When threatened we automatically fire off adrenalin in a natural urge to survive. Neuroscientists can now pinpoint exactly what is happening chemically in our brains during these reactions. In short, when we get fearful and go below the line, our ability to think and perform is greatly reduced. It's as if our smarts are hijacked by the primitive "lizard" parts of our brains.[5] Instead of being curious and wanting to learn, we constrict and want to win the argument. We want to be right (dammit!). Clearly, when we go below the line our capacity to think is reduced and we limit our chances to make top notch decisions. In short, high performing investment teams need to spend as much time as they can above the line. They need to learn the "above the line" terrain and the skills for spending most of their time there. (Game theory would say that they need to learn cooperative behavior vs. betrayal behavior, the main part of which is building trust.)

If trust, curiosity, candor, and accountability are key behaviors in the "above the line" mindset, then these characteristics are common to the "below the line" experience:

Fear All of us have three core fears: security, approval and control. When one of these gets "triggered", we naturally drop below the line. For example, if I'm on an icy road and my car starts to spin, then my need for control kicks in and I become fearful that I cannot keep the car on the road. It's natural to feel a surge of adrenalin race through my body seconds after the car starts to slide. Similarly, if I am heading to an investment meeting thinking that our portfolio is weighted far too heavily in fixed income securities, and then my boss announces "we need more fixed income exposure" I may feel reluctant to challenge her. Why? She may not like me for doing so. Conformance bias is well studied in behavioral finance. In short, the more fear in an organization, the more constricted and reactive people become.

Villain As fear builds, people rely on old strategies to survive. The villain resorts to an age-old strategy of blaming someone else, the quicker the better. If messengers are being shot and risk-takers are being thrown to the wolves, then get your finger ready for pointing!

Victim Another reaction to fear is to give up. Another variant to the "fight or flight" response to fear is the "freeze" response. Victims go passive and say, "poor me." Keep your head down and wait it out.

Hero This character in the drama triangle plays the role of "fixer." The hero over functions; he meddles. He comes in uninvited to solve other people's issues. Only he does not really solve anything, he just puts Band-Aids on issues. Often the hero burns out from over functioning and becomes villain or victim-like. Worse, the hero encourages others—unconsciously—to be victims, that is, incompetent and in need of help. From whom? The hero, of course! Heroes get big payoffs in corporations. And unless leaders are savvy about this triangle—victim, villain, hero—they will busily reward heroes for over functioning instead of resolving the performance issues and letting people "grow up" and contribute.

Starting at the top, the senior team must begin to see when and how they themselves go below the line. They must educate themselves about the skills needed to be a high-performing team (above the line). These skills are not developed over night. We recommend that a senior team take 3 to 6 months to practice these behaviors before introducing them to their direct reports. The danger of introducing them too soon is a cynical reaction from the staff: "You don't practice these behaviors. Why should we?"

One of the side benefits of developing a culture that lives above the line is that it automatically addresses the ethics/integrity issue. Corruption and deceit live below the line, so teams that are genuinely moving in the direction of trust and accountability will be building an ethical culture as they do so.

What does this look like in practice? The following chart reveals fragments of actual interviews from staff, on the left who are below and on the right above the line:

Reactive statements: below the line	**Proactive statements: above the line**
I don't have the information I need to do my job." (victim mindset, powerless)	"I will find out who has the information and request it." (Proactive mindset)
"The marketing team has not performed well. It's their fault." (villain mindset, blame)	"How have I contributed to our mediocre results in raising AUM? What changes can I make?" (Proactive mindset, taking responsibility)

Part Two: adding the investment piece to culture

The core behaviors discussed above will serve any organization well. They are based on a shift from a reactive ("to me") mindset to a proactive ("by me") mindset. Investment firms can take a further step into excellence by carefully analyzing their philosophy, processes, and structure and then adding additional cultural elements to improve investment performance.

Long term vs. short term One clear example of a value that would serve most investment firms is emphasis on the long term. Many papers have been written about "short-term-itis", which means that investment horizons have shortened to the point where true skill is nearly impossible to demonstrate. (I can choose undervalued stocks that will outperform in a one year time frame; I cannot reasonably expect to do that in a month.) Most

investment professionals know this and yet clients fire firms for three quarters of bad performance. The only defense against this irrational behavior is to solidly remain rational within your firm. To be clear about what you can control and what you cannot control. If clients become irrational and fire you for bad performance in too short a time, then so be it. Your firm must remain rational and have a culture that reinforces rational decision making.

Process trumps outcome Another best practice of top investment firms is to build into their culture a strong preference for process over outcomes. Somewhat related to the short-term-itis point made above, many investment firms claim to be "performance driven" and so they become pre-occupied with results over process. Any fund manager who racks up good performance for a few quarters—especially if it brings in new clients—is heralded as a genius and hero, whereas other fund managers who have demonstrated skill over long periods of time and who are known for excellent research and process may be shunned for average performance in the short term. In an industry where luck and skill walk side by side down the same path, top firms keep their eye on process, knowing that an excellent process will indeed yield excellent results…eventually. In fact, the very best firms track the key elements of their process—quality of research, rigor of debate, devil's advocacy, etc.—with numerical ratings, so as to make sure that they continually improve. Complacency becomes the enemy of top firms, so they must build "continual improvement" into their culture.

Overconfidence bias Yet another cultural element to top firms is the recognition and defense against behavioral finance biases. All of us fall prey to these cognitive errors, so wise firms talk about them openly and develop strategies for overcoming them. An example is overconfidence bias. It is well researched and identified that all people suffer from over-valuing their own skill. When a room full of people is asked, "Are you an above average driver?" 80% typically respond, "yes." The investment professionals are hard-wired to be even more susceptible to this bias. (Most investment professionals are "rationalists" according to the Myers-Briggs personality assessment, and they are the most confident of all the types. That is, the least likely to doubt their own view.) The anti-dote to overconfidence is to consciously look for disconfirming evidence to your view. You must develop the ability to automatically flip into a mindset of: "what's wrong with my position?" (Note: Darwin kept two journals. One confirming his hypothesis, the other attempting to disprove it.) Top investment professionals must watch their own tendency to overweight their own view. A cultural bias towards humility—"holding one's opinions lightly"—and towards routinely practicing devil's advocacy can help undo this overconfidence.

The list of thinking biases and traps is—unfortunatley!—rather long, so we won't address them all. But you get the idea. Culture can be your biggest ally in defending against these cognitive errors. A thoughtful analysis of your investment philosophy, your process, and your team of professionals can help identify the leading causes of error. Then you can design a culture that provides the anti-dotes. (An outside advisor can be helpful here because blindspots are often hard to see by the team itself. The overconfidence bias mentioned above allows many teams to dismiss as "insignificant" key behavioral problems.)

How to Implement a Culture Initiative: starting at the top and working down

Culture has to start at the top. You are taking on the firm's "status quo" when you initiate a cultural change, so be prepared to encounter resistance. In fact, most firms that try to build performance cultures fail. McKinsey puts the number at 70%. Within that 70% figure, nearly ¾ of it is explained by two cultural factors: either management behavior does not support change (management does not "walk the talk"), or employees are resistant to the change (they cling to the existing culture). Our experience in the investment industry is similar. Never underestimate the survival instinct of the "existing culture." It will fight hard to live on. Most people love the status quo and resist change.

So, leadership must be fully committed and savvy about instituting any change. The primary attitude towards a culture initiative will be, "Wait it out. It's the flavor of the month. Everything will return to normal in a few months." For this reason, leaders must not only be fully committed themselves, but they must create a compelling reason to change and present it convincingly to the staff. The two levers here, as mentioned earlier, are pain and dream. Either or both will work if used effectively. Create a painful picture of the future if change does not occur. Or create an exciting vision of the future if change occurs. Better still, present both pictures.

Another important aspect of culture change is to remember the warning of culture expert Edgar Schein that wholesale transformation of culture is a formidable challenge. Success is much more likely when you work around the edges of your existing culture, respecting what is already there and tweaking what needs to be changed.

Culture Change: the process

So, how would an organization go about implementing culture change? Step-by-step, as described below is much more effective than all-at-once. The latter is chaotic and usually results in cynicism. Step-by-step looks like this:

1) *Leader's clear commitment to making culture a strategic advantage for the firm.*
   Because culture reflects the personality of the top person, s/he must be clearly on board and committed to the process. By leader we mean the person who directly manages a given area of a firm. The head of investments could institute cultural change in his department regardless of what other leaders in the firm are doing. Ideally, the CEO of the firm would originate the culture initiative and would model the values and behaviors that are chosen. But as long as the CEO is not hostile to a culture initiative by, say, the chief investment officer, then the localized effort can work.

   Often times a multi-national firm will have chosen a core set of values for all their offices everywhere. Old Mutual for example, chose these values: respect, integrity, accountability, and moving beyond boundaries. In our language, these values are "meta-values" and are nearly always widely accepted norms. If you work for a large organization that has such meta-values, it still may pay off for you to choose specific values that will allow your region or department to succeed. The following picture shows this concept of meta-values and specific values:

2) *Senior team discusses and agrees on values and behaviors* that will give them a competitive advantage. Rationale for each one is explained. Senior team commits to living by these chosen values and behaviors, and to be open to measurement: peer review and direct report review. Goals: clarity of culture and alignment around it: "walk the talk"

As stated above, several values/behaviors are core to high performing cultures:

- Trust/ethical behavior
- Curiosity
- Accountability
- Openness and candor

Additional values/behaviors that relate to the firm's investment philosophy or client service process are added to this core list.

3) *Senior team aligns around key behaviors* (3-6 months) and is measured, alignment is confirmed.

4) *Senior Team passes on values/ behaviors to their direct reports:*

- Leader is role model
- Explains and teaches behaviors to direct reports
- Reinforces behavior through structure and rewards. Eliminates obstacles, conflicts

5) *Cultural norms are rolled out to entire organization*

- Communication meeting to describe Culture Initiative
- Senior team teach values and behaviors to all staff
- Stories are main tool for conveying meaning of culture
- Emphasis placed on measurement: Leaders are walking the talk
- Support materials: written and visual (laminates and videos) provided
- Baseline measurement taken of Culture Assessment for benchmarking

This paper does not pretend to represent all aspects of a culture initiative. Rather, it is meant to highlight the difference between paying "lip service" to culture and the hard work of actually creating a high performing culture. Only a handful of companies have achieved a distinctive cultural advantage in the investment industry. The key to their success is a deep conviction that culture represents a strategic advantage that cannot be bought or quickly duplicated by competitors.

1. *How do I create a distinctive performance culture?* By Carolyn Aiken, et al.
2. Interview with David Fisher, Oct. 07.
3. From a speech on nevblog.com on Oct. 20, 2006
4. *Can You Say What Your Strategy Is?* David Collis and Michael Rukstad in Harvard Business Review, November, 2008.
5. *Your Money & Your Brain* by Jason Zweig is an excellent source for learning more.

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Books by Jim Ware, CFA and the Focus Consulting Group:

- *High Performing Investment Teams* (Wiley, 2006)
- *Investment Leadership: Building a Winning Culture for Long Term Success* (Wiley, 2003)
- *The Psychology of Money* (Wiley, 2001)

Additional papers by Jim Ware, CFA and the Focus Consulting Group:

- *Life Stages of an Investment Firm* (with Jane Marcus, Heidrick & Struggles)
- *Applied Behavioral Finance*
- *Ethical Leadership*
- *Adaptive Leadership*
- *The Trust Project*

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