Focus Consulting Group

Managing Culture: Leaders as Shapers of Reality

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January 2013

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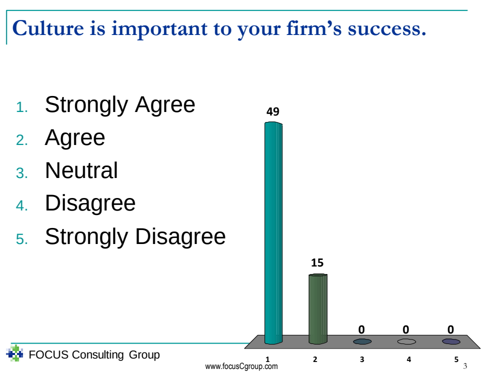
Note: This paper was written in conjunction with a speech given by Jim Ware to a group of 64 investment CEO's at the Portfolio Management Association of Canada annual dinner in Toronto on November 21, 2012. The data in the paper were collected during the presentation using real-time voting devices. Follow-up interviews were conducted with selected CEO's after the event. Some liberties have been taken with the order in which material is presented but not with the accuracy.

Investment leaders acknowledge that culture matters. Over 95% of surveyed investment professionals answer "agree" or "strongly agree" to the statement: *Culture is important to our firm's success*. In a room full of investment CEO's in November of 2012, the exact count was:



If this is true, why don't more firms leverage the strengths of their culture to drive sustainable results? A simple question with a complex set of answers.

What we know is:

1. Culture drives results and can be your greatest asset or biggest liability.
2. Culture is definable and measureable.
3. Leaders can have a major impact on culture by shaping reality.

Further evidence that culture matters comes from the authors of the "HOW Report" (Dov Seidman, et al at LRN Partners) who studied hundreds of organizations—not primarily investment firms—in 18 countries, interviewing 32, 000 employees and focusing on the question: *what is at the core of strong, effective cultures?* Their answer:

- Trust
- Purpose
- Values

Firms with a clear mission that developed a solid set of core values and built solid working relationships on trust and respect outperformed the control group of firms that had not. (In many respects the findings of the HOW report mirror Jim Collins' work, "Built to Last.") The good news is that all the work done by FCG in the investment world is confirmed by a third party research team in the world at large. The bad news is that only 3% of firms in their study were "strong and effective culture" firms. FCG has found similar results in the asset management world: about 6% of the firms in our data base have strong and effective cultures.

The HOW Report provides the following examples of superior results linked to superior culture:

Culture Factor	Top 3% - Superior Culture	Control Group
Financial Performance	*93% rate their firms financial performance higher than the competitions*	*48% rate their firms financial performance higher than the competitions*
Innovation	*Top 3% is 8 times more likely to innovate than the Control Group*	
Employee Referrals	*98% would recommend their firm to a friend or professional colleague*	*33% would recommend their firm to a friend or professional colleague*
Client Satisfaction	*99% report high levels of client satisfaction*	*42% report high levels of client satisfaction*
Mis-conduct	*24% report observing mis-conduct*	*47% report observing mis-conduct*

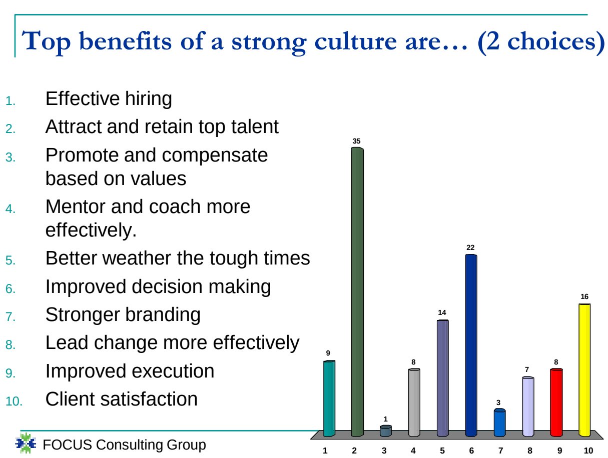
The data comparisons are striking. Firms with clear purpose (what are we doing and why), high levels of trust and respect, and a set of core values (such as accountability, integrity, excellence, teamwork and meritocracy) deliver superior results on many fronts, not just financial. The data also support the finding that employees at the 3% firms have higher levels of engagement and satisfaction.

Benefits of a strong culture

In the investment industry, our surveys have shown that the following benefits accrue to firms that build superior cultures. They are ranked in this order, based on surveys taken around the world with hundreds of investment professionals.

1. Attract and retain top talent
2. Improved decision making
3. Improved execution
4. Client satisfaction
5. Lead change more effectively
6. Stronger branding
7. Promote and compensate based on values
8. Mentor and coach more effectively
9. Better weather the tough times
10. Effective hiring

Note that our group of 64 CEO's elected the same two top benefits:



So, the wisdom of the crowd has been confirmed by additional data. Culture drives results and can be your biggest benefit and/or liability depending upon how you leverage it. This industry is all about talent and decision making. Which side of the ledger is your firm on?

If culture is so important, then how do we define and measure it in order to drive results?

Defining strong culture and the "Red X"

Let's begin by defining our terms. Culture is defined as the values, beliefs and behaviors that would differentiate one investment firm from another. Like people, investment firms have distinct personalities. Some are loud and "in your face", others are quiet and cautious. Another useful way to think of culture is simply *the way that employees think and act*. In other words, their mindsets and actions. In the investment industry, the core values are as follows:

These four values are core to most firms in the industry. And, importantly, they are also core to the "tribes" in an investment firm as well. (See our paper "Tribes: Understanding the sub-cultures in the investment firm" for a detailed discussion) The major tribes are: 1) investment professionals, 2) distribution/client facing professionals 3) support professionals (all the functions that support the first two).

The black "X's" above represent people in the organization who are modeling these core values and behaviors in their work life. The blue X (NW of the black X's) represents a staff member who is highly ethical, very client centric, and a good team player but has not performed well. This person may need to improve their skillsets or their motivation in order to return to being an employee highly aligned with the culture. Most investment firms embrace the idea of meritocracy which means that underperformers may struggle to survive.

The red X (SW of the black X's) is the difficult character and represents an organizational dilemma. Again, we have written about this phenomenon (see

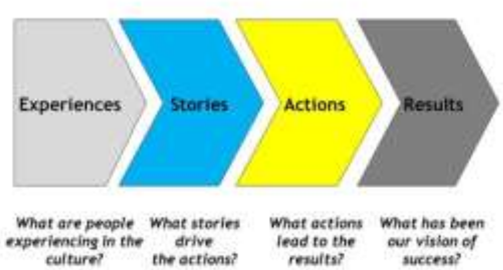
"The Red X: Managing the outliers in the investment firm") Red X's may be excellent performers and they may make clients extremely happy—due to their strong performance—they may even be highly ethical, but they are painful to work with and may cause the loss of talent around them. Typically leaders have five choices when dealing with Red X's:

1. Fire them
2. Firewall them
3. Fix them
4. Forget about them
5. Fret about them

We call these the "five F's." Increasingly, we are convinced that option #1 is underutilized, primarily because Red X's are very good performers and drive revenue. The allure of performance often overshadows the destruction they can cause. Sometimes options #2 and #3 can work, we've seen it in our engagements, but roughly half of the time #1 is the only real solution. Obviously options #4 and #5 give support to the phrase: "Denial is not just a river in Egypt." (That is, let's just deny the problem and do nothing. And hope the problem goes away.) We have seen time and again that the courage to choose #1 pays dividends for all concerned. In most cases, the Red X who was fired ends up much happier and more productive in their new environment. And the firm experiences immediate improvement in teamwork and morale.

Managing culture: the ESAR model

So, what is a useful mental model for culture? Is there a simple way to think of it, such that leaders could proactively manage it? We believe the model below provides one. We call it E-S-A-R:

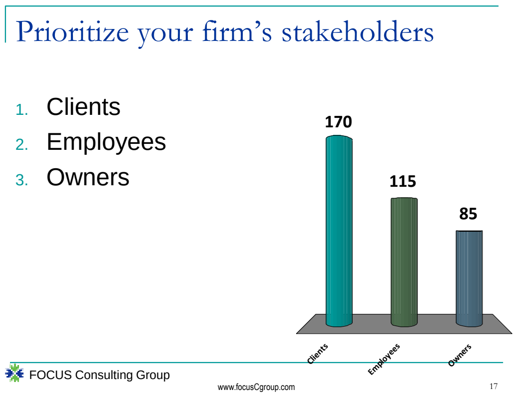


The way to use this model is to start with results (as the late Stephen Covey said, "begin with the end in mind"). We use the word results because it suggests concrete outcomes, not blue sky wishes. What is the firm looking to achieve? What is the vision of success? And, we mean specifically. We apply our "CEO" model to think about and develop metrics of success. What will make your main stakeholders happy?

3 Main Stakeholders	Desired Results (R)
Clients	*Exceptional long term performance*
	High quality service
	Stable investment teams and process
Employees	*Financial rewards*
	Excellent work environment
	Career opportunity
Owners	*Wealth creation*
	Reputation of the firm: legacy

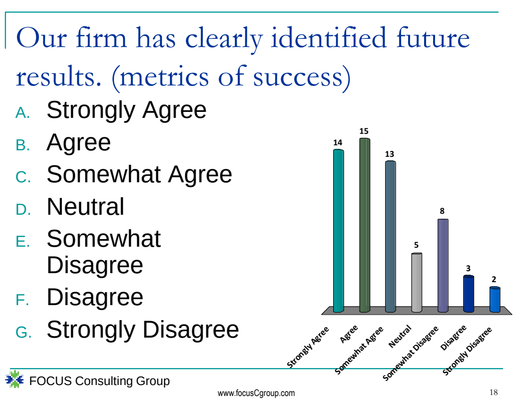
The example above is typical for many asset managers; however we encourage dropping in specific metrics to define each of the Desired Results. For example, we once participated in a three hour discussion with an equity manager on defining "exceptional long term performance." They considered relevant time periods, risk adjustments, standards of excellence, benchmarks, and many other factors. Getting specific about the metrics of each Desired Result is important because the role of culture is to align the goals of the firm! Employees should be excited about the mission of the firm (Desired Results) and then believe fully that the firm's culture supports the ultimate goal.

From our group of 64 CEO's they rank-ordered the stakeholders as follows (3 points for top ranked stakeholder, 2 points for the next, 1 point for the third):



As one would hope in a fiduciary business, the clients are top priority, followed by employees, then owners. This result aligns with the earlier graphic (Venn diagram) where "clients" was the top value in the industry.

After explaining and discussing the "CEO" formula with the audience of investment leaders, they gave the following response to this survey question:



Interestingly, the range of responses runs the full gamut from very clearly identified future results to the opposite: unclear vision of the future. In the case of the 18 CEO's who responded "neutral" or lower to this survey question, our recommendation would be: clarify your future goals!

Culture is only useful in that it serves a higher purpose: the mission of the firm.

Culture example: how ESAR works in real-time

To better understand the ESAR model, let's take an example. Here is the profile of a firm that wanted to improve its culture:

- $20 billion AUM
- Long only equity strategies
- 142 employees
- U.S. based
- Fair long term performance: 1, 3, 5 years (upper 50th percentile)

The leader of the firm had been CEO for ten years and was looking ahead ten years and asking, "What's next?" He was aware that morale was under pressure. We were able to verify this view by using culture diagnostics that we have developed in conjunction with the ESAR model. The table represents how the current employees were experiencing the culture. They selected the words below from a list of seventy three choices representing values/behaviors:

February 2011 N=142
Results Oriented
Accountability/Responsibility
Blame
Intelligent
Fast Paced
Defensive Behaviors
Disrespect
Negative
Independent
Competitive/Win/Be the Best

All 142 employees at this firm took the culture survey. The values and behaviors shown here are the top ten in the firm, shown in order. The firm is indeed very focused on results. Aligned with the firm's focus on results is their emphasis on accountability/responsibility. The "dark" side of accountability is blame, their third ranked value/behavior. The next two "intelligent" and "fast paced" accurately reflect what we experienced during numerous interviews with the staff. The next three items—along with blame—are what we call "sludge" behaviors because they slow down the effective and efficient functioning of the firm. Seeing these survey results, the CEO acknowledged that they confirmed his suspicions that morale was sinking.

Disappointed with these results the CEO was ready to try the ESAR model in an effort to eliminate sludge, improve morale, and strengthen the culture. This CEO had examined and decided upon the longer term results he was hoping to achieve for his "CEO" stakeholders: clients, employees and owners. The next step was to look at what experiences in the firm were leading to the poor culture. Specifically, what was happening at the firm that created the sludge behaviors: blame, defensiveness, disrespect and negativity?

To illustrate how ESAR is used to combat sludge, let's examine "disrespect" more closely. When we interviewed staff members, they identified a practice at the firm that they found particularly offensive: the taking of attendance, or alternatively, sending emails inquiring as to the whereabouts of people. Using the E of the ESAR model, we can say that it was a "fact" that these actions were occurring. An admin assistant was walking around the floor each morning with a clipboard. And staff members who were out of the office were getting emails that said, "Where are you?"

These experiences led to two common stories by staff members:

1. "They don't respect us as business professionals."
2. "They treat us like children."

Some senior team members weren't aware that the attendance was being taken, while others acknowledged that it was. This was a clear lesson about intent versus impact. The experience wasn't *intended* to create the negative story. In fact, the leaders who were aware of this practice were intending that it would assist in creating good and efficient practice when someone was needed for a meeting or client call. The *impact* however was quite different. In either case, none of the senior team wanted to create the two stories listed above. So this is where the idea that leaders shape reality creates such an impact. They do it in two ways:

1. They create experiences for the staff by making decisions, calling meetings, designing policies, behaving in certain ways, etc. All of these experiences are factual: they can be filmed or recorded, they actually happened.
2. Leaders then interpret reality—or fail to—by managing the beliefs and stories that are made up about the experiences.

A simple but powerful way to think about this is to imagine the investment team meeting in the coffee room and discussing a recent "experience." In the case of "taking attendance" we know that the coffee conversations went something like this, "Can you believe that they take attendance here? What, do they think we're 8 years old?" We know that senior leadership did very little to manage this story about attendance taking. It took on a life of its own. Staff began citing it as evidence that the leaders were disrespectful. Notice how intent and impact diverged. The intent was to create efficiencies by knowing the whereabouts of staff, but the impact was harmful: "They treat us like children."

Harmful stories (S's) lead to destructive actions (A's). What we tell ourselves affects our behavior. The stories about disrespect and childlike treatment created the action of gossip within the firm and caused turnover. Two high performing staff members quit (A's) and went to competitors where they felt they would be treated with more respect. In a business driven by the talents and decisions of the team, this example illustrates a costly problem.

The most common mistake that we observe with investment leaders is their preoccupation with the "Actions-Results" components of the ESAR model. Instead, leaders need to understand and work with the "Experience-Stories" piece of the model, as shown in the diagram below:

Leaders who want to build and maintain strong cultures must understand their influence. Every day they create experiences for their staff that either help or hurt the culture. In this way they shape the reality for employees. Further, when leaders set in motion an experience—say firing someone—that is clearly going to be ripe for gossip, so they need to proactively manage the resulting stories. Candor and transparency are the best antidotes to deal with gossip. Leaders need to be candid and transparent about the controversial experiences.

Let's return to the "attendance" example. Shaping reality is having a clear understanding of the stories portion of the ESAR model. Consider the following steps in how a proactive leader might work to eliminate the harmful story and replace it with a constructive one.

Step	Description	What you say:
1	*First, understand the story that exists and the underlying experience. Remember that whether or not you think it's reality, it is their version of reality that counts.*	*"That's not the story I want you to hold."*
2	*Be transparent and candid about the intention behind the experience and the story you want them to hold.*	*"The story I want you to hold is…"*
3	*Describe the way you will change the experience to fit the intended reality.*	*"Here's what I will do differently to back up the new story. Will that be enough?"*
4	*Ask them for feedback both now and along the way as the new experience is created.*	*"What feedback to you have for me now and as we go forward?"*

Note that an important responsibility of leaders is to KNOW what stories are being told. Are they useful to building a strong culture? Or are they harmful? In the case of the attendance experience, the CEO used the script below to deliver this message to his staff:

1. I don't want you to hold the story that leaders view you as children, or that we are disrespectful in this way.
2. The story I want you to hold is that leaders view you all as highly talented professionals, worthy of trust and respect.
3. Here's what I am going to do to show you that this statement is true. We will eliminate attendance taking from the firm. Instead, we will give each of you the responsibility of letting us know when you are out of the office.
4. Will that be enough, or is there something else we need to do, and will you give me feedback about this disrespect issue once the policy is changed?

This approach directly addressed the staff's concerns. It replaced the current experience with a new one, which then creates a new story. ("We consider you highly talented professionals...") In this case, the staff was a bit surprised to learn that the senior leaders were quickly willing to eliminate the attendance practice. It took care of the stories almost immediately. This was the start of a journey towards mutual respect. There were many more stories that had to be challenged, ones that did not reflect the reality of the leaders' beliefs or intentions. The leaders constructed a Culture Statement, which took the results of their culture survey and transformed them into a "Rules of Engagement" document.

Rules of Engagement

Cultural Value	Description
Respect	"I listen carefully to my colleagues without interrupting. I *verbally* acknowledge and appreciate their contributions."
Trust	"I work to create trust on my team. I reduce fear by creating safety and openness."
Collaboration/ Teamwork	"I understand that we are one team, and I look for win/win outcomes."
Accountability/ Responsibility	"I take responsibility for my actions and outcomes. I do not blame others."
Clear Goals	"I understand how decisions are made and how goals are established. I work to eliminate politics."
Professional	"I practice candor. I do not engage in gossip about my colleagues."
Appreciation	"I value and appreciate my colleagues. I create a positive environment by following the 5-to-1 rule of appreciation."
Leadership Development	"I take responsibility to develop my leadership style, so that it empowers and engages team members. I hold myself to the same standards of culture. I develop myself as a leader."
Ethics	"I understand and practice the highest ethical standards."

In the year that followed the initial culture diagnosis, the senior leaders practiced shaping the experiences and the stories generated by the staff. When new experiences were needed to change a widely held story, senior leaders designed one and used the steps given above. Leaders became increasingly aware of their role as "reality shapers" for the staff. They realized that the staff will readily make up their own stories if no alternatives are presented. Hence, they became better and better at proactively managing the experiences and stories. Note, none of this works if the leaders are trying to manipulate or "trick" the employees or if they are trying to spin a genuinely bad experience. Leaders must operate in good faith.

One CEO in the audience shared this story. He decided that he was going to create an experience of spending more time with his staff, so that their stories would become ones of trust and respect for him. His plan fell short almost immediately. Why? Because after seating himself in a staff member's office and asking him/her, "How are things going?" out came the CIO's Blackberry. The old stories remained in place: he doesn't really care. The staff reasoned, "If he really respected us, then he'd pay attention to us!" *To repeat: any attempts to change the mindsets (stories) of your team members must be genuine.*

Returning to our case study, over a year's time the senior team made great strides in changing the mindsets of the staff and getting them aligned with the cultural value statement above. When it was time for the annual culture survey, the results were significantly improved:

FEBRUARY 2011 N=142	**MARCH 2012 N=144**
Results Oriented	Professional
Accountability/Responsibility	Competence
Blame	Client Satisfaction
Intelligent	Humor/Fun
Fast Paced	Intelligent
Defensive Behaviors	Analytic/Research Oriented
Disrespect	Results Oriented
Negative	Competitive/Win/Be the Best
Independent	Entrepreneurial
Competitive/Win/Be the Best	Excellence/Continuous Improvement Fast Paced, Collaboration/Teamwork

The summary chart below shows the key areas of improvement: higher cohesion (rallying around the same set of values/behaviors, reduced sludge, significantly more core values (from 2 to 5).

	FEBRUARY 2011	**MARCH 2012**
Participation	**100%**	**100%**
Culture Cohesion % rallying around core values	**24%**	**37%**
Sludge Negative behaviors	**27%**	**11%**
Core Values	**2**	**5**

While this firm has not hit the 3% level—the superior firms in the HOW Report—or the 6% in our asset management research, it has taken big steps in the right direction. The staff is more engaged in their work and values like "humor/fun" and "excellence/continuous improvement" have both found their way into the daily routines of these professionals. The yellow highlighted values were the carryover values from the earlier survey. They are definitely true of this firm, but they are not as "core" as the green values, which represent the values that the staff calls "aspirational." That is, if the firm is to perform at its highest level, they will need to get better and better at executing on these values.

Conclusion

"All the world's a stage, and all the men and women merely players." Leaders would do well to remember this insight from Shakespeare. They are always on stage. Every word and action is scrutinized by the staff. In this way leaders are continually shaping the reality in their firms. The decisions they make, the actions they take: it all becomes grist for the story mills. Leaders must be aware of the ESAR model (Experiences>Stories>Actions>Results) so they can consciously shape the first two elements of the model: the E and S.

While this may seem like a daunting task—to always be on stage—there is huge relief in knowing that you don't have to do it perfectly. You will indeed mess up. You will do things that create "harmful" stories in your firm. But, take heart. The formula in this article provides the antidote, beginning with the "recognition that a bad story has been created." Create enough open feedback in your firm such that you hear about the negative stories in fairly short order. Then use the formula to address the stories directly. Identify and state the negative story, replace it with the accurate one (i.e. the positive one that was intended), ask what needs to happen for people to believe it, then take action. All the time asking for ongoing feedback: is the intervention working?

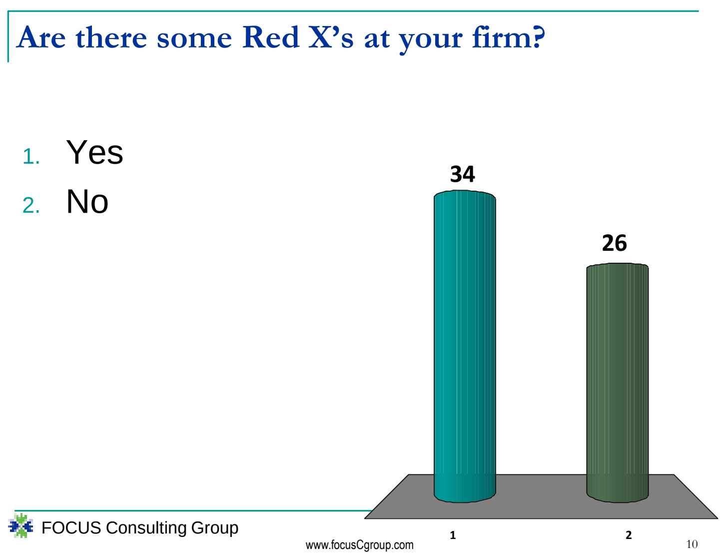
We have seen this approach work time and again. Leaders can and do successfully navigate the “stage”. But only if they understand the forces at work (ESAR) and consciously address them. In this way leaders step into the noble role of shaping a positive reality for their teams. And better outcomes for their stakeholders.

Bonus Information

Questions and answers from the CEO audience

Q: I'm curious about the frequency of Red X's in investment firms. What percent of firms have these issues? Of course, this is just theoretical; I'm not talking about my firm! (laughter)

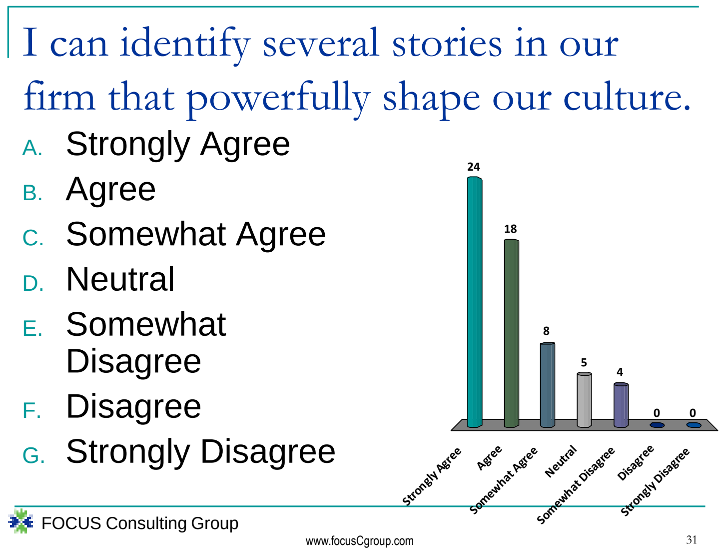
JW: In all survey work we've done, we find that nearly 75% of leadership teams acknowledge that they have Red X issues in their firms. So, it is pretty widespread. Shall we test for it in this room? (general agreement)



So, this group of leaders is a bit lower than the averages, but still more than half of the room agrees: we have Red X's. We have a running joke at FCG: "there are two kinds of leaders in the investment world: those that have Red X's and acknowledge them, and those that have them and don't!" (laughter) The key really is what you do with them, and we talked about that earlier with the Five F's.

Q: Do investment leaders usually know what the most important stories in their culture are? The ones that most affect outcomes?

JW: Well, let's test for that one as well:



These results would indicate that nearly all of the leaders in this room have a sense of what the powerful stories are. And 42 of you can readily identify those stories. The fact is that stories do drive actions in a firm. So, as a leader you want to understand what those stories are. And if they are negative, you must work to change them to positive stories.

Follow up material on changing bad stories to good

Following the speech above, FCG conducted interviews with investment leaders and ongoing clients to identify both good and bad stories within investment firms. The following table shows examples from various firms of "bad stories" that are targeted for conversion into "good stories"

Harmful story (belief)	Useful story (belief)
Sales requests are last minute for investment's time	Sales requests are agreed upon and orderly
People have been "flogged" for speaking against the leaders (fearful)	People are safe to speak openly and proactively
Independent thinking is not embraced in investments	Investment staff thinks independently and has good debate
Teamwork across tribes breaks down	Tribes work well together
Senior business team has high turnover	Senior business team is stable, effective and empowered
Insufficient leadership communication about firm strategy and issues	Investment team is well informed about firm strategy and key issues.
Investment team stretched too thin	Investment is well staffed, fully resourced

In each case above, the leaders have targeted a bad or "harmful" story to convert into a good "useful" one.

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- Acquisition and team lift out due diligence for cultural fit
- Hire for fit

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  (360, psychometrics)
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- Onboarding of new leaders
- Personality typing & application
- Genius and strengths

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- M&A analysis, integration, implementation
- Culture sustainability and process

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James Ware, CFA is the founder of Focus Consulting Group, a firm dedicated to helping investment leaders leverage their talent. James is also a highly acclaimed industry author and international speaker on the subjects of investment leadership, culture and building high performing teams. A frequent keynote speaker at CFA Institute, Mutual Fund Educational Alliance, Investment Adviser Association, U.S. Institute and other major industry conferences, James is recognized for his insightful, inspiring and entertaining presentations. His recent books, "Investment Leadership: Building a Winning Culture for Long-Term Success" (Wiley, 2003) and High Performing Investment Teams (Wiley, 2006) identify those elements of leadership and teamwork that lead to sustainable success for investment firms. James has 20 years experience as a research analyst, portfolio manager, and director of buy-side investment operations. He has been a guest lecturer on the topic of investment firm management at the Kellogg Graduate School of Management at Northwestern University. His educational background includes a Masters in Business from the University of Chicago and a degree in philosophy from Williams College, where he graduated Phi Beta Kappa.

Keith Robinson is the Managing Director of Focus Consulting Group and brings over 27 years of global investment experience to his consulting and coaching work at FCG. As an expert in human resource and talent management at Allstate Investments, UBS, and Marsh & McLennan, he was selected to develop a cutting edge leadership development program for Northern Illinois University. His specialties include: Management and Leadership Development, Education and Training, Organizational Design and Performance, and Business Strategy. He is the co-author of the highly acclaimed white papers, "Investment Tribes" and "The Red X – Managing the Outliers in an Investment Firm" co-written with Jim Ware, and was recently published in Smart Biz magazine for his work on "Managing the Human Portfolio." Keith holds an MBA from University of Illinois and graduated Summa Cum Laude with a business degree from Western Connecticut.

Michael Falk, **CFA**, is a partner of Focus Consulting Group and is passionate about the singular principal of providing value-added asset consulting. He is also partner and chief strategist on a global macro hedge fund, and was a former CIO in charge of manager due *diligence and asset allocation for a multi-billion dollar advisory. His background includes* extensive asset allocation research and portfolio development expertise along with a multi-faceted understanding of behavioral finance and retirement issues. The asset consulting perspective acknowledges that the wisdom of crowds can denigrate into madness at times. Assets should be managed with the serenity to accept the market's realities; the courage to pursue its opportunities; and the ongoing pursuit of wisdom to understand the difference. Aside from his consulting work, Michael is part of the CFA Institute's Approved Speaker List, a contributing member of the PDDARI group within the Financial Management Association (FMA), the Vice Chair of the Profit Sharing 401(k) Council of America's Investment Committee, teaches as an adjunct professor at DePaul University in their Certified Financial Planner (CFP) Certificate Program as well as on behalf of the CFA Society of Chicago and is frequently quoted in the financial press. He graduated from the University of Illinois with a B.S in Finance. He also holds the Certified Retirement Counselor (CRC) designation.