Culture and sustainable alpha generation - six key factors

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14 August 2017

IN BRIEF

- Culture is pivotal because it plays a key role in determining how firms make decisions to achieve their business objectives.
- Culture is at the heart of competitive advantage today; this is particularly the case for investment firms where people and their judgments are the chief assets.
- A firm's culture creates the context and incentive structure to support an investment process based on a longer time horizon, a collaborative team approach that can integrate diverse insights and robust risk management.
- Culture also underpins business decisions, including talent management, strategy and capacity management.
- A strong culture in investment management firms is a requirement for sustainable alpha-generation.

> "I came to see in my time at IBM that culture isn't just one aspect of the game, it is the game." - Lou Gerstner.

Culture matters - and it *really* matters in investment management firms. Culture is key because it plays a pivotal role in *how* organisations make decisions to achieve their business objectives. Given the nature of investment firms, the way in which teams interact and collaborate to make investment decisions can be material to the performance of a strategy and the firm as a whole.

Culture in organisations is usually defined as "the values and behaviors that differentiate one firm from another." Values and beliefs are somewhat hidden and more difficult to shift,[1] while behaviors are more visible and easier to shift. The interplay between these two factors - values and behaviors - largely determines the culture of an organisation.

A number of studies have shown that culture is at the heart of competitive advantage today. Among them is research on culture and performance conducted by Kotter & Heskitt.[2] The authors conclude, based on studying the largest nine or 10 firms in 22 different US industries over an 11-year time period, that firms with strong cultures outperformed - by a large margin - those that did not exhibit this characteristic. Over an 11-year period, firms with strong performance cultures increased revenues by an average of 682% versus 166% for the firms that measured lower on cultural attributes. Furthermore, such firms grew their stock prices by 901% versus 74% and improved their net incomes by 756% versus 1%.[3] They also make the point that strong culture needs to be matched with an appropriate strategy for the performance benefits to be realised, and it also needs to be adaptive given the pace of change in the world. Culture is a unique ingredient in the recipe for competitive advantage – while business strategy can be mimicked by competitors, culture is very difficult to recreate.

Culture is particularly important in asset management firms whose principal assets are its people and the judgments they make. In the investment arena, the facts do not unambiguously lead to one conclusion or another; one must make judgments based, in part, on "unquantifiable" factors. The underpinnings of this decision-making process are meaningfully influenced by a firm's culture.

Research on the links between culture and success in asset management firms have been conducted by Focus Consulting Group.[4] Based on these studies, Jim Ware and his coauthors conclude that improved decision-making along with attracting and retaining talent are the most tangible benefits of a positive culture and that "long term, sustainable success is built on strong culture".[5] The sustainability of performance is a key factor given asset owners' diminished appetite for risk (volatility) in the aftermath of the 2008 global financial crisis and their longer investment time horizons in light of demographic trends.

In investment firms, culture has an impact on investment results as well as how well firms perform from a business perspective. In view of this, we examine the role of culture in both the investment and business domains in this paper, encompassing six aspects, three in each of these two areas. The three aspects of the investment process reviewed are: investment time horizon, the approach to analysis and risk management. Business decisions are examined along the following three dimensions: talent management; business strategy; and, capacity management. Together, these form the pillars of our thesis, i.e., a strong culture in investment management firms is a requirement for sustainable alpha-generation.

CULTURE AND INVESTMENT DECISIONS

The culture of a firm sets the stage for how investors work in teams and collaborate with their colleagues to make investment decisions. Teams need to be highly functional and produce synergistic value if they are to be effective and contribute to differentiated performance.

Published research by MIT sheds some light on the role that the collective insights of a team can play.[6] While individual performance on a wide variety of cognitive tasks has been extensively studied, only more recently has the question of team or group intelligence been systematically examined.

The MIT study finds evidence for a general collective intelligence factor or “c factor” that explains a group’s performance on a wide variety of tasks. This “c factor” was not correlated with the average intelligence of group members or the presence of one very intelligent member, but was correlated with the average social sensitivity – or emotional intelligence (EQ) – of the group, which relates to the ability to read and work with others, as well as with more equal conversation turn-taking in the group.

Another recent paper focused on effective team-building, authored by Mauboussin and Callahan,[7] provides a related perspective. The authors make the point that diversity is valuable in teams, though the best teams have high cognitive diversity and low value diversity (i.e., shared group values). Diversity of insights has long been recognised as helpful in the investment process. This research indicates that common cultural values form the bedrock for cognitive diversity to lead to differentiated performance, rather than "group think" as some might argue.

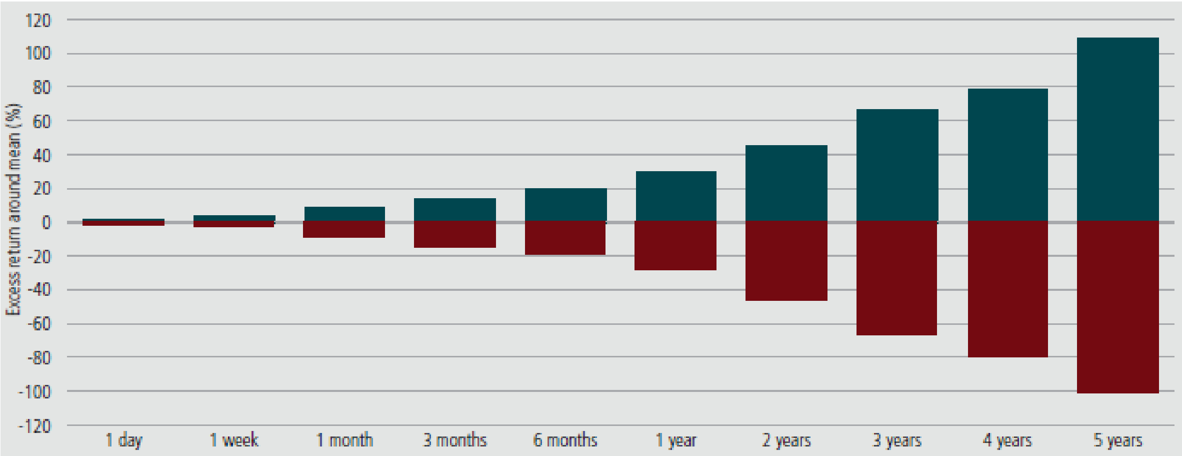
These studies suggest that people and how they interact in teams is pivotal in the investment process, a finding with which most leaders in the industry would likely concur. Against this backdrop, this paper examines how investment decisions are made across the following three dimensions: the investment time horizon; the way in which investment analysis is conducted; and, risk management practices.

Investment time horizon

Time horizon matters because an arbitrage opportunity exists for investors who manage their portfolios with a longer time frame in mind, i.e., there are more opportunities for differentiated performance when one holds securities for longer time periods.

Figure 1 shows the return dispersion for stocks held for various time periods, ranging from one day to five years. It indicates the greater dispersion of returns between the 10th and 90th percentiles as the holding period extends, bolstering the view that there are more opportunities for performance differentiation when securities are held for three to five years, rather than the current average holding period in the range of 1.5 to 1.9 years.[8] It is difficult for investors to profitably trade markets on a weekly basis because stocks tend to move in tandem in the short term and opportunities to add value after trading costs are very limited.

Figure 1: Return dispersion grows with time
MSCI World total return dispersion around the mean return (2010 – 2015)



Source: MSCI World holdings 31 March 2010 to 31 March 2015. Forward total cumulative returns around the mean in USD within the 10th to 90th percentile range.

Paradoxically, investors are increasingly short term in their orientation despite the arbitrage opportunity identified – and demographic trends that point to longer life expectancy, creating the need for larger pools of retirement funds managed with a longer investment horizon. A number of reasons have been posited for the observed short-term behavior. These include the structure of incentives for portfolio managers; behavioral decision-making biases; the quarterly earnings reporting cycle; and the role of the financial media, which churns out a vast amount of information and commentary on the markets, spurring short-term investment behavior.

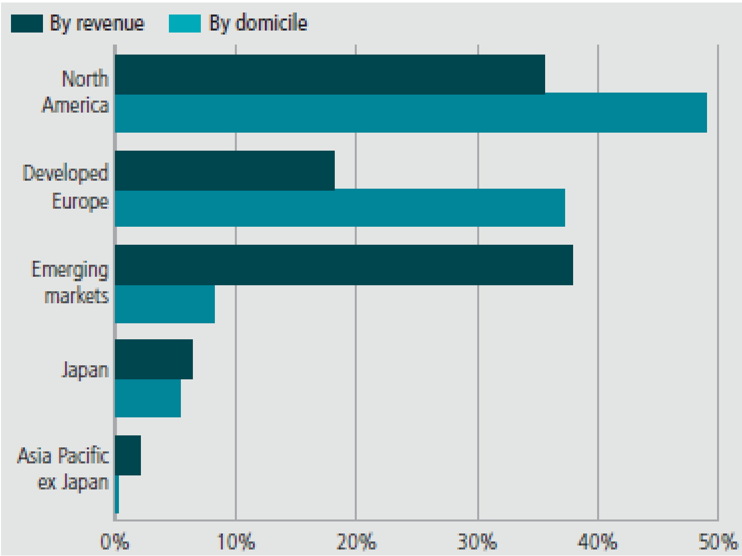
Maintaining a longer-term investment focus requires a culture that rewards longer-term performance and tolerates short-term underperformance, in practice and not just in name, along with an investment process and team orientation that supports this objective. It's not easy to create this kind of culture and maintain it over time. It requires strong buy-in from senior leadership as well as institutional supports, such as an incentive structure that is aligned with this longer-term view.

The analysis advantage

Making decisions based on research, analysis and judgment is at the heart of investing. Culture is the underpinning of this decision-making process. The increasingly global nature of the 21st century has spawned the need for a deep understanding of industries and companies from a global and regional perspective.

The influence of globalisation is apparent when one examines companies' source of revenues alongside their domicile. The data shows that in all regions, bar emerging markets, the proportion of companies' revenues that stem from outside the home region is in excess of 30%. This trend is even more marked in certain industries. For instance, if one examines the MSCI All County World Index (ACWI) technology sector, almost 50% of the companies are located in the United States, whereas only about 35% of revenues are sourced in the United States (Figure 2). On the other hand, emerging markets account for more than 35% of revenues while less than 10% of technology companies are located in emerging markets.

Figure 2: Revenue vs. domicile in tech sector
Regional weightings for the MSCI ACWI technology sector



Source: MSCI. Data as of 31 March 2015.

It stands to reason that an analyst covering US technology stocks needs to have a deep understanding of the industry from a global standpoint, since most of the earnings of technology companies stem from outside of the United States. Apple is an example of a company characterised by this dynamic, i.e., with a complex global value chain.

The importance of understanding global industry dynamics is bolstered by research conducted by Credit Suisse, which shows that industry effects is the most important factor in explaining the sustainability of high-performing companies' returns.[9]

In addition to the value of global and regional industry and company insights, there is a benefit to both equity and fixed-income investors to include cross-capital structure views in the investment process. For instance, when a company has been privately held for a period of time and is now coming to the market with an initial public offering (IPO), the perspective of bondholders who held the firm's debt during the time it was private can be invaluable to an equity investor examining the company anew. Similarly, when fixed-income investors meet with the management of companies, along with their equity colleagues, they gain a deeper understanding of the issuer than they otherwise would have. Collaboration across the capital structure is especially important when analysing banks, which issue a variety of securities (equity, debt, convertibles, preference shares, etc.) to comply with regulatory capital requirements.

To ensure these diverse views are integrated into the investment process requires that firms embrace a culture of collaboration and communication, both within teams and across the investment platform. A team-oriented culture can also be very helpful in mitigating behavioral biases, such as anchoring and confirmation bias, which are common in the investment process.

Another benefit of a collaborative culture is that the diversity of viewpoints help investors sift the signals from the noise. This has become increasingly important given how ubiquitous information is today.

A collaborative culture together with a long-term time horizon provides an "analysis advantage" as it makes for better insights and investment decisions over time. It is also important that incentives are structured to promote the desired behavior. A transparent review process with clear parameters can be helpful in this regard. A firm's culture is supported by incentives that are aligned with the firm's objectives.

Risk management

The failure of risk management is often cited as the leading contributor to the 2008 global financial crisis, given that the probability of tail risk appears not to have been properly factored into risk assessments. In the aftermath of the crisis, asset owners have placed particular emphasis on sound risk management that includes a consistent and repeatable process to manage risk. The risk culture of an organisation plays a key role in determining the efficacy of risk management. A strong risk culture leads to shared values and consistent behavior – as well as a sense that there is shared responsibility for risk management.

It is very important that a culture of risk management be *embedded* in the investment process and not appended or seen as an overlay. This means that a portfolio manager thinks about risk as part of his or her research and security analysis, rather than as a portfolio constraint he or she sometimes encounters. Risk management needs to be viewed as a valuable part of the investment process and not a compliance procedure.

Strong risk management is characterised by a risk-aware culture together with an approach that views risk through multiple lenses and a clear objective of actively preparing for the unexpected. A risk-aware culture that actively manages tail risks, i.e., the unexpected, can only thrive if the broader firm culture is strong and supportive of strong risk management. A risk-aware culture has certain key attributes (Figure 3):

- Commitment of senior leadership
- Alignment of incentives
- Independent oversight
- Integration in the investment process
- Clear objectives

Figure 3: The attributes of a risk-aware culture

Source: MFS

The buy-in of senior management is particularly critical as the other attributes listed above derive from the commitment of the firm's leadership.

As the ramifications of the 2008 crisis continue to reverberate around the world, the importance of an embedded risk-aware culture and sound risk management practices can hardly be overstated.

CULTURE AND BUSINESS DECISIONS

A firm's culture influences business decisions made by the leaders of investment firms in meaningful ways that have a broad impact on the investment process as well as the overall success of the firm. This paper discusses these important areas in the domain of business decision-making: talent management; business strategy; and, capacity management.

Talent management

Effective talent management is vital for sustainable investment performance and the long-term viability of a firm since people are the firm's chief assets. The talent management lifecycle encompasses recruiting, developing, deploying and connecting employees within the firm. It is key that firms hire people suited to their particular culture and investment time horizon – and that new hires are effectively mentored to allow them to integrate into the investment team and develop professionally.

The need to manage these highly skilled employees is intuitively felt, though often overlooked, particularly in firms where individual investment performance trumps team orientation. We contend that the ongoing management of talent in keeping with the firm's culture is as important as making the right hiring decisions.

The turnover of investment professionals is an important metric in the investment industry for good reason. High turnover rates involve discontinuity in the management of firms' portfolios with potential performance impact; they also involve greater hiring and mentoring costs, both in money terms and in the time allocation to hiring and mentoring new people. For instance, if a firm has an annual investment team retention rate of 80%, the entire team will turn over in five years; whereas, if the retention rate is 95%, it will take 20 years for the investment team to turn over.

The nature of incentives is also an important factor in a strong culture. Incentives need to be aligned with the investment and business objectives – and they need to motivate investors. There is nothing more corrosive to a firm's culture and performance than the perception that a meritocracy is not woven into the fabric of the firm. The more transparent both quantitative and qualitative performance measures are, the more a culture of meritocracy is cultivated.

Business strategy

Positive cultural attributes lead to differentiated performance only if the firm has a coherent and adaptive business strategy for the environment in which it operates.[10] Culture, then, is a necessary, but not sufficient, condition for superior long-term performance. For a firm to reap the benefits of a positive culture, it must be accompanied by an appropriate strategy. Culture underpins many business decisions made by investment firms, such as the regions in which the firms operate, the products they offer and the clients they choose to pursue.

An article published in the *Harvard Business Review* makes the argument for a coherent business strategy.[11] A coherent strategy is achieved by aligning differentiating internal capabilities with the appropriate external market. In the study, the authors examine a number of companies in various industries – comparing their strategy coherence with their operating margins – and finds that greater profitability is strongly correlated with coherence in capabilities. Their conclusion: “Sustainable, superior returns accrue to companies that focus on what they do best.”[12]

A facet of business strategy in the asset management context is the question of how firms manage the tension between their fiduciary responsibility to asset owners and the internal pull towards asset gathering and increased revenues. Some of the distrust that has arisen in the industry post-2008 is, arguably, the result of investment firms leaning too far in the direction of their own commercial interest at the expense of clients’ interests and, in doing so, compromising their professional integrity.

Capacity management

The necessity of capacity management centers on the degree to which growth in assets under management (AUM) affects the firm’s alpha-generating capability for clients. Capacity is sometimes, but not always, viewed under the rubric of risk management. We take the view that considering capacity within a broader risk framework is the best approach. Alongside this, a firm’s business strategy plays a key role in determining the firm-level approach taken to capacity management.

The way a firm makes capacity decisions gets to the heart of the tension between AUM and revenue growth, on the one hand, and the fiduciary duty to clients, on the other. The resolution of this inherent tension reflects the firm’s culture and investment time horizon. Firms with a longer time horizon are more likely to embrace robust capacity management.

Typically, capacity questions arise only when a firm has successfully married a strong culture with a relevant strategy and, consequently, achieved consistent differentiated performance for clients.

CONCLUSION

Culture matters a great deal, in large part because it is concerned with *how* an organisation makes decisions to achieve its business objectives. Culture is particularly consequential in investment firms where people and their judgments are the principal assets. In addition to affecting the way in which investment decisions are made at the portfolio level, culture has a material impact on the business decisions taken by the senior leadership of a firm.

A longer-term investment horizon results in greater opportunity for differentiated performance. To realise this requires a culture that supports a willingness to stray from the herd and the concomitant short-term underperformance that can result.

Increasing globalisation and complexity calls for more collaboration and teamwork across the globe and across the capital structure. The culture in an investment firm underpins how investors work in teams and collaborate with their colleagues to make investment decisions. A diversity of views is the hallmark of synergistic investment teams. While diverse cognitive insights are beneficial, teams tend to perform better when diverse views are accompanied by common cultural values. A collaborative culture also helps investors sift the signals from the noise and mitigate behavioral biases.

Appropriate incentives are vital. They need to be aligned with the desired behavior and objectives of the firm and its investment strategies. Positive cultures are the result of everyone in the firm living the core values and acting from this standpoint. The leadership of investment firms need to set a visible example and, in this sense, they are required to be both carriers and cultivators of their culture. They will do well to remember the maxim, "culture is difficult to create and very easy to lose".

In sum, this paper argues that a strong culture in investment management firms is a requirement for sustainable alpha generation.

ENDNOTES

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2. Ibid.

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7. Mauboussin, Michael and Dan Callahan (2014). "Building an Effective Team: How to Manage a Team to Make Good Decisions." Credit Suisse (www.credit-suisse.com).

8. NYSE data shows that holding periods are the lowest they have been since the Great Depression: 1.92 years; similarly, investment managers turn over their stocks every 1.51 years on average (based on Morningstar data reflecting the Large Blend category of open-end funds for the calendar year 2014).

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11. Leinwand, Paul and Cesare Mainardi. "The Coherence Premium." *Harvard Business Review*. June 2010.

12 Ibid.

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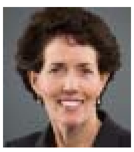

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