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WCM
INVESTMENT MANAGEMENT

Why Culture Matters

Contents

> “Everybody uses the word culture, but what the f*** does it mean?
>
> —CEO OF A LONG-TIME HOLDING

Over the years, we’ve come to believe that culture is one of the most important—yet least understood—drivers of long-term value. It separates the great companies from the merely good ones. It can grow a firm’s competitive advantage, provide a compass when faced with a difficult decision, and help avoid disruption. At the same time, it’s extremely hard to pin down, and even more difficult to quantify.

As a management professor we met with joked, defining culture is about as easy as nailing Jell-O to the wall. Researchers have struggled to agree on a definition for decades. As a result, many different constructs are being studied under the name of culture, and a unified theory of organizational culture has yet to emerge.

This confusion has only been compounded by the growing popularity of the topic. Ten years ago, there was very little mention of culture in annual shareholder reports; today, there are entire sections devoted to it. The media has muddied the waters, too. They’re quick to ascribe a superior culture to a company with a high-flying stock—when it is often simply in the right place at the right time.

For those of you who have come to know us well, it shouldn’t be surprising that we’ve settled on a simple definition: culture is the set of shared values and norms that guide behavior within an organization. In other words, culture isn’t just a set of aspirational values—it’s how people actually behave and make decisions in a company.

But if the culture is out of sync with the strategic needs of the organization, companies fail to maximize their potential and sustain success. It can even be disastrous. Remember Enron? They claimed respect, integrity, communication, and excellence as core values. When the gap between stated and actual values gets too large, things can really go sideways.

However, when values are well aligned with a company’s strategy, the results can be magical, surprising even the most optimistic financial forecasts.

OUT OF SYNC: AN EXCERPT FROM ENRON’S 1998 ANNUAL REPORT

RESPECT
We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness, and arrogance don’t belong here.

INTEGRITY
We work with customers and prospects openly honestly, and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won’t do it.

COMMUNICATION
We have an obligation to communicate. Here, we take the time to talk with one another... and to listen. We believe that information is meant to move and that information moves people.

EXCELLENCE
We are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

WCM'S CULTURAL JOURNEY

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Culture is the key that unlocks the power of a business to compound returns beyond anyone's expectations.

—PAUL BLACK, CO-CEO, WCM INVESTMENT MANAGEMENT

In living our firm's journey, we've come to realize that nurturing and strengthening WCM's culture is the single most important thing we do. At first blush, that may sound strange—the most important thing ought to be building the best possible portfolio, right? Of course that's important, but the lesson we've learned is that building a great portfolio needs—in fact, requires—a healthy, vibrant cultural underpinning. Why? Because a healthy culture enlivens and invigorates great people, and great portfolios are, after all, built by teams of gifted, bright, motivated people. Prioritizing culture is thus foundational to everything else—to all those things an outside observer typically identifies as the source of success, like great products, great service, competitive advantage, or all of the above.

Our backstory begins in 1976 as a small, boutique investment firm, focusing on high-net-worth clients and small private corporations. In many ways, it was a one-man show—the founder owned almost all the equity, made almost all the money, and definitely made all the decisions. With ill-defined and limited opportunity for professional growth and economic upside, talent came and went through a revolving door. The result: WCM plugged along for twenty-plus years without ever growing beyond a few hundred million dollars. And that was during an era when equivalent firms—including some formed just outside that revolving door—grew to be much, much larger.

Then, in the late 1990s, four employees bought out the founder and set out to create a very different kind of firm. They admit today that they didn't know exactly what to do, but would often reason—only half-jokingly—that a good start might be turning 180 degrees from what the founder would have done. So, they flattened the hierarchy, fostered transparency, shared opportunity, spread ownership across the firm, and prioritized employee inclusion and engagement.

Naturally, cultural change takes time, but gradually the firm started to experience a new kind of success. Clients multiplied, they were happy, assets grew, and employees became totally engaged. By the mid-2000s, assets were measured in billions, not millions.

However, like any real story, this one had some bumps in the road. Just as the firm started to taste success, investment performance suffered—the consequence of some difficult investment-style headwinds and, more significantly, some self-inflicted mistakes. To make matters worse, after three years of poor performance, we faced the Global Financial Crisis. Confidence in our ability to keep our clients—or even to keep the lights on—dimmed. The personal pain was tough enough, but not nearly as bad as having to face the disappointment felt by those who had embraced us.

Most boutique investment firms do not survive this kind of experience. Finger pointing becomes rampant, personal relationships suffer, and people eventually leave to seek other opportunities. However, in our case, not a single person left. Instead, we collectively resolved to grind it out and to embrace the challenge of rebuilding. Make no mistake, at a certain level, it was about survival, but—equipped with a litany of lessons learned—we became energized about building something better than before and getting the outside world to recognize how much stronger we'd become.

Eventually, that's what happened. We've consistently delivered for clients. However, we don't consider our returns or assets under management to be our greatest accomplishments. Not even close. What we're most proud of is the fact that we all stuck together and never quit—we kept showing up. In other words, when the storms raged and the winds blew, the house did not fall, because the (cultural) foundation was deep and well built.

FUN AND GRATITUDE

While we credit our culture for getting us through the tough times, we also know it's the key to expanding our potential and long-term success. As a result, we continue to work very hard on making the culture as healthy as possible. A big step came five years ago with the establishment—nay, acknowledgement—of our core values. As the story goes, a group of us holed up in a hotel room for two days and asked the question: "what really makes WCM unique?" Most firms in our industry think success boils down to hard work and superior intellect. While those are certainly important, we'd also say they are nothing more than the price of admission for any reasonably successful organization. Instead, we wanted to identify what made us different, what described who we really were.

Eventually, we settled on two words that defined us: gratitude and fun. Gratitude resonated because, even during the most difficult times, we never forgot we were fortunate to do what we do. We were blessed to be in the game, and couldn't take anything for granted. In particular, an attitude of gratitude has fostered a kind of humility, and recognition that any success we've achieved, though certainly due in part to hard work and intellect, is not fully explained without acknowledging we were given some breaks along the way. In turn, that means we know we have much to learn, and thus are continually striving to get better. And because this business (and this world, for that matter) makes no promise that your best efforts will necessarily result in a good outcome, we like to say, "hold it lightly." Finally, since we are fortunate, we feel obligated always to strive for exceeding expectations, for clients and for each other.

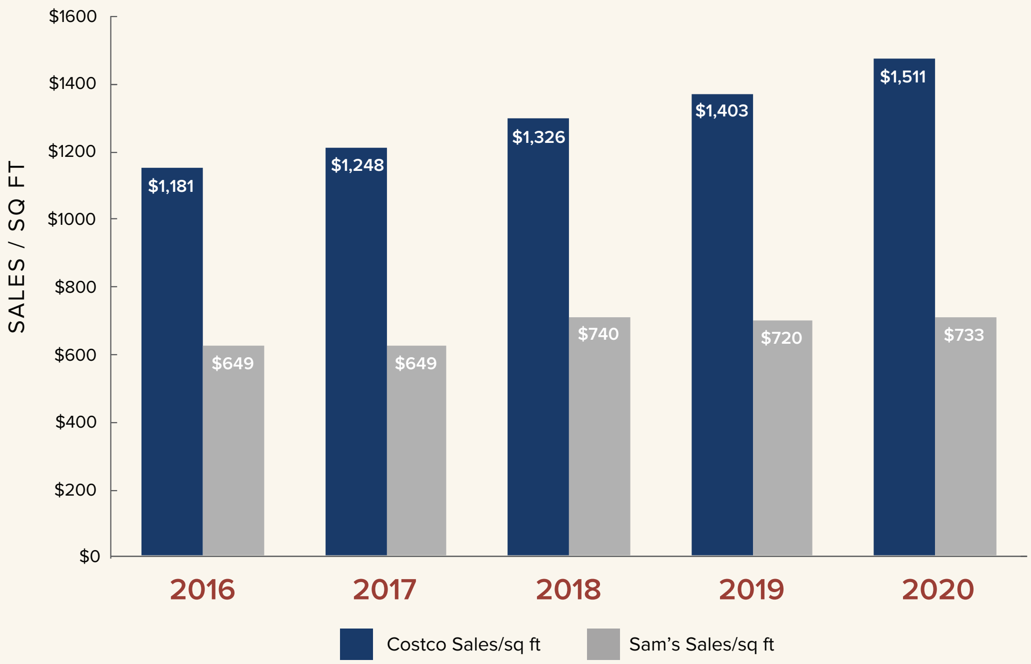
Fun was more unconventional. Could we tell clients that fun would guide every decision we made? Would it be better to say "enjoy"? Yet, at the end of the day, fun is really what defines us. We've never taken ourselves too seriously (knowing how fortunate we are), and we truly enjoy one another. Plus, there's nothing more fun than challenging the conventional wisdom and proving the skeptics wrong. Being different—and delivering better results—is a blast.

LESSONS LEARNED

The more we learned—from experience, and from studying the best—the more our thesis crystallized: if culture is critical to great organizations, then culture should be a key focus in our effort to find great portfolio companies.

The evidence was all around us, and not just from our own back story. For example, most everyone has an intuitive sense that culture matters. Think of a job you had where the culture was unhealthy. Did you give your best to an organization that was toxic, or didn't care about you? Further, the best investors—those with multi-decade outperformance (e.g., Buffett, Fisher, et al)—valued culture more than even their most ardent disciples recognize. And then there were the clear examples in our own investing. How is it that two companies—in the same industry, with the same business model—produce dramatically different results? As we dug deeper into the differences, we kept coming back to culture.

COSTCO VS. SAM'S CLUB



Costco's unequivocal focus on the member experience is no accident: it drives every decision the firm makes, from the policy of passing down all economies of scale as lower prices, to maintaining a maniacal focus on merchandising. The resulting phenomenal shopping experience stems from Costco's real secret: a culture that never stops supporting and investing in its people. That's why Costco has continued to exceed the market's expectations for growth and store productivity, bringing the old adage to life: happy employees make happy customers make happy shareholders.

Source: FactSet and Company 10-Ks

However, when we tell people we evaluate culture as part of our investment process, we're often met with skepticism: isn't culture too "messy" to analyze? How can you tell the difference between a "good" culture and a "bad" culture? How exactly does culture affect the bottom line? These are the same questions with which we struggled, so we set out on a journey to develop a cultural framework.

Initially, we had a one-size-fits-all approach, thinking WCM was the benchmark for a "good" culture. Our culture worked well for us, so we reasoned that a similar culture would work well for other companies. But over time, we noticed many high-performing companies doing really well with cultures quite different from our own. Canadian Pacific and DSV have been hugely successful by focusing on efficiency and profitability. These may not be the types of firms that some of us could ever work for (spend some time clearing train tracks in Calgary in the middle of winter, if you don't believe us), but they attract a certain kind of person that can't imagine working in any other environment. For some, a high degree of accountability, a constant turning of the lowest performing employees, and formulaic compensation schemes is the only way to go. Yet, if you tried to export this regimented style to an innovation-driven business, such as Shopify, we can say with confidence the developers wouldn't be as creative.

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> There is a catchy, popular, oft-repeated view that, "Culture eats strategy for lunch." This implies a relationship that is not helpful. Culture and strategy are not in some kind of competitive race for success. It's more useful to think of culture and strategy operating in tandem to produce competitive superiority.
>
> —JAMES HESKETT, PROFESSOR EMERITUS, HARVARD BUSINESS SCHOOL

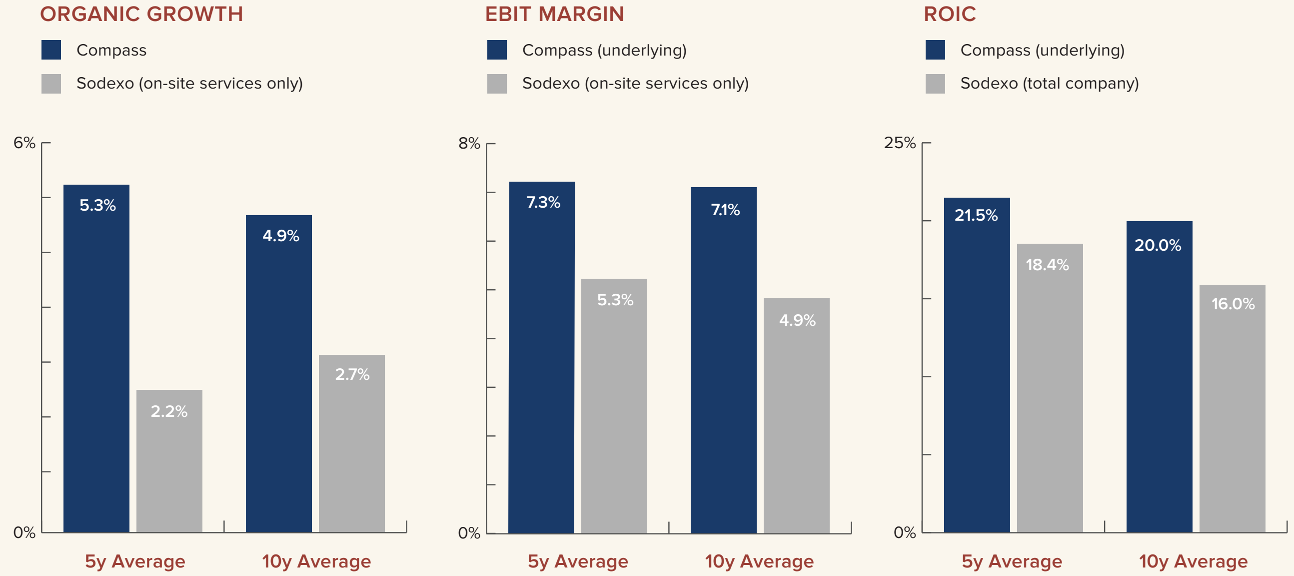
Another lesson learned was that culture doesn't exist in isolation. It must be considered in the context of a company's strategy and competitive advantage (or "economic moat"). Our investment philosophy is built on the idea that moats are not static. They ebb and flow, and it's the direction of the moat ("moat trajectory")—not the width—that drives stock returns. And here is where culture comes in: we think that effective (strong, moat-aligned, adaptable) cultures serve to extend the duration of moat expansion, or "positive moat trajectory."

Gathering cultural data is time consuming. It's every bit as much an art as it is a science. To demonstrate this point, one of our favorite stories involves a meeting with China's Tencent Holdings many years ago. We started off with the obvious—and not so different—question: asking the executive to describe the corporate culture. He began by talking about the rising salaries of programmers and, ten minutes in, it occurred to us he had said nothing about culture. Fortunately, we stumbled into a discussion about a recent change in strategy and very quickly he began to wax poetically about the firm's obsessive focus on the user. The more he spoke, the more it became clear that user satisfaction guides every decision the firm makes, far outweighing any financial goals. However, we had to ask the right questions to get that on the table.

This was one of several events that compelled us to up our game when it came to interviewing people about culture. Eventually, we hired a dedicated culture analyst who now works closely with our analysts and portfolio managers to evaluate culture within the context of a company's broader thesis. The benefits are numerous. Analyzing culture is very different from the rest of fundamental analysis, so it's extremely helpful to have someone who is participating in the research process solely through a cultural lens. And to guard against useless conventional wisdom, we work hard to protect our culture analyst from outside influences (e.g., recent stock price and/or financial performance).

We are convinced the only way to truly understand a culture is to hear from those who have lived it. To tease out the "cultural DNA" of a company, we perform extensive culture-focused interviews with C-suite executives and former employees. We ask questions that require CEOs to venture beyond their standard talking points about mission, vision, and values, and that get more to the heart of whether they think about and manage culture in a thougtful and impactful way. We also continue to collect data that shows how firms may be trending across important cultural qualities.

COMPASS VS. SODEXO*



How two companies respond to the same question can illuminate massive differences in culture. Compass Group is the largest outsourced caterer in the world, serving 50,000 customers in 50 countries. The more we've learned about what it takes to run a global catering operation, the clearer it's become there is a tremendous amount of complexity. After all, what's easy about managing 550,000 people and serving 5.5 billion meals per day?

Compass has been able to strike the right balance between being decentralized when necessary (e.g., having a strong local sales presence) and instituting centralized processes (e.g., procurement). When we recently asked Compass how it did this, they said: Any process we add requires one be taken away. Chefs don't want to be told what to do. They like some guiderails, but want to do that last 5% themselves. Contrast that to the answer from Sodexo, its largest competitor: It's a big issue. We have to convince chefs. It can free them up to run teams, or run accounts better. Some of our competitors are more radical on that ... it's very complex. Chefs want different things.

As those answers suggest, Compass has found the right balance between keeping people engaged, while leveraging its massive economies of scale though sensible processes. Meanwhile, Sodexo is still struggling to get everyone on the same page. Nevertheless, this stark difference in alignment has not kept analysts from making the case for years that Sodexo would eventually close the growth and margin gap with Compass, thus making it an attractive investment given the discounted valuation. Those market participants have thus far failed to recognize the differences in culture.

**Averages calculated as of 2019 to exclude impacts from COVID*

MARATHON, NOT A SPRINT

Looking back on our journey, we're grateful to have learned the importance of culture, and to now be in a position to exploit that insight. However, we'd be lying if we said we had all the answers. Even after reading countless books and academic papers, talking to experts and CEOs, and scrubbing various sets of data, culture remains extremely difficult to analyze. Fortunately, this also means it continues to be woefully misunderstood and underappreciated by most investors.

Our goal is to continue to improve our ability to identify strong cultures, flag those that are on the verge of deteriorating, and get better at finding firms that are putting the right pieces in place to improve. There is no text book for this; we'll continue to blaze our own trail. Our goal is simple: to carve out a novel source of long-term alpha generation for our clients. Stay tuned as we continue to grow our moat by pushing this differentiating work forward.

> "Culture is what analysts need to be asking about. It's what CEOs are thinking about every day.
>
> —PAUL PERREAULT, CEO OF CSL LIMITED

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