CHAPTER 1

Culture at the Core

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Every organization—whether a business, a not-for-profit entity, or government—reflects and operates from a unique culture. It's an inherent and essential element that brings order to the internal and external environments[1] and reduces uncertainty[2] among members of the group. The quality and strength of cultures explain many of the differences in organizational performance. But culture often operates below the surface of an organization, so that studying the abstraction of culture is elusive.

Organizational culture is especially important to the workings of a knowledge transfer business, such as investment management, because much of the work produced is intangible, and the environment changes so rapidly. Accordingly, culture is a critical component of any professional service firm, and we have made culture the introductory topic for this book.

Culture is a subject that has occupied management consultants and academics since the 1950s. One definition that we have found useful was put forward by Edgar Schein, an early scholar on culture and leadership, and today professor emeritus of MIT's Sloan School of Management. He writes:

"The culture of a group can . . . be defined as a pattern of shared basic assumptions learned by a group as it solved its

problems of external adaptation and internal integration, which has worked well enough to be considered valid and, therefore, be taught to new members as the correct way to perceive, think and feel.[3] . . . Culture is to a group what a personality or character is to an individual."[4]

Schein adds that culture often is those principles and beliefs a founder or leadership set has imposed on a group—and which have worked out well: "[The] dynamic processes of culture creation and management are the essence of leadership, and make you realize that leadership and culture are two sides of the same coin."[5]

The owners or managers of an organization might consciously work at developing a culture, or a culture may evolve on its own as the result of years of decision making, but a culture is present in any setting where people are working toward common goals. In a new organization, culture can be very strong, as it is one of its few assets, and crucial to its early efforts.

Employees have a hand in corporate culture as well. "Not all of corporate culture is created from the top down," wrote Andrew Lo, a professor of finance at Massachusetts Institute of Technology, in a paper on corporate culture in finance. "A culture is also composed of the behavior of the people within it, from the bottom up. Corporate culture is subject to compositional effects, based on the values and the behaviors of the people it hires, even as corporate authority attempts to inculcate its preferred values and behaviors into its employees."[6] Indeed, an organization benefits from a diversity of opinions to prevent "groupthink."

"Most companies' culture just happens; no one plans it. That can work, but it means leaving a critical component of your success to chance," wrote Eric Schmidt and Jonathan Rosenberg, executive chairman and adviser to the CEO, respectively, at

global technology giant Google Inc.[7] They observe that the right time to plan a culture is early on, because after it takes shape—consciously or not—the founding principles are likely to reinforce themselves, as like-minded people will be attracted by them to join an organization, and those with other viewpoints may not.

The values and principles of a culture permeate every aspect of a business: operating strategy; products, services, and relationships with customers; firm structure and business model; "people processes"; and governance. Culture determines relationships among authority and peers, an organization's common language, granting rewards and status, and the measures of success.[8]

Thus, culture is a shared view of how to carry out day-to-day tasks, as well as dealing with unusual conditions—how the firm's long-term principles inform short-run actions. Culture also determines how a firm treats its customers and employees, and how the employees treat each other. Accordingly, organizations fortunate enough to arrive at the right culture gain a competitive advantage that carries the firm toward its long-term goals. In this section, we will consider the different approaches firms take to building and expressing culture and, in particular, its importance to success in the investment management industry.

The Original Organizational Culture: Command-and-Control

Cultures vary according to the sizes and activities of individual groups, and are intertwined with an organization's structure. One combination of structure and culture, however, has prevailed during most of the evolution of corporate America, and

probably for most of human history: "command-and-control." (It's often illustrated in management textbooks by a pyramid, but anyone reading this book has seen that image a thousand times, so we don't repeat it here.)

The command-and-control structure assumes that one person, or a few people, at the top of an organization can determine the best direction, and that subordinates should carry out leaders' decisions without inserting any ideas of their own—a principle called the *great person theory.*[9] It's the operative, and necessary, culture in any sort of military operation, or police and firefighting unit, where lots of people have to be trained to do the same thing, in exactly the same way quickly and without doubt or question, often in dangerous settings.

"In corporate cultures that lack the capacity to incorporate an outside opinion, the primary check on behavior is the authority," wrote Andrew Lo: "From within a corporate culture, an authority may see his or her role as similar to the conductor of an orchestra, managing a group of highly trained professionals in pursuit of a lofty goal." Others looking from the outside in might see a particular organization's authority as blatantly forceful.[10]

Command-and-control became the favored form of culture in American business starting in the late nineteenth century, when standardized processes and behaviors were essential to the rapid growth of the manufacturing economy. The idea was advanced by Frederick W. Taylor, who was very successful as an engineer but also invented the profession of management consulting. For a growing manufacturing sector that had lots of workers, who possessed varying levels of skill and were accustomed to carrying out their work by hand in their own different ways, he developed a structure that imposed defined tasks—rewarding successful workers with high pay and terminating those who failed.[11]

Command-and-control cultures still prevail in most industries[12] because, in many settings, a rigid hierarchy is useful and desirable. For instance, manufacturing organizations often need central control over the use of resources and quality control over processes, and to be able to respond swiftly to emerging problems. It also can work well in single-line businesses operating in stable markets, where little flexibility is called for. The short leash of command-and-control also is essential in situations where the organization's goal is cutting costs.

It's also suitable where creative thinking and initiative can create risks.[13] For instance, a pharmaceutical maker has to follow strict controls over the manufacture of its products, and how they are sold: a drug firm's Western region sales head could hardly decide to come up with his own custom version of the company's big cholesterol drug. Organizations such as electric and gas utilities or hospitals must adhere to well-defined practices to ensure reliable service and the safety of their customers and employees. Similarly, bank credit officers have to follow standardized processes for lending, with decisions and approvals at several levels, to allow for systematic credit rating and proper allocation of the firm's capital. Accordingly, command-and-control structures and cultures are often present in highly regulated industries.

Drawbacks of Command-and-Control

Although command-and-control allowed the industry of a young America to flourish, in the past couple of decades the structure has been discredited. Command-and-control is not an agile form, and in industries that are rapidly changing, a few senior managers don't have enough time to micromanage an entire company. Moreover, the structure is not equipped to allow individuals further down in an organization to contribute their ideas upstream: a one-way information flow from

the top of the pyramid to the bottom can result in significant missteps or missed opportunities. In many cases, people in the field may have better information about product and competitor dynamics, while those at the top may possess the least relevant information and therefore lack the insights needed for optimal decisions.[14] The gap between the leadership team and the customer or client—that is, an organization's layers of management—is often too wide in command-and-control cultures. Some firms have layers of reporting structure numbering into the teens. Many management consultants recommend a maximum of six to eight.

In human terms, employees in command-and-control structures have well-defined boundaries, duties, and career paths. Such a work environment may be desirable for many people, but current thinking in management science and practice recognizes that employees want to contribute ideas to their organizations, and argues in favor of fostering collaboration and creativity. For instance, IBM Corporation published a study in 2012 that surveyed corporate CEOs around the globe, who said they were aiming to change the nature of work "by adding a powerful dose of openness, transparency and employee empowerment to the command-and-control ethos that has characterized the modern corporation for more than a century."[15] As a practical matter, corporations, large and small, may have little choice: through the Internet and various social media, employees are probably sharing and collaborating whether management wants it or not.

An Alternative Culture for Knowledge Businesses

In contrast to the rigidity of the command-and-control model, professional service businesses such as legal and management consulting firms—as well as investment managers—often

develop structures and cultures that better suit the nature of their work and the economics of their businesses.

Unlike manufacturers, which can carefully specify their standardized products, professional firms offer no tangible goods to sample or road test, and there are no set manufacturing processes: each lawsuit, audit, or financial market environment is unique, and a firm's reputation and brand is built from past successes in contending with the varying circumstances. Accordingly, predicting product and service outcomes is much less certain for most investment managers, as well as other services businesses such as law firms, management consultants and medical practices. Prospective customers can look to firms' prior work to understand their areas of expertise and skill, and even the reliability of their services in the past, but a firm's success depends greatly on the context—for a law firm, the facts of a court case, or for a consultant, the state of a client's affairs before a business is redesigned. Compared to a physical, manufactured product, the design of which can be reworked over many years, the environments in which professional service businesses work are often too complex, varied and rapidly changing to provide reasonably objective evaluations ahead of time.

The identity of professional service firms is closely tied to the people in possession of skills—individual lawyers, consultants or asset manager teams. (An investment industry bromide says that a firm's most valuable assets leave by the elevator every night.) Accordingly, successful employees in these firms are highly compensated and often hold equity stakes, in order to tie their day-to-day efforts and resulting personal wealth to their firms' long-term success.

Of course, professional partnerships have senior management teams: a completely flat organization, where everyone is enabled to decide and act on anything, would be chaotic. Senior management's role, however, is more about leadership—guiding

firm strategy, high-level business development and problem solving—as their detailed involvement in every client situation would be impractical and unnecessary. Professional partnerships operate by a set of rules, but don't have a single absolute ruler, as do command-and-control organizations.

Senior management also typically sets compensation and controls the addition of new partners. Importantly, in less tangible matters, senior managers provide practical examples of the firm's culture and what constitutes good behavior. Meanwhile, in handling client engagements, client teams apply their own experience and judgment to handling challenges as they arise rather than follow specific directives made at the top.

The differing characteristics of command-and-control versus professional partnerships will attract different sorts of people to each type of culture. Professional partnership careers tend to require more extensive training just to enter, and typically call for greater commitments of time to the job. Taking intelligent risks and raising individual initiative also are central to professional work. People with risk-seeking natures are more likely than not to be attracted to the more complex and challenging careers of professional partnerships, while risk-averse people may prefer a different environment.

The Partnership Culture Model

With less involvement of senior management in day-to-day decisions, the economic success of a professional firm is dependent on "multiple leadership," that is, key decisions being made at many points in the firm. Figure 1.1 illustrates the relationships among the financial and working elements of a partnership: interdependence in carrying out their work, and support that individuals offer and rely on from one another. Both are built on a foundation of economic interests shared among the partners.[16]

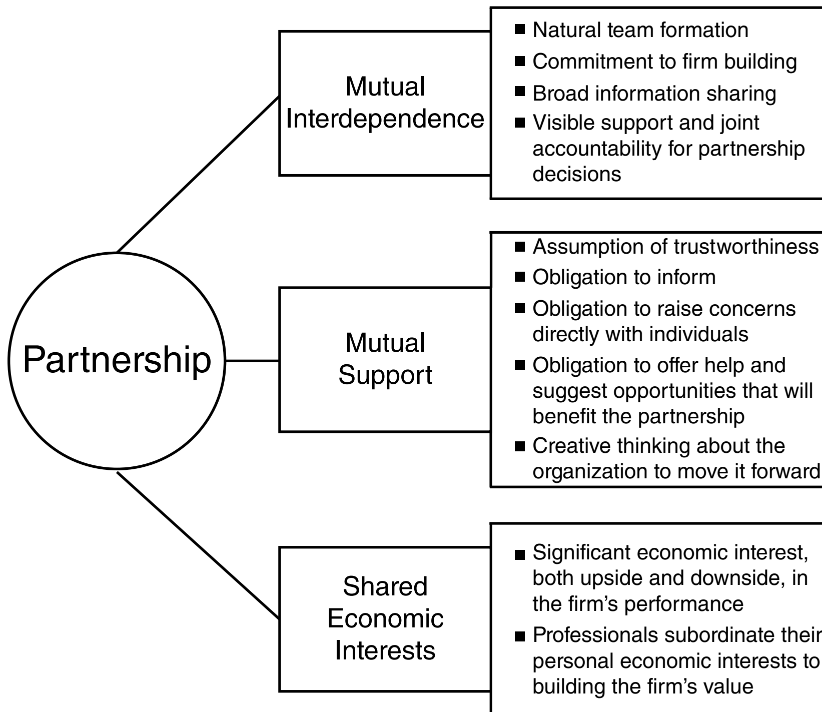

FIGURE 1.1 Tenets of Professional Partnership

Source: Epoch Investment Partners

Interdependence

In serving the complexities of a given assignment, client-serving teams at professional partnerships often are likely to draw on the expertise in several areas of the firm. Attorneys, consultants, and investment analysts should be eager to share their knowledge, both within and among teams, in the interest of providing the best service to clients and moving the firm forward. Implicit in those goals, of course, is that the hard work and judgment has to be reciprocated among all members of the group when called for.

An illustration: in an investment management setting, it's typical for analysts and portfolio managers in a firm's equity

group to share insights on the prospects for individual companies or industries with those running fixed-income portfolios. Each approaches the analysis a bit differently, providing complementary (and sometimes opposing) views.

Narrow views and overspecialization often get in the way of idea sharing, typically to organizations' detriment. Gillian Tett, the U.S. managing editor of the *Financial Times*, has written on corporate culture and idea sharing from the perspective of an anthropologist, noting: "We need specialist, expert teams to function in a complex world. But we also need to have a joined-up flexible vision of life."[17] She cites companies hobbled by the "silos" within their structures, for example, Sony Corporation beginning in the 1980s, and the turnaround potential of removing them, such as at IBM Corporation in the mid-1990s.

Ms. Tett lauds Facebook, Inc. for its resistance to building silos, instead promoting an open organization where employees rotate through various teams, and come to know people in all parts of the company. It's not the most efficient structure, she concedes, but citing a senior executive, "[It's] a small price to pay to meet the goal of keeping the organization fluid and connected; it was crucial to have a bit of slack, or inefficiency, to breed creativity and give people time to stay connected."[18]

Rotating people through the firm's various departments isn't feasible for us at Epoch (or for many asset managers). The knowledge needed to work on the investment teams, for instance, is quite specialized, and assigning people without in-depth training to our portfolio teams would fall short of our fiduciary obligations to clients.

In the case of Epoch Investment Partners, we manage several complementary strategies—all in equities, but investing in various markets and company sizes, and we encourage analysts and portfolio managers to share whatever they know about their companies with anyone else who might be able to use it. We don't obligate people to rely on others' decisions, but what

counts is that the information—in the forms of both data and opinions—is freely available for everyone's use. (Epoch maintains a research database that is open to all analysts and portfolio managers.) It is not uncommon in some firms to find people who feel protective of their hard work and want to keep it for their sole benefit, but in our case not sharing insights with another analyst or portfolio manager will lead to a collective loss—or at least a forgone opportunity to enhance the returns of another strategy. And since we reward employees on the firm's overall results, the effect on returns from not sharing affects everyone's rewards.

Fostering that sort of sharing is not easy, however. Some people that are drawn to the specialized, expert nature of investment management are introverts, and would be more comfortable in their offices than handing away their insights (or fitting the insights of others into their own work). We try to create a natural environment for sharing and collegiality with a set of regular meetings, on companies' earnings reports, portfolio performance reviews, and the like, to give people a chance to hear what others are saying, and to offer their own ideas. By so doing we hope to avoid the NIH ("Not Invented Here") syndrome—"If I did not invent it, the idea has little or no value."

Epoch's ultimate success in winning for our clients depends in large part on our ability to transfer knowledge from one person to another. Firm meetings are a platform for people to then form their own groups, where they discuss in greater depth the good and bad points of different ideas or decisions. In turn, we hope the individuals in those groups will reach out to other portfolio managers, or the senior management team, and share their thoughts, even if their points include disagreement or opposition. What counts is that all the ideas are given air time: for the interdependence principle to work, people at all levels in a professional partnership need to know that their opposing views, and their reasoning behind them, are welcome.

"Everything we do should be about transferring knowledge with one another."

—Bill Priest

At Google, Eric Schmidt and Jonathan Rosenberg caution against the encroachment of HiPPOs, (or Highly Paid Persons' Opinions): "When it comes to the quality of decision making, pay level is intrinsically irrelevant and experience is valuable only if it is used to frame a winning argument. Unfortunately, in most companies experience *is* the winning argument."[19] The best decisions are reached from considering the best ideas, rather than one person's opinion, and the ability to participate in decision making will encourage all team members to make a contribution.

Schmidt and Rosenberg also believe that team members have an obligation to speak up when inferior ideas make their way to the table, and that they later share the responsibility for decisions that don't work out: "If they don't [raise their concerns], and the subpar idea wins the day, then they are culpable. . . . [D]issent must be an obligation, not an option."[20]

"An organization is like a tree full of monkeys, all on different limbs at different levels. The monkeys on top look down and see a tree full of smiling faces. The monkeys at the bottom look up and see an entirely different perspective."

—Anonymous

Support

A companion to interdependence is support among team members, although it operates more at a personal level. Support includes encouraging people to advance their ideas, as well as formal and informal coaching and mentoring.

An equally important aspect of such support is offering candid feedback on the decisions of team members—simply stated, discussing their mistakes as well as their successes. Hospitals hold regular reviews of mortality and morbidity, which look into the how and why of patients' outcomes, with an eye toward safety and quality improvement. Professional firms can conduct similar postmortem reviews and make them a regular part of the management process, in a forum that is not critical or threatening, but intended instead to gain understanding of how mistakes have come about, and how to minimize and avoid repeating them.

Support also calls for raising concerns, both at an individual level and for the benefit of the organization as a whole, when an individual believes a mistake or incorrect judgment is "in process." For this facet of support to have value, however, individuals and managers have to be receptive to such ideas and seek them out, even when they face challenges or criticisms.

Ray Dalio, the founder of Bridgewater Associates, a highly successful investment organization, has codified over 100 pages of cultural and management principles published on the firm's web site.[21] On the topic of support (of both sorts—coaching and candid feedback), he states that he expects people in his organization to:

- Stress-test their opinions by having the smartest people they can find to challenge them;
- [Be] wary about overconfidence, and [be] good at not knowing; and
- Wrestle with reality, experiencing the results of their decisions, and reflecting on what they did to produce them so that they can improve.

It's a part of human nature to avoid these sorts of conflicts, but in an open and thoughtful professional partnership, people

need to feel free to take the other side—even if it means questioning a decision by the boss—and point out something that might have been missed. By the same token, it's up to senior people in the firm to both advocate—and accept—that sort of candor.

> *"If you don't know what you don't know, you can get the organization into a lot of trouble, but if you do know what you don't know, you can seek help from others, and everyone just gets better."*
>
> —Bill Priest

Shared Interest

Because so many people in professional organizations have direct input and influence to the success and quality of client engagements, everyone in the firm owns the responsibility to move the firm forward. In turn, for individuals to be motivated to engage and commit deeply with clients and colleagues, they need to have a significant financial interest in the firm's performance. This calls not just for an expectation of bonuses every year to reward good work, but a participation in both the potential upside and downside, and a long-term tie to the firm that comes from equity ownership (or often in the case of an investment management firm, a stake in the strategies it offers to clients).

A shared financial interest requires a great commitment from a firm's partners. Aside from the long and hard working hours and commitment of personal life, there can be significant financial commitments—contributing to the firm in times of financial difficulty, of course, but often during good times as well, when a firm is growing and requires reinvestment of profits that might otherwise be paid out to the owners. Accordingly, balancing short-term rewards with the best interests of the firm through compensation policies is a crucial role for senior management.

Partnerships' policies vary on what they emphasize in professional compensation—events of individual merit, or collaboration that contributes to firm continuity. A "lockstep" model is formulaic, with compensation based on seniority and contributions to the firm over time, while a discretionary "eat what you kill" model, paying out bonuses tied to specific revenue events, recognizes particular successes in a given year.[22] Most firms, including Epoch, opt for the flexibility of combining the two in some fashion, to allow both *fairness* and *justice* in compensation.

> *"Tell me how a person is paid, and I'll tell you how he'll behave."*
> —Bill Priest

Justice and Fairness

"Fairness seems to have three main features: equality, agreement, and transparency," wrote Paul Woodruff, professor of philosophy at the University of Texas at Austin.[23] With respect to compensation, he adds, "transparency allows anyone to predict accurately what results to expect." Woodruff goes on to caution leaders, however, that "fairness is a trap, because once you commit yourself to it, you must submit to it. You are no longer in control because you have waived the right to exercise good judgment," and any deviations from established rules would appear unfair.

Justice in a corporate culture is a subtly different concept, Woodruff says, calling for judgment and leadership rather than formulas. Having a discretionary component in compensation combines fairness and justice, giving a firm's leaders leeway, and the ability to reward both individual achievement and teamwork, and thus reinforce the culture.

Justice has the greater challenge. It goes to the heart of preserving "the community," and the attributes valued by the community—frequently at times when the application of rules based in fairness might have the opposite and negative effect.

For a professional firm to be viable for the long term, however, the shared interest of the partners has to transcend the financial rewards, and include the intangible achievement of helping to build a quality organization. This calls for assembling a group of partners with complementary values and temperaments who will be able to work together, to understand each other, and to put up with each other during hard times over many years.

Notes

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6. Andrew W. Lo, "The Gordon Gekko Effect," NBER Working Paper Series, Working Paper 21267, National Bureau of Economic Research, 2015, p 6. Accessed at: http://www.nber.org/papers/w21267
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8. Edgar H. Schein, *The Corporate Culture Survival Guide*, New and revised ed. (San Francisco: Jossey-Bass, 2009), 52–58.
9. Booz Allen Hamilton, "Beyond Command-and-Control: Managing the Diverse Corporation in Today's Turbulent Times," 5. 2000. Accessed at: http://www.boozallen.com/content/dam/boozallen/media/file/80674.pdf
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16. This framework for describing investment management culture arose from an offsite meeting many years ago, between the management of Credit Suisse Asset Management-Americas (at the time, led by William Priest) and consultants McKinsey & Company. We have found it to be a durable and reliable guide.
17. Gillian Tett, *The Silo Effect: The Peril of Expertise and the Promise of Breaking Down Barriers* (New York: Simon & Schuster, 2015), 19.
18. Ibid., 179.
19. Schmidt and Rosenberg, with Alan Eagle, 29.
20. Ibid.
21. Ray Dalio, *Principles* (2011), 40. Accessed at: http://www.bwater.com/Uploads/FileManager/Principles/Bridgewater-Associates-Ray-Dalio-Principles.pdf
22. Maxine Boersma, "My Job Is to Protect the Firm's Culture," *Financial Times*, May 9, 2012.
23. Paul Woodruff, *The Ajax Dilemma: Justice Fairness and Rewards* (Oxford, England: Oxford University Press, 2011), 120.