Introduction

Benjamin Graham wrote in *the Intelligent Investor*, that "Investment is most intelligent when it is most business-like."

If we want to get to the core of this idea, we probably need to study company culture – because culture is the foundation stone and the DNA that behind a firm's attitude toward doing business in its field.

This paper aims to shed more light on this topic with the help of the best individuals and companies I know that focus on qualitative company research and specifically culture.

I wrote it as part of my remote internship with Guy Spier at Aquamarine Capital.

In addition to this being a first draft, you should know that I am no expert at studying company culture.

Although I have had some exposure to the topic in my role as an investment analyst, I come at this with the perspective of an intelligent layperson, and perhaps with the benefit of fresh eyes.

The purpose here is to share some of what I've learned and to prompt conversations.

You will, no doubt, read things that you disagree with and will also see gaps in my knowledge. But with that in mind, please send me your thoughts – as I will revise and update this discussion based on your and other readers' feedback, before recirculating this back out to you. My email is roilipovetzky@gmail.com

<u>Appropriate culture research can be a valuable but not very popular tool</u>

Some of the best performing investors put more emphasis on company culture: Berkshire Hathaway, WCM Investment Management, Polen Capital, Akre Focus Fund, Lindsell Train, Fundsmith, Marathon Asset Management, AKO, Baillie Gifford and more.

"..Strong cultures can persist long after the careers of those who put them in place. Still, sceptics might ask, why should investors bother with something so ineffable, so intangible? Well, the evidence suggests that culture pays" Marathon Asset Management[1]

"The three best operating companies I'm aware of are Costco, Kiewit and Glenair. There is nothing remarkable about the product or field for any of these. But there is something remarkable about the culture of all three." Charlie Munger[2]

In addition, and even more important, the best companies themselves put more emphasize on culture:

[1] Capital Returns by Edward Chancellor – Page 102
[2] A talk to Capital Group executives – Intelligent Fanatics

"The very foundation of Starbucks, our true competitive advantage, is our culture and guiding principles." Howard Schultz, Starbuck founder[3]

"Our final advantage is the hard-to-duplicate culture that permeates Berkshire. And in businesses, culture counts." Warren Buffett[4]

Culture – Part of a company's DNA:

So what is company culture, really?

Culture is best described when a company employee talks about "the way things are done here." It's behaviour and values that are rooted in the heart of the organization. Those values and principles might have existed since the foundation of the firm. The company's employees see those values as the company's mission as well as their own, and ideally are measured, remunerated and promoted in light of those values.

Why is it so important?

Culture is part of a business's DNA. In order to better understand a business, understanding culture is crucial. Company culture passes through the whole organization chain – from the CEO through the mid-level executive and to the recently accepted university graduate. Thus, it's important to understand: What characterizes the culture? Is it a good or a bad culture? Is it sustainable?

As it is a very qualitative metric, it's hard to quantify a good culture, and thus investors are mostly willing to see evidence for its existence and its influence on the company's competitive advantage and direction. A good culture provides value to customers, company employees and shareholders.

Culture can have wide-ranging implications during key changes, revolutions and difficult times. Goldman Sachs' deteriorating culture during the 1920s caused a disaster during the Great Depression of 1929, which made one of the founder's descendants, John Whitehead, write down the company values and rehabilitate this culture – a long and exhausting process that took many years.[5]

James Bullock, Portfolio Manager at Lindsell-Train, mentioned RELX as a company that went through the analog to digital era quite smoothly, with preserved market shares and wider margins. James says that although they have invested in RELX because of its valuable intangible assets, company culture was the reason for the company's successful transform during this critical point in time.

Unilever is another company whose culture helped its survival quite successfully through many events, such as countless mergers and acquisitions, reorganizations and global penetration. Another test to Unilever's culture was its ability not to be tempted to take the short term actions prevailing in their industry a few years ago, with main competitors performing aggressive cost-cutting strategies.

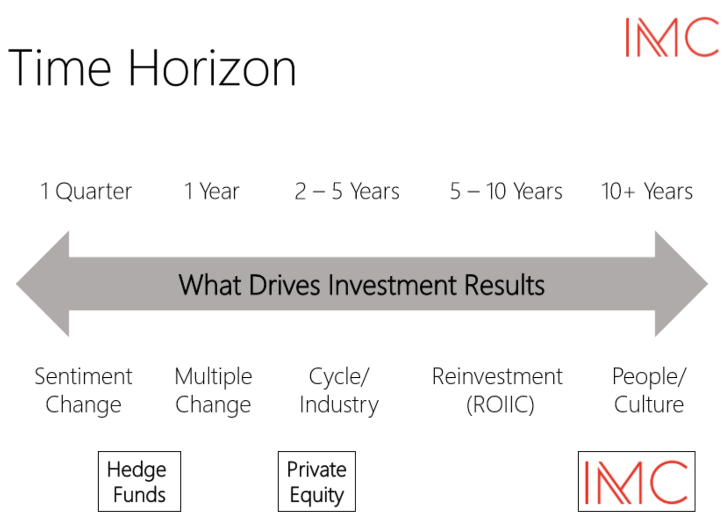
[3] Master Invest – Investment Masters Class
[4] Berkshire Hathaway – Letter to Berkshire Shareholders 2010 – Page 8
[5] The Culture Cycle by James Heskett – Pages 71-74

Company culture orientation – Depends on your time horizon

Company culture research is highly important for investors with a multi-year horizon. The longer your time horizon in investing, the more important culture research is.

"There aren't that many great cultures with alignment to their competitive advantage, but when you find them, you hold them for a long time..." Paul Black, WCM Investment Management[6]

You can also see this long-term and culture-oriented investor's correlation in this slide from the presentation of Connor Leonard from IMC:



Although culture is a key component in the making of a great investment, it should be complementary to the existence of growing competitive advantage and high barriers to entry.

Make sure culture is reinforcing the company competitive advantage

Lindsell Train is known for its really long-term investment horizon – maybe the longest I have ever heard of in the public equities world. James Bullock says they put emphasis on investing in strong brands with a very long heritage behind them. Company culture is highly important, but it's not enough for making an investment. Since they invest in a company for decades, they accept the fact that people will change and leadership will change, and so culture might deteriorate or become stronger.

A culture reinforcing a company's competitive advantage and moat is a very precious asset. It's important to emphasize that strong culture is necessary for the existence of a company in the long term and for outperforming its peers, but without other significant intangible assets such as strong brand, network effect, exceptional distribution channels or other significant competitive advantages, strong culture alone might not be sufficient enough in order to have high conviction that the company will become stronger over long periods of time.

[6] Capital Allocators Podcast – Meeting with Paul Black

Culture and remuneration:

Culture is not only about remuneration policy, even though that can affect culture in a material fashion.

What are the best remuneration techniques? There is not one right method, and it depends on the type of culture the company has.

"..I want to emphasize that some managers whom I admire enormously - and whose operating records are far better than mine - disagree with me regarding fixed-price options. They have built corporate cultures that work, and fixed-price options have been a tool that helped them.. "If it ain't broke, don't fix it" is preferable to "purity at any price". Warren Buffett[7]

The most popular place to look for remuneration matters is senior executives' compensation. How do they get paid, and does it look reasonable? It's also important to compare the highest paid executives to the average employee – what is the amount of inequality in the company? The investors I spoke with were not very fond of options since most employees don't see it as an ownership in the company. David Poppe, the former president and CEO of Ruane, Cunniff & Goldfarb, and now CIO at Giverny Capital Asset Management, tells a story of a CEO complaining that his employees were realizing their stock options too early in order to pay their day to day liabilities.

It's important to check that remuneration method is based on metrics that the employee can control directly. James Bullock says they don't like stocks or options compensation since it makes people dependent on stock price while they want employees to be compensated based on things they can control. Michael Faherty, Analyst and Portfolio Manager at Seilern Investment Management, suggests that if you find that employees, and especially managers, are compensated by a metric they can control, as an investor you should think about the risk of them being irresponsible because of that. An example would be compensation method highly dependent on earning per share growth. Long term investors prefer to see return on capital invested as a key compensation metric instead (of course, depending on industry).

Michael Feherty also notes that the remuneration method should be a sustainable one. He mentioned the remuneration by options for employees in tech companies during the Dot-com bubble: The stock options being given by the company were only valuable if the stock was increasing in value. As soon as stock prices were falling, the options were no longer a useful incentive.

You want to see a remuneration mechanism that makes the employee want <u>the success of the organization over the long term</u>. A remuneration method that compensates managers based on long-term results helps them to think long-term, take short term crises into better perspective and automatically repulses short-term-minded employees.

Incentives are not only about money, but also about reputation, respect, independence to express one's opinion and freedom to criticize but also to make decisions. It's important that an employee feels his work is recognized, not only by money. The incentives mechanism in a company is a way for

[7] Berkshire Hathaway – Letter to Berkshire Shareholders 1985

an outside investor to notice what the company pays attention to, but culture is a much broader thing; it's about people and the way they think.

Recruitment – A key part of culture:

The recruitment of the right employees is crucial. In order for company culture to exist effectively, emphasis should be placed on the recruitment of employees that identify themselves with the company mission and goal. The company mission should be an exciting one, particularly for the employees. It should be a big ambition, some supreme mission.

Fred Liu, Founder and Portfolio Manager at Hayden, tries to emphasize the importance of the recruitment process by explaining that the people you hire today might work for the company in the next years or even decades. Those people will train more employees and will influence them.

When it comes to recruitment, it's essential to focus on the amount of effort being made during the process in selecting the right people that can identify themselves with the main company values. A resume is not enough.

Amazon, Goldman Sachs and Mckinsey are example of companies that invest a lot in their recruiting process. The work environment is not very convenient, but it fits the company mission and values – a key part in making those companies the leaders in their respective industries.

"..Charlie and I believe that if you establish the right sort of culture, and that culture, to some extent, self-selects who you obtain as directors and as managers, that you will get better results that way in terms of behaviour than if you have a thousand-page guidebook."Warren Buffett[8]

The most common values in companies with great cultures:

The most common values in winning cultures emphasize innovation, the ability to change and adapt to changing environments and an obsessive focus on the customer. A long-term culture that enables change and independence within the firm is a great trait. However, as history proves, the ability to preserve a culture of change is a very difficult task, to say the least.

Michael Faherty says that Google is a great example of a company that encourages independence. It gives its people the ability to solve Google's problems and be happy about that since it gives them a high amount of independence to do so in the way they (the employees) want to do it. However, in many ways Google is being sneaky – in the book 'In the Plex', it's explained that often employees will spend their 20% time working on a Google problem, to the delight of management.

When it comes to company management, investors say that humility is another factor they look for.

There is no one way to create the right culture:

---

[8] Berkshire Hathaway Annual Meeting 2017

It's important to note that there isn't one right way to create the right culture. Cultures can be different among certain industries and can vary depending on company size and stage of its lifecycle. In a small VC backed company, it's important to have a high energy culture that attracts people to be a part of a big mission that requires much time and effort and enhances growth. In a large company such as Unilever, such culture will be less likely to work since the company doesn't need to try and to grow at a very high rate; that kind of behaviour might even cause some damage.

It's also important to notice the differences in culture between industries. Fred Liu is a great example for an investor focused on tech companies. For that reason, he looks for companies with tech supportive cultures, which means more emphasis on innovation, creativity and a very lean business model. If one looks for companies that are dependent on distribution, such as Pool Corp, one should put emphasis on assessing the company culture in terms of relationships, cooperation and sales. Size and maturity of the company are also important – Does the company able to sustain its culture? If it becomes global, can it sustain its culture in other geographic areas?

Fred Liu gave an example that by using Glassdoor and also by directly speaking with employees, he and his team noticed a company having a very flat hierarchy so that some 20-year-old guy can explore a new market with a lot of independence. That is something very important in tech companies. In a business like SE, you need no bureaucracy; the organization needs to be very flat in tech in order to move quickly.

Some investors claimed that Goldman Sachs might be an example of a company that has a great culture even though it might not fit to other industries. Their employees' work-life balance is very uncomfortable and employee turnover is high. On the other hand, the exit opportunities and the reputation of the company in the business world make people want to work very hard at Goldman Sachs.

""One solution fits all" is not the way to go. All these cultures are different. The right culture for the Mayo Clinic is different from the right culture at a Hollywood movie studio. You can't run all these places with a cookie-cutter solution.." Charlie Munger[9]

Assessing company culture – suggested sources and methods

One very important thing I noticed is that culture research involves emotional intelligence. You should have the ability to reach people, make them want to speak freely with you, notice the way they feel about the company in its values and also note when they are biased or not very authentic. You need to see if you can trust a person – Warren Buffett can see if he trusts a person in a few minutes; that's how fast he can close a deal of billions of dollars. You need a level of intuition and emotional intelligence for that.

".. What you are doing is building a mosaic when you're going after culture. A lot of people don't do it because you can't quantify it, you can't put it in a box and score it, or scale and number ranking. You really have to build a mosaic." Paul Black, WCM Investment Management[5]

[9] Corporate Governance According to Charles T. Munger By David F. Larcker, Brian Tayan

When it comes to culture research, investors might try to reach anyone they can speak with about the company. The rule is to look for a <u>large</u> amount of <u>relevant</u>, <u>objective</u> and <u>rare</u> pieces of data (with the limit of public information regulation of course). One should prefer data and try to avoid opinions. Another point to keep in mind is that sometimes it's better to ask indirect questions (but to have the direct question in mind) in order not to influence the interviewee.

- Speak to **consumers**. Consumer **surveys** are more controversial as a source. Surveys are more useful in a big market with many clients and when combined with other sources – in order for the conclusions to be sufficient enough. You might also want to call customer relations and learn how the company treats clients.
- Company **visits** and **current employees**. David Poppe says he really likes to visit shops and talk to salespeople. When he visited some of Costco's warehouses, about 20 years ago, he spoke with mid-level employees. He could see immediately those were really high quality people who were very dedicated to their job and their company. O'Reilly is another example of a company that, when you visit its stores, you meet people who see the place as their ultimate career and love to work there. In businesses that don't have physical stores, such as software companies (let's take Constellation Software as an example), you can attend events and meet employees and senior executives.
- **Ex-employees**. You should always take into account how biased the person is: Did he/she left on good or bad terms? Michael Faherty says the most interesting part is to find employees that didn't finish on good terms but have great things to say about the organization – "I had the worst manager but the organization itself is amazing." It's really essential to understand an employee experience with the company, their job qualification and the requirements. You should try to understand the recruitment mechanism in the company. How did their time at the company affect them in their current job?
- **Competitors**. Do they have respect for the other company? "We don't want to compete with this company in that specific market since they just don't give up on any sale." – that's the kind of sayings you are looking for. Fred Liu gave the example of speaking with some employees of an SE competitor named Lazada. One of Lazada's employees said that his personal account is invested in SE stocks. Some other employees of competitors said that people at SE work much harder than others in the industry.
- **Suppliers**. How does the company treat suppliers? Does it push them too much?
- **Friends** and **other investors** which investigate the same company or a competitor. Fred Liu says he knows of other funds, who routinely hire private investigators in order to follow and learn more about company management, the way they live and how humble they are. You can also search for long-term shareholders in the company and ask them how the management treated them.
- **VC investors.** According to Fred Liu, it's also very useful to have connections with VC investors since they might have spent a lot of time with the company and accompanied management from the private stage. They should know the characteristics of the founders really well and might have a very intimate relationship with them.
- **Journalists**. Journalist friends can also be very helpful says Fred Liu. A well-known, great qualitative investment firm in New York named Select Equity Group writes on its website: "Our

due diligence process often includes extensive fieldwork conducted by research analysts in conjunction with our internal Qualitative Field Research team, including several ex-investigative and business reporters."

- **Facebook groups** and **forums** where people complain about or praise the company
- **Outsourced service providers.**
- **Glassdoor**, **LinkedIn** and **job forums**. These can help you understand how people feel about working in the company.
- **Industry forums** and simple **Google search.**
- **Expert networks** such as **GLG** and **ThirdBridge**. They might be useful, but it is better to use them as a complementary source to other sources in order to attack the subject from many directions so you have a sufficient sample of data.
- **Company reports**. These might be more useful in several countries than others. The topic will be discussed later.
- **Management**?

Meeting with management

Most investors I spoke with agreed that meeting management should be at the end of the process. What do you want to see? You might want to understand if management really listens to customers and employees rather than just talking, how customer-focused it is, if it is too promotional, and understand the difference between the way they see the business and the way their competitors see the business. Girish Bakhoo, Partner at TenCore partners, says that current management is highly important since culture evolves over time. Even if values were established by the company founder many years ago, current management has a high influence on the culture's direction and the company's execution.

Trust is a very important issue when it comes to meeting with managements. David Poppe says that Bill Ruane definitely influenced him in that regard. Bill quoted Warren Buffett, as a close friend of his, suggesting the following test: "If you'll be in the desert for ten years and have to deposit your money with somebody, will you trust this person?"

Another interesting idea is to feel how openly the management is speaking about business. Do the CEO and senior executives read about business? Do they read about culture and how it drives performance? You might notice such a management. Stripe CEO Patrick Collison can be such an example.

Others claim that they find management afraid of speaking openly with investors because of regulations or being quoted and receiving public criticism. You might want to use company management of one company to talk about a competitor, but an indirect one. Speaking to management is less helpful today than it was ten years ago because of public criticism; regulation, etc. Speaking with management of small companies might be more effective than speaking with huge companies' management which have been trained by their investment bankers on how to speak with investors.

James Bullock says that many times they made a substantial investment without even meeting with management.

<u>Culture turnaround – Is there such an animal?</u>

"I think it's a lot easier to build a new organization around a culture than it is to change the culture of an existing organization. It is really tough. And I like that fact, in the sense of Berkshire. I mean, it would be very tough to change the culture of Berkshire. It's so ingrained in all our managers, our owners. Everything about the place is designed, in effect, to reinforce a culture. And for anybody to come in and try and change it very much, I think the culture would basically reject it." Warren Buffett[10]

Michael Faherty says that while creating a new business and planning its culture in advance can work, doing that with a living and moving business is a completely different story. Try to educate an old man or fix a moving car – it's almost impossible.

Culture turnarounds are really hard to perform. Culture can be upgraded, but it is quite difficult to change. David Poppe says that Sequoia had been an investor in TJX for several years when the CEO changed in 2004. The new CEO upgraded the culture, mostly by emphasizing training and improving the quality of senior management. As a result, the company transformed from a fairly good investment to a spectacular one. In his words, life is too short; it's better to look for businesses with an already existent strong culture.

I found that successful culture-oriented investors look for companies that have great cultures in the first place. The most prevalent turnaround they have noticed was in situations where the company's culture was interrupted by some manager, but then someone else brought that culture back on track.

It's much easier to change strategy than to change company culture

James Bullock says that at Lindsell Train they had invested in Shiseido and Prada, where in both cases the thesis included a turnaround, both already had the right culture, though they needed a change in strategy. At Shiseido, there was a strong brand with a great heritage and good market share, but it was clear that the company hadn't been managed in a way that maximized its potential in the aspects of strategy and distribution channels. The new CEO, Masahiko Uotani, who came from Coca-Cola Company, brought a new and more modern spirit into the company, changed the remuneration method and the operational metrics managers should watch and switched the prevailing language to English. In the case of Prada, a family-owned business, Lindsell Train hasn't seen any culture problems. It's a traditional business with good heritage and a strong brand, but again, the management missed some distribution channels and especially the rise of ecommerce in their sector.

Girish Bakhoo thinks that cultures usually change in a bad fashion and not the other way around, even though he noticed a good change in MasterCard, Fiat-Chrysler and Microsoft. The change resulted from the presence of one unique leader.

<u>Owner-operator companies – A controversial topic:</u>

[10] Berkshire Hathaway Annual Meeting 2010

Some culture-oriented investors say culture is more than a management only issue, and that's why they think the owner-operator model is less relevant. Others say that they prefer family-owned businesses because of the "skin in the game" effect on behavior. When it comes to a family business, management sometimes holds this huge stake of company shares. They know it's not only their reputation, but also an investment in their children and grandchildren – in other words, they might have an investment horizon of decades.

Fred Liu says that almost every business he ever invested in was founder led. And even those that were led by hired managers, were still able to retain the "founder mentality". He thinks it's about the manager having an emotional connection to the company and being able to make decisions with the firm's long-term competitive position in mind.

What are the differences in cultures among countries?

"I think it's hard to judge corporate culture in the foreign countries as well as we can judge it in our own". Charlie Munger[11]

In reading company reports, one might see the gap between cultures in different countries. The Chinese are known for providing fewer details – does it means culture of a Chinese company isn't a good one? Not necessarily. In the United States companies are more transparent, and the greater the amount of relevant details one company is providing, the better sign it is. Management that writes direct letters to investors is seen as more shareholder-friendly.

Fred Liu says that when you research a specific industry, you start to notice which details are more important and which are less. Then you can be much more aware of a company hiding something.

Others note that it's not only about reports. An example was given that Scandinavian companies have great business models and cultures in their own countries but face difficulties in exporting those traits to their operations in other European countries.

Another claim was that Japanese companies have a big advantage of usually having very loyal employees with very low turnover. They are also known for slow decision-making (a bit problematic in very dynamic industries such as tech).

Key questions when trying to perform a company culture Scuttlebutt

Fred Liu says you should always base your conclusions on actions and not words only. When you ask the following questions, try to look for examples.

- How are decisions made in the company? (Try to find specific examples.)
- What is the level of freedom the company's employees have?
- If the project the company is working on was given to a competitor, how quickly would it be approved?
- What differentiates the business? Why can't other people do what they are doing?

[11] Berkshire Annual Meeting 1998

- What will make the business survive for the long term? How will the company sustain its return on capital invested in the long term?
- Questions for the employees and customers – How did the company improve today/this month/this year?
- How does the company get feedback from customers in order to understand the value it provides to them? How does this process work?
- Where do graduating students of the company's specific profession wish to work?
- What three things would a company employee tell a friend about how to be successful in his company? [5]
- How important is the recruitment process for management? What are the most important criteria when recruiting new employees?
- If the culture is not working for an employee – why is it about, usually? What is really hard for new hires to get used to in this firm? [5]
- In a company where R&D is an important factor – what do they do in order to preserve engineers? (Same question for any other important division in the business.)
- What is the remuneration policy in the company?
- How does management want the customers to remember the business? How does it want to be remembered in the pages of history? What does it want to be known for?
- What is the appropriate growth rate for the business? (Try to understand how much the management cares about stability and risk management.)
- Of their competitors, who do they respect the most? Why is that?
- Is the management promoting from within the organization?
- What is the churn rate of the company employees?
- How did the company perform during difficult times? What were the management's actions?

Reading and resources:

The main sources for this paper were:

- Personal interviews I have conducted with great investors and analysts such as David Poppe, the former president and CEO of Ruane, Cunniff & Goldfarb, and now CIO at Giverny Capital Asset Management; Fred Liu, Founder and Portfolio Manager at Hayden; Girish Bhakoo, Partner at TenCore partners; James Bullock, Portfolio Manager at Lindsell-Train; Michael Faherty, Analyst and Portfolio Manager at Seilern Investment Management, and other investors from well-known qualitative funds who preferred to stay anonymous.
- The book *The Culture Cycle* – One of the best books ever written on culture according to several culture-oriented investors – and the book *Capital Returns* by Edward Chancellor.
- Berkshire Hathaway's annual meetings, Warren Buffett's letters to shareholder and past interviews with Warren Buffett and Charlie Munger.
- Interviews with Paul Black, Portfolio Manager and Co-CEO of the famous culture-oriented firm WCM Investment Management.

Further Resources

Many great investors agree that the best resource to learn about culture is to read biographies – whether they're about companies, leaders or countries.

Michael Faherty suggested reading about sports as a mechanism. It should be useful, he mentioned, to learn specially from team sports that cause people to work with others, where during events and in the months leading up to them, there is a clear and defined goal that everyone works towards and where there is direct and unambiguous feedback along the way. This direct feedback is very valuable and allows the organisation (the sports team) to quickly readjust its course, like a ship sailing toward a destination. You can find some stories about teamwork and very direct criticism, such as the Chicago Bulls in the 1990s or Barcelona in the last couple of years.

It might also be useful to invert and look for books on bad culture. David Poppe suggested some books such as *Liar's Poker* by Michael Lewis and *Fiasco* by Frank Partnoy that show the example of a culture encouraging short term-ism and not working for your client.

Among books being recommended on the subject: *Invested: Changing Forever the Way Americans Invest* by Charles Schwab, *The Innovator's Dilemma* by Clayton M. Christensen, *Built from Scratch* by Bernie Marcus, Arthur Blank and Bob Andelman, *Good to Great* by Jim Collins, *What Great Brands Do* by Denise Lee Yohn and of course, one of the sources of this write-up – *The Culture Cycle* by James Heskett.