Ninety One

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Investing for a
world of change

Culture as a driver of sustainable alpha

Using insight into workplace practices to identify investments with long-term potential

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The fast view

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- Academic research strongly indicates that corporate culture drives business performance and stock returns.
- Because culture is challenging to evaluate, it is often poorly understood and consequently may be mispriced – suggesting an opportunity for active investors.
- Ninety One’s Multi-Asset team has developed a framework for appraising corporate cultures, with the aim of helping portfolio managers and analysts identify investments with underappreciated long-term potential.

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About Ninety One

Ninety One is an independent, active global asset manager dedicated to delivering compelling outcomes for its clients, managing £130.9 billion in assets (as at 31.03.21).

Established in South Africa in 1991, as Investec Asset Management, the firm started offering domestic investments in an emerging market. In 2020, almost three decades of organic growth later, the firm demerged from Investec Group and became Ninety One.

Today the firm offers distinctive active strategies across equities, fixed income, multi-asset and alternatives to institutions, advisors and individual investors around the world.

Investment involves risk; losses may be made.

Introduction: capturing the culture advantage

Business leaders have long been vocal about the importance of culture in driving company performance. Despite this, investors rarely incorporate formal appraisals of corporate culture and workplace practices into their investment decision-making.

Few people would argue that culture doesn't matter. Most of us have seen at first-hand that the way a company is run – and how work is done – can strongly influence productivity, innovation, customer satisfaction and ultimately business success.

We think culture is often overlooked simply because it is difficult to quantify and measure. But it is precisely in culture's multi-faceted, hard-to-pin-down nature that we believe the alpha opportunity lies for active investors. If culture is hard to assess, there's a good chance it will be mispriced.

In this paper, we introduce a framework Ninety One has developed for assessing corporate cultures, with the aim of helping our portfolio managers and analysts identify investments with underappreciated long-term potential. For a detailed discussion of the framework, please see 'The Corporate Culture Advantage'.

> If culture is hard to evaluate, there is a good chance it will be mispriced.

A business leader's view of culture...

3M

William McKnight

"If you put fences around people, you will get sheep. Give the people the room they need."

Evidence that culture influences shareholder returns

Appraising culture may be tricky, but the academic evidence suggests it's worth the effort. Research provides strong support that culture – which we define as an organisation's work practices: how it is run and the way that work is done[1] – influences business performance and stock-market returns.

For example, studies by Professor Alex Edmans at the London Business School found that the top 100 firms in the 'Great Places To Work' survey – which he used as an indicator of good cultures – had higher abnormal stock-market returns following their inclusion in the ranking.

One of his analyses suggested these companies delivered stock returns that beat their peers by 2.3% to 3.8% per year over 28 years, and generated profits that exceeded analyst expectations.

The implications of this research are that: (1) culture is one of the factors that drives business performance; and (2) the stock market is slow to recognise its value. Edmans estimates that it takes the market four or five years to price employee satisfaction into share prices.

> Research provides strong support that work practices influence business performance and stock-market returns.

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1. Academics commonly define culture as 'the set of norms and values that are widely shared and strongly held throughout the organisation'. This is of limited use for investors as it is very difficult to reliably identify norms and values. More useful for our purposes is the 'practitioner's' definition of culture, which focuses on workplace practices and organisational systems.

Using culture evaluations to inform investment decisions

For investors, the insight that corporate culture can influence business performance (and may be mispriced) is only useful if it can be applied in a way that helps them make better decisions.

Some investors have tried to assess corporate cultures by scoring companies based on their policies (for example, whether they offer parental leave). There are two major flaws in this approach. First, the existence of a policy doesn't tell you whether it changes behaviour. Many companies report how many hours of staff training they supply in a year, but does that tell you how well they nurture talent? Second, and more seriously from an investment perspective, this information is easily obtainable and hence likely to be priced into a company's stock-market valuation.

We took a different tack. Our starting point was to recognise that the most valuable insights into culture may lie in non-financial, non-reported data. That's because companies are complex human ecosystems, elements of which aren't visible – or at the very least opaque – from the outside. Consequently, cultures can only be truly appraised by getting close to a company.

We think this presents an opportunity for Ninety One. As an active manager, we conduct detailed analysis of companies all over the world and routinely engage with them, often over many years. We believe that gives us an ideal vantage point from which to gain differentiated insights into corporate cultures.

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Ninety One's culture framework

To capitalise on this advantage, we initiated a research project – working closely with Professor Edmans – to identify the key attributes possessed by companies with strong cultures. Our ultimate aim was to use our bottom-up approach to analysing companies to identify those with strong cultures, and in doing so to uncover businesses with long-term potential whose value may not be fully appreciated by the market.

By combining our analysis of businesses with the empirical evidence, we created a culture framework, which comprises two core components:

1 The universal perspective

We have identified four cultural attributes that arise more often in high-performing, high-quality, sustainable businesses over time.

2 The contingency perspective

Elements of culture are valuable in certain circumstances. We have developed a methodology to help us analyse whether a company's culture is consistent with its specific circumstances and business strategy.

Our culture framework is described in detail in our paper 'The Corporate Culture Advantage'. We summarise the key elements overleaf.

1 The universal perspective

The four 'universal' features of strong corporate cultures that we identified, which are generally desirable across industries, are as follows:

1. Ownership mindset:

Businesses that create a strong sense of ownership in their employees encourage each individual to perform at their best. Successful companies have been able to establish this sense of ownership through empowerment, entrepreneurialism and decentralisation.

Supercell, a Finnish e-gaming company, is one of the most human-capital productive companies we have come across. The gaming industry is prone to cycles of hits and failures. Yet Supercell has created five hit games and generates 8x the revenue-per-employee of a major competitor. Decentralised authority is key to Supercell's success, with game-development teams treated as independent companies, known as 'cells'. Supercell's boss says his ambition is to be the "world's least powerful CEO".

2. Recognition:

Companies with strong cultures are able to create broad-based identification with the company's success and a sense of equity through ensuring workers receive fair pay. They motivate staff to perform well via a combination of monetary and non-monetary rewards (the evidence suggests that, in recognising achievement, small gestures matter).

Costco, the largest wholesale membership retailer globally, has built a strong reputation for paying fairly and rewarding loyalty. That partly explains why Costco's sales-per-employee are close to double the US retail average, while employee turnover is the lowest in the industry. Costco pays above average, but when turnover costs and productivity are factored in, its labour costs are lower than its competitors.

3. Trust:

There is a strong link between trust in an organisation and corporate performance. One of the most common features of high-performing cultures is psychological safety, whereby business environments foster open dialogue and encourage diverse perspectives, and where employees feel able to innovate and experiment. Trust is built when management teams are credible. That stems from effective two-way communication.

Google-parent Alphabet's X Development division, aka 'The Moonshot Factory', works on potentially revolutionary projects. It has a reputation for investing huge amounts in businesses that ultimately failed, but it has also produced several business successes. Tolerance of failure is one of the foundational cultural principles at X. It even offers financial rewards for team members who shut down projects likely to fail. Psychological safety is a cultural feature that permeates many Alphabet businesses.

4. Support:

Businesses with a good 'support' element to their cultures empower staff to do their jobs well. They typically have measures such as mentorship, coaching and methods for establishing internal personal networks, and they create a horizontal information flow throughout the business. They also exhibit talent mobility (i.e., they move and promote talented individuals), which improves communication and value creation across the business.

The founders of Home Depot, the largest home-improvement retailer, established a unique management construct called the inverted pyramid, which remains in place. The executive team sits at the bottom of the pyramid and the associates serving customers are at the top. As one of the founders put it, "if we take care of our associates, they'll take care of our customers, and everything else will take care of itself[2]". Home Depot boasts industry-leading asset and inventory efficiency, and cash returns on investment of 22%.

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2. Interview with Michael Jones, senior director of customer care at Home Depot https://execsintheknow.com/magazines/april-2020-issue/creating-a-culture-of-excellence-remarkable-customer-experiences/

2 The contingency perspective

As well as identifying universally desired cultural work practices, our framework recognises that some elements of culture are valuable in certain circumstances – i.e., their value is contingent on the type of business and the industry context. Our culture analysis therefore includes examining whether a company's workplace practices are appropriate for its business model and strategy.

To assess the appropriateness of a given culture, the contingency element of our framework includes separating businesses along the following dimensions, as the best companies within each grouping tend to manifest similar cultural attributes:

Cost and risk: businesses that are required to focus on costs and/or managing risks need to minimise variance, have a lower tolerance for failure, and put a greater focus on process optimisation. Employee autonomy is less valuable in such companies.

Quality: businesses that are focused on quality products and services prioritise the customer experience. These businesses require workplace structures that place greater authority and decision-making power in the hands of those closest to the customer.

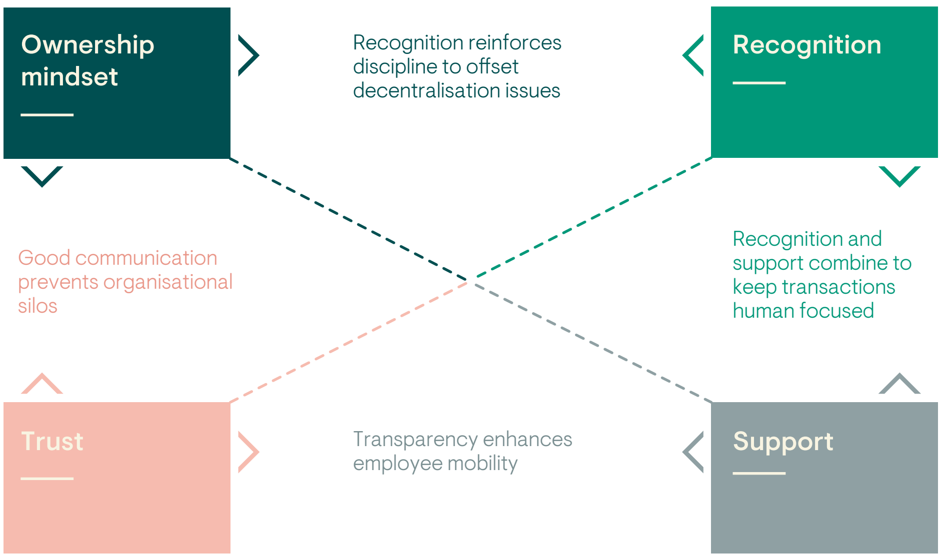
Flexibility: businesses that are focused on flexibility prioritise having leading products at a given point in time, which means relentless innovation. In these business settings, cognitive diversity and a high degree of psychological safety are critical, which tend to manifest in small autonomous teams.

> Our culture analysis examines whether a company's workplace practices are appropriate for its business model and strategy.

Interaction effects: getting the right balance

To appraise corporate cultures, it is not enough merely to identify whether certain characteristics (universal or contingent) are present. It is also necessary to consider how these features interact. For example, decentralised decision-making – a common feature of cultures with a strong ownership mindset – may lead to a lack of discipline and inefficiencies. A strong culture of recognition, in which rewards and incentives reinforce discipline and establish clear performance standards, can counteract this tendency.

In our culture assessments, we aim to understand the total influence of a culture on business performance. A summary of some of the interaction-effects of the four universal culture characteristics is shown below.



Source: Ninety One.

Applying culture insights to gain an investment edge

With the steady transition in balance-sheet dominance from tangible to intangible assets, people and culture are growing in importance. We increasingly find that a company's culture can influence its investment-return potential.

Evaluating culture is difficult, but we believe worthwhile. Understanding it can help investors identify businesses with long-term potential that may not be fully appreciated by the market.

Our culture framework, based on rigorous academic research, is designed to enable our portfolio managers and analysts to build a picture of a company's culture and embed a cultural lens into fundamental company analysis.

Companies are complex systems and typically opaque to outsiders. We believe the most valuable insights into culture come from interacting directly with company management teams, as Ninety One's investment professionals do every day. To help them gain a deeper understanding, we have developed a series of carefully crafted questions designed to reveal the true nature of a business' culture and work practices. The questions were developed in collaboration with Ninety One's Organisational Development team to probe nuances and insights, rather than for the purposes of data acquisition or box ticking.

By applying the insights gained from these engagements and our researchers' wider analysis to our culture framework, we believe we can gain useful knowledge to inform our investment decisions.

For a full discussion of our research into culture and our analytical framework, please contact us for a copy of 'The Corporate Culture Advantage'.

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