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In focus

Why corporate culture matters – and how you track it

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The right corporate culture is key to a company's success. Why is it so important, and how can investors assess it?

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Culture is a slippery concept. We all know it matters, but that's where agreement ends. I'd venture most of us would struggle to define it. It's a challenge to articulate the culture at your own company, let alone a potential employer or companies across a portfolio. But just because something cannot easily be measured or quantified doesn't mean we should ignore it – in fact, for the active manager, there's a certain appeal in variables that can't be modelled. Analysing company culture relies on a long and deep relationship with a company as well as wide-ranging research.

What is culture?

There are over 50 different definitions of culture in the academic literature. But while it's hard to define, we all have a reasonable idea of what it means. For what it's worth, culture is considered to be an informal institution within an organisation; it's the values and norms that guide behaviour outside of what is covered by explicit rules or policies. It provides intrinsic motivation for actions beyond the prospects for reward or punishment. It's the spirit rather than the letter of the law.

The circumstances this year, for example, were not covered by any corporate policy. It is culture that has shaped behaviours – whether newfound home-workers reverted to doing the bare minimum – and the support companies provided to staff and clients. For some companies, Covid has revealed and bolstered the strength of the culture. Here at Schroders, employees raised £4.3 million for Covid charities, sent home-made masks and baked goods to colleagues, and organised countless glitch-y Zoom quizzes. Our CEO, Peter Harrison, even recorded a weekly podcast updating us on the health of the business and the minor dramas in his household, from his own ironing prowess to his son's saxophone lessons.

Why does it matter?

This definition indicates the importance of corporate culture. It is impossible for executives or legal to contract for every possible situation, and an effective culture fills in the gaps:

When corporate culture is working at its best, it reduces dramatically the agency costs within an organization because you have an invisible hand at work inside of each of the employees that helps to guide their decisions and judgments in a way that the overall corporation would desire it to be. – **Grennan**

As such, culture is often considered to be the 'secret sauce' of successful companies. It influences their ability to innovate and adapt in response to unforeseen problems and challenges. It determines their openness to dissent and debate, reducing the risk of fraud and 'cover-ups'.

For example, it is well recognised that companies such as Barings bank had a culture where mistakes were not tolerated. Rather than reporting his mistake upfront, 28-year-old Nick Leeson tried to make back the money he'd lost in unauthorised trades and eventually drove the company to bankruptcy.

In fact, as many as 85% of executives believe an ineffective culture increases the chances that an employee acts unethically or even illegally. In particular, an organisation that prioritises short-term earnings and share price performance may be more prone to 'earnings management' and aggressive accounting, endangering long-term value creation.

Interestingly, 40% of executives would turn down a project with higher lifetime value if it would result in worse near-term results; 80% of these attributed their decision to culture.

Our experience at Schroders also illustrates the value of corporate culture in human capital management. A strong and healthy culture makes employees proud to be associated with a company, making it easier to attract and retain talent. This is hugely valuable given the cost of recruitment and on-boarding new employees and the competition for the best talent in the knowledge economy. Head hunters typically charge 20–30% of first year salary, and even for small companies, on-boarding costs can run to $4,000 per new hire.

These are all potential reasons why studies find that companies with an effective culture (with obvious caveats around measuring this – see below) have better results with lower volatility. Research on banks finds that culture was correlated with their return-on-equity (ROE) performance through the financial crisis. Industry leaders are also more likely to have effective cultures than smaller rivals.

From a practical point of view, one obvious implication of corporate culture is in M&A activity. Of nearly 2000 US executives interviewed by academics at Duke University, over half would walk away from a 'culturally misaligned' target, and another third would pay a lower acquisition price.

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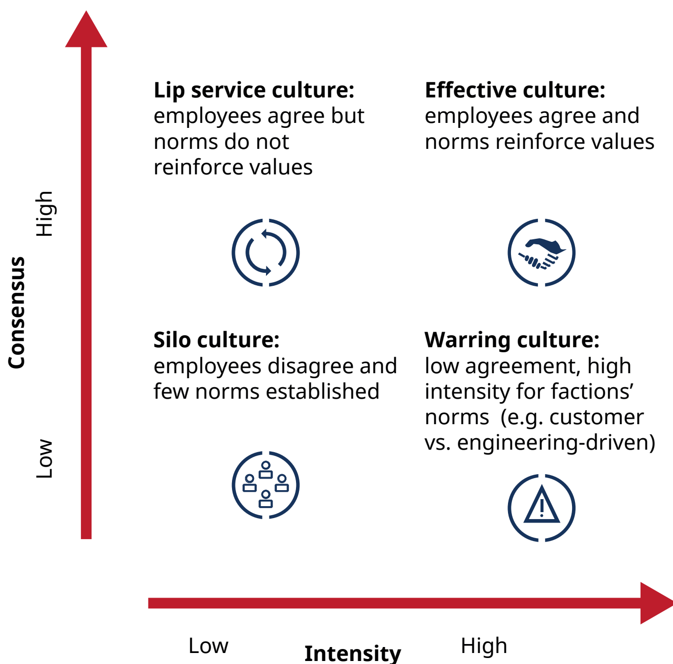
It is worth noting that we are careful in our choice of words here: when we say culture is effective we mean it is shared widely and deeply across an organisation, and absorbed by employees in such a way that it impacts their daily activities. This is not to say that all successful organisations have the same culture or taking any kind of normative view on what is a 'good' culture applying to all companies. It is possible to have an 'effective' culture that is results-focused and risk-taking, and different industries and geographies should – and do – exhibit different cultural tendencies. While it is interesting and informative for us to look at which values are strongest at the companies in which we invest, the strongest empirical results are actually for measures of cultural alignment and consistency across the firm rather than specific values.

Figure 1: What can effective culture look like?



Source: Jillian Grennan, 2020.

How do you assess it?

The above graphic highlights the importance of assessing the actual culture within the organisation, rather than the stated or target culture. A company's own articulation of its culture should be read more as goals – or, more cynically, as advertising – than indicative of reality. The challenge is figuring out whether they 'walk the talk'. An MIT study finds that 80% of large companies publish their corporate values on their website, but there is a negligible or even negative correlation between official statements and employee views.

This is a problem for most rating/scoring systems which rely heavily on the presence of specific policies and other 'formal institutions'. The presence of a policy or target may provide some information about the values or aspirations of the persons making the rules, but nothing about whether these are strongly and widely felt within the organisation.

Volkswagen and Wells Fargo both had ethics and integrity in their stated core values before their respective scandals; Boeing had integrity, safety and quality.

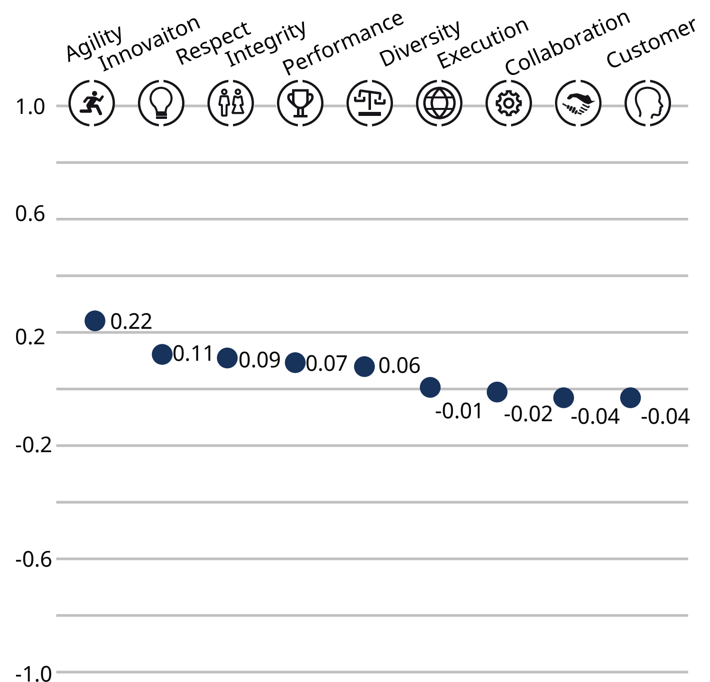
The rise of '#wokewashing' makes this even more challenging. #wokewashing is when a corporation, institution or individual says or does something that signals their advocacy for a social cause but also continues to cause harm to vulnerable communities.

Proper analysis of culture within an individual company is generally carried out by consultants using broad surveys and hours of interviews across different departments. This is clearly not feasible across a large sample, or really for anyone outside the organisation (though investors with a longstanding and intimate relationship with companies can have the best stab).

Various studies have tried to examine culture for large groups of companies, both the content – in terms of the specific values exhibited – and the effectiveness – in terms of the consistency and commitment across the organisation. The cutting edge of research tends to focus on natural language processing to tease out a company's culture from its website, regulatory filings, recruitment materials, earnings calls and – crucially – employee reviews.

The first challenge is that it is hard to create any consistent taxonomy for analysis because of the sheer diversity of company responses – MIT found over 60 distinct cultural topics mentioned by at least 1% of the nearly 600 companies in their study. This calls into question the usefulness of frameworks that try to plot all companies on a few key dimensions (e.g. risk-averse vs risk-taking; flexibility vs control). Instead, MIT's Culture500 project simply focuses on nine of the most commonly cited values in company documents and compares these to employee reviews.

Figure 2: Are companies 'walking the talk'?



Source: MIT, 2020.

When it comes to employee reviews, Glassdoor is the most popular source of data given its breadth: 70 million reviews for over 1 million employers around the world . Glassdoor also benefits from policies and standards that have been shown to reduce the polarisation of results and try to prevent companies from cheating.

However, it still has its limitations. Firstly it is very US-centric, and biased towards large, long-established companies which will inevitably have more reviews; there are similar sites in some geographies but not all. There is sampling error, because certain demographics are more likely to post on these kind of sites (younger workers, for example). The additional challenge for investors is that job review sites do not allow commercial use of its data (quite reasonably given the value of the data): we can generally access the headline scores but not the free text comments, which are far more valuable.

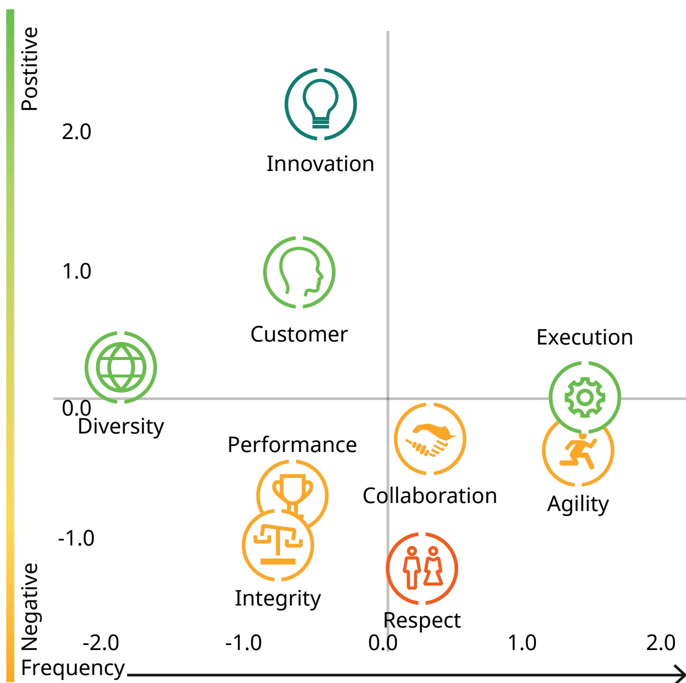
There is generally more flexibility for academic research, so we can try to leverage this. The Culture500 is certainly a useful source for large US companies: it covers companies that collectively employ over 30 million people, over one-quarter of private sector employees in the US. For each company, it scrapes reviews for the nine most frequently cited values and ranks these by frequency (the percentage of reviews that mention the value) and sentiment (whether it is discussed in positive or negative terms). We can use this to compare to official corporate statements and to get a high-level idea of the internal culture of a company.

For example, the chart below shows the mapping for Amazon: it will surprise few people to see that the company is highly regarded for innovation but criticised for a lack of respect. This is consistent with what we hear from the media and whistle-blowers about treatment of warehouse workers.

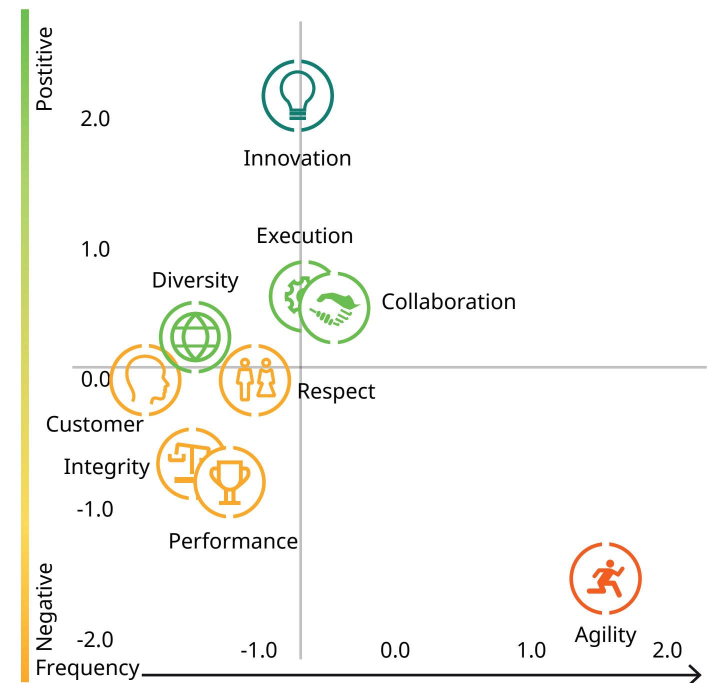
For Alphabet, we can see that positive comments on innovation are offset by surprisingly negative mentions of agility. But generally values like respect, diversity and collaboration are more highly ranked than at Amazon, providing some reassurance given historic employee unrest over discrimination. Interestingly, the whole of big tech is less likely than any other industry to have integrity in their values.

And of course there is nothing to stop investors reading through the comments for an individual company. While this doesn't lend itself to quantitative analysis, it can still be informative for fundamental investors as part of detailed analysis of a company and provides insight that is not available from other channels. For example, it can be used to cross-check or challenge the reported results of internal employee surveys. Recurring criticisms or an inflection point in the overall scores can be extremely useful to start a conversation with management. Job review sites are one of our regular sources when analysing companies and we have undertaken numerous engagements based on employee comments we have found on Glassdoor.

Figure 3:
Amazon Culture500 mapping



Alphabet



Source: Culture500. Note that the values for each company are normalised so that zero is the average for each value and the axes show standard deviations above or below the average on each dimension. Companies cannot strictly be compared side-by-side based on the values in their company-level mappings, but the site also provides comparison tools within industries for each of the nine values.

What about companies without a meaningful presence on any of these sites? An alternative approach is to try and deduce something about corporate culture from more measurable outcomes. As mentioned above, one of the key benefits of a strong culture is human capital management.

As such, we can deduce something about culture from looking at, for example, employee turnover. If staff are loyal to an institution and stay for a long time, it suggests they're doing something right. Texas Instruments, for example, scores highly in the Culture500 on measures of integrity, diversity, respect and collaboration: without this data, we could have drawn the same conclusion from the fact that over half the staff have been there for more than 10 years.

Despite being wary of policy or disclosure-based approaches, there is also some information to be gleaned from the presence of whistle-blowing channels and legal protections. Diversity (of all sorts) throughout the organisation is a reasonable indicator that a company has a culture of respect and collaboration. Speaking to the executives about their understanding of culture can be illuminating, and access to current or former employees through expert networks can be a useful source for a deeper dive or for companies with no Glassdoor presence. Interestingly, studies have found no consistent link with board independence or other governance indicators.

Researchers also recommend looking at what happens when actions are taken that are not consistent with a company's stated values: is there 'wilful blindness', showing an ineffective culture, or are there real sanctions?

The #metoo campaign has highlighted interesting examples on both sides. This is one of the reasons we have remained more sanguine about culture at Alphabet despite, or in part because of, regular incidents of employee protest.

In most cases these employees remain with the company and allegations of retribution against whistle-blowers are very rare, which suggests that the culture allows free expression and debate. And, even better, in many cases the senior leadership has responded to employee demands e.g. pulling out of a project for the Pentagon and ending mandatory arbitration for employees in discrimination trials.

A company that never ends up in the news may have the most effective, contented culture in the world; or it may be a ticking time bomb.

What determines culture?

Creating an effective culture is even more challenging than defining or assessing it! It is unsurprising that most experts say culture is shaped by a company's leadership, though this is a necessary but not sufficient condition given the importance of alignment across the company.

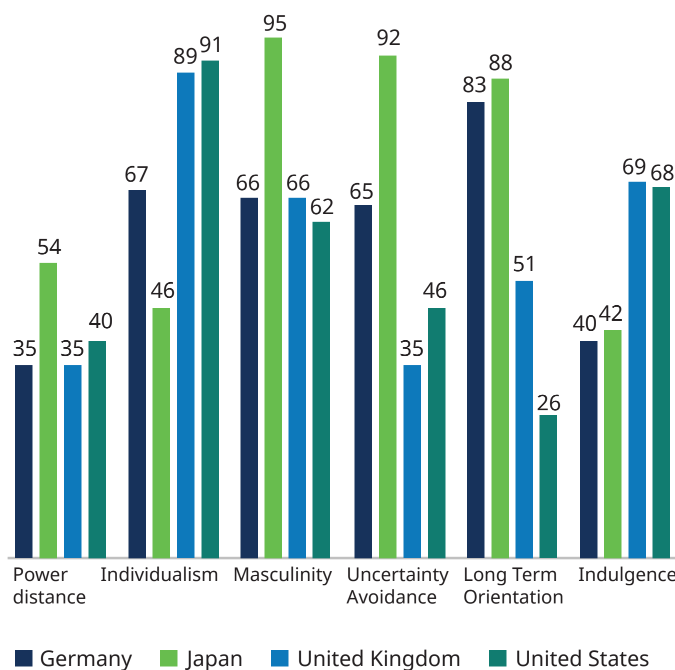
Other parts of the organisation such as human resources and, more surprisingly, the finance department can also play an important role. The latter influences the degree of focus on short-term earnings, analyst views and the share price. This can also be impacted by the market environment: countries (like the UK) which have done away with quarterly earnings should enable more long-termism within companies. Alternatively, today's market environment in the US in particular, with an extremely low cost of capital for innovative, risk-taking companies (Tesla, tech IPOs), encourages and rewards those cultural values.

Formal institutions – contracts, policies, incentives – can be used to some degree to influence employee behaviour and indicate desired values. For example, collaboration could be encouraged by incentive structures where your compensation is tied to the wider success of your firm or team as well as your individual performance.

However, the definition of effective culture is that it is goes beyond what is covered by contracts: for collaboration to be part of a culture, employees need to collaborate because its 'the right thing to do' rather than out of pure self-interest. An effective corporate culture thus requires employee empowerment and trust.

This is inevitably tougher in larger organisations and multi-nationals, where allegiance to your local team or business area is likely to be more meaningful than the amorphous corporate headquarters. The strength of national cultural norms in different geographies poses additional challenges for global companies, and investors trying to compare companies in different markets. Anglo-Saxon countries, for example, tend to have a more individualistic culture and higher risk-tolerance than Japan and Northern Europe:

Figure 4: The impact of cultural norms in different geographies



Source: Hofstede Insights.

The research on cultural alignment is encouraging because it suggests there can be a benefit from just improving the communication of corporate values within an organisation. In one study, inconsistencies between the descriptions of culture on the careers site, investor relations page and main website for US banks were found to be correlated with weaker ROE through the financial crisis, completely regardless of content. This is good news for companies as it steers them towards low-hanging fruit. MIT provides some suggestions on common problems with values statements, and how values can be more clearly articulated to the workforce:

- **Abstract:** Provide examples and guidelines to make abstract notions like 'integrity' more comprehensible in terms of how they impact behaviours. Many companies now include FAQs and/or case studies in their Code of Conduct.
- **Generic:** Focus on values that are more distinct and specific to your organisation rather than a generic list. Again examples can help, spelling out what 'customer service' looks like at an hotel versus an asset manager. MIT specifically recommends not choosing gimmicky acronyms that force you to shoe-horn in particular values: your values should not be determined by the name of the company!
- **Irrelevant:** Explain why they matter. This may seem blindingly obvious to those higher up but is still worth saying especially in larger organisations where staff may be further removed from the wider mission. Less than one quarter of large US companies do this now. For example, Netflix has radical candour as one of its values, because "we will learn faster and be better if we can make giving and receiving feedback less stressful and a more normal part of work life."

This is also handy for investors because it is much easier to check the visibility and consistency of the official message than the content. We can look at different parts of the website and documents: astonishingly, only 20% of US companies put their values on their recruitment site and the same percentage in their Code of Conduct. It is also a good sign when companies talk about culture, employees or qualitative performance on their earnings calls and in meetings, and when values are reflected in some way in management compensation.

How can investors influence culture?

Clearly culture cannot be installed from the outside. And even if investors could influence it, it is not clear that we should try to. Perhaps it is viable for some activist managers to conduct the necessary diligence to understand a company's cultural shortcomings and install more suitable leadership, but this will be the exception rather than the norm.

There may be more of a role for investors to engage where there are glaring problems – illustrated by, for example, Glassdoor reviews or poor outcomes data. In these cases, we can initiate a conversation with the management team and/or board and potentially push for new leadership or changes in incentive structures to try and establish a fertile environment for cultural change. For example, we have engaged with financial institutions in our portfolio to ensure sales staff are not compensated purely/mostly on quantitative targets which could encourage excessive risk-taking or fraudulent activity á la Wells Fargo.

However, in some cases investor pressure may be part of the problem. Particularly in the US market, where analysts tend to be more focused on short-term results, trying to please investors may push companies towards certain practices that could destroy long-term value. One study finds that investor resolutions passed at AGMs ¬(barring environmental and social related engagements which could skew the results) tend to result in stronger 'results-orientation' – focus on profits, returns etc. – but a deterioration in the strength of other cultural values such as collaboration and particularly integrity. This may impair the longer-term earnings power of the firm through the channels discussed earlier e.g. human capital management and compliance.

This highlights the danger of focusing our (and management's) attention on easy-to-measure factors and looking for short-term 'wins' from engagement. As long-term shareholders, our most important consideration should be that managers' incentives are aligned with long-term success and that we support companies that may need to sacrifice short-term earnings or dividends for long-term investment. We should conduct thorough research using a mosaic of qualitative as well as quantitative sources, and use our findings to engage with the company and its stakeholders. Lastly, we should encourage an effective corporate culture by pushing executives to talk about culture fluently, frequently and - above all - consistently with internal and external stakeholders.

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