

SLUDGE

Is a toxic culture poisoning your investment firm?

“When you have a lot of sludge in the system, you are not going to be making good decisions,” says James Ware, CFA

BY JONATHAN BARNES

Is there more to performance than performance? James Ware, CFA, founder of Focus Consulting Group, has worked with investment firms for more than a decade on what he calls “leveraging talent.” Great culture, says Ware, encourages great performing teams and great client service. In a research survey of 60 asset management firms, Ware found firms that best weathered the financial crisis (called the Focus 6) also scored highest in key



areas of leadership and firm culture. To describe the “culture effect,” Ware and his team have come up with a language of their own. The author of three books, including High Performing Investment Teams, Ware spoke with CFA Magazine about the effect of “sludge” on decision making, the problem of “the Red X’s,” and relating the three tribes of the asset management firm.

What’s the secret to great culture?

Here’s the problem a lot of firms have. As they grow, structures and processes that support clear roles and decision rights are needed. At the same time, these structures need to support the creativity and innovation that attract and retain the most talented people. Too little structure leads to chaos and no accountability; too much leads to bureaucracy, which can stifle people and even drive out your top talent.

Another big factor is compensation. The very best investment firms are good at setting fair and transparent compensation. They get the compensation issue right, and they get it off the table. That takes people’s focus off the money issue and puts it on three important things. One is mastery, the idea that you can get better and better at your job. Second is autonomy. This would be the structural process issue. If you have too much structure and process, people lose autonomy, they lose the freedom to do whatever

they’re talented at for most of the day. And third is purpose. People want to feel like their work is meaningful.

How do you “get compensation right”?

The key element is trust among team members. We get all the relevant people in the same room—the CEO and other senior people—and we say, “In the coming year, how should this bonus pie be divvied up? What should be rewarded?”

For an investment team, it’s usually three factors. Performance—how are they performing investment-wise? Performance should be rewarded. Also, business development—are they good at bringing in new clients, raising assets under management? Then there’s a factor for team scores and good citizenship. This is usually done with a 360 review kind of process. In other words, everybody gets rated by their colleagues as to how much they contribute to the team’s success.

Those are the three big pieces. If you let your team develop this through conversation and they sign off on it, then nobody complains about compensation—because it is clear, transparent, and fair.

How does culture become a competitive advantage?

The first step is a conscious commitment to culture. In other words, leaders recognize that culture is important. They get it. That’s true of most of your really good firms, whether we are talking about Wellington Management or Capital Group or State Street Global Advisors (SSgA) or any of the Focus 6 firms from our study.¹ The leaders need to be willing to live it themselves. To quote David Fisher at Capital Group, “Our culture is our only competitive advantage.”

In practice, it means asking four basic questions. First, how strong or cohesive is our culture? In other words, is there a core set of values that everyone shares? Second, how much “sludge” do we have in our system? Third, how engaged are our people?

¹ The Focus 6 firms are Snow Capital Management, Aronson + Johnson + Ortiz, Disciplined Growth Investors, Retirement Advisors of America, Forest Investment Associates, and a firm that chose anonymity.

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Are they really loyal and excited about being at the firm? Or are they looking around and taking calls from recruiters? Fourth, how effective are we in our decision making?

What's the link between culture and decision making?

In our surveys, 93 percent of investment people said culture is important to their firm's success. So then we asked them, "What are the benefits of culture? If you think culture is so important, what do you get out of having a strong culture?"

The answer that investment people choose is "better decision making." I find that fascinating because I don't think there is a very obvious link between the two. It's not like saying, "If you eat a whole lot of french fries, you'll get fat."

But if you look at the Focus 6, 73 percent of their employees say, "Our culture supports really effective decision making," whereas for the average firm in the asset management world, only 43 percent say that. That is wildly significant—at the 99th percentile level. These Focus 6 firms believe their culture has allowed them to make really good decisions. That is related to having less sludge. When you have a lot of sludge in the system, you are not going to be making good decisions.

What is sludge?

Sludge is unproductive behavior like power trips, bureaucracy, rumors, negativity, and defensiveness—these sort of things. We use the term sludge because a firm is like a finely tuned engine. Sludge slows down the efficient workings of the engine.

One of the firms that got in trouble with Elliot Spitzer immediately ran up 30 percent sludge (0 to 100 percent is the range) versus 10 percent for the industry. The legal trouble drove high levels of fear, which in turn drove behaviors like gossip and blaming. Within a year, that firm went under. Our research shows that firms with more than 30 percent sludge invariably fail.

Firms with a lot of sludge tend to be slow moving and less effective at decision making. Sludge is driven by fear and greed. What are the enemies of the great investor? Fear and greed. Fear and greed drive sludge. The opposite of that is trust.

It is no surprise that during the crisis, slow-moving and reactive behavior (and short-term focus) went way up for the industry. I've heard all kinds of stories about how people became focused on "What is going to happen today?" or "What is going to happen tomorrow?" People became very concerned with having safe portfolios—portfolios that weren't going to blow up or have clients asking a bunch of questions. Everything got very conservative and

very short term. Many firms basically stopped trying to find new ideas for the portfolio. They kind of got in the fetal position and just curled up in a ball.

What about sludge inhibits execution?

Sludge has an awful lot to do with trust. If you and I are working together and we get along well—we really trust each other—I don't need to double-check whether you actually did the thing that I asked you to do. I know you are going to do it. So that is a real benefit. It's not on the balance sheet, but it is a real benefit to have that level of trust.

One CIO reported that a single portfolio manager created so much sludge (i.e., drama) that everyone's thinking was compromised.

Despite the manager's skill at investing, which was considerable, he interfered so significantly with the team's ability to discuss and debate ideas that they moved him off the team. The CIO said the improvement since the change is remarkable: "I should have done it much sooner. The remaining team has high trust and virtually no sludge."

What can a leader do to encourage trust and candor?

First, get really authentic and real with yourself and say, "Do I operate that way? Do I believe that is the best way to run a successful organization?" At the end of the day, the people in the asset management world are trying to be successful. So if you don't think that candor and trust and accountability are important to success, you would say, "You know what, we are not going to play that way."

What we know from the leaders, those at the Focus 6 firms, is they have made a conscious decision to collaborate. They are going to win through collaboration, and they are going to model it themselves and reward people who play that way. They're going to punish people who don't. If you are really serious as a leader about building a strong culture that has characteristics like candor and honesty and accountability, you need to address the Red X's.

What are the Red X's?

Red X's are natural to our industry. They are people who are mavericks, who think differently, and who can take a stand against the market. The problem is that sometimes they can have a negative effect on culture. According to *The Cost of Bad Behavior* by Christine Pearson and Christine Porath, some of the effects of Red X's on other employees are decreased time at work or decreased work effort, time lost in worrying about Red X's or avoiding them, even a decline in commitment to the firm. So the costs are real.

A company we work with hired a Red X and, after a little time, they fired him. The same company hired him

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back and fired him a second time. This is a true story. Then they hired him a *third* time. When we interviewed his directs, the people who report to him, they said, “We would rather give our money to this guy than to Bill Gross at PIMCO.” That’s a really high endorsement. You can see why there was this love–hate relationship. They loved the alpha he could create, but they hated his effect on the rest of the people in the firm. He drove out talent. People left because they didn’t like working with the guy.

So what’s to be done?

It’s not an easy solution. We’ve asked rooms full of CFA charterholders, “Do you have a Red X in your firm?” and 75 percent said, “Yes, we have a Red X at our firm.” We asked the senior team of a firm in London, “Do you have Red X’s on the senior team?” and the answer was yes. Then we asked, “Are you a Red X?” Everybody said no.

The most popular fix is to “firewall” the Red X’s, isolate them, let them create alpha but not bug anybody. In another room full of CFA charterholders, a third of them said, “Fire the person.” The best way to do that is if the individual self-selects out. If the individual can go elsewhere and succeed, that is a good solution.

If the rest of the team supports the Red X and is sort of forgiving and the individual is open to feedback, then about one-third of the time, we have some luck in helping the Red X fit better into the system. Sometimes it’s structural. Sometimes the Red X isn’t being compensated for being a team player, so the Red X doesn’t give two thoughts about the team. You have to put something in their compensation to tell them, “It is important around here to be a team player. One-third of your bonus is how well you play with the team.”

How do you know if you’re a Red X?

Let your team know you are open to feedback. You could say to your colleagues, “Give me ongoing feedback about how I am doing.” One of the things that our firm offers is a 360 review for leaders or investment professionals. It includes something called a talent audit, which is 21 factors that play into the competencies of analysts and portfolio managers: “How good are you at gathering data, analyzing data, making decisions about data, communicating the data, etc.?” We get the people who know you best to do a write-up and an interview, and we feed the results back to you privately. That is a very good self-awareness tool. But people have to be open enough to go through that experience.

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it learning agility. Just think of Darwin. It is not the strongest or the fastest species that survive but the most adaptive. Well, you can’t adapt if you are not open to feedback.

Do you find that employee ownership is a factor in success?

It seems to be really important. This is a tough one to say in front of groups of investors because often they are from the bigger organizations. But in the spirit of candor, it has been my experience—and now the data support this—that when you have firms that are self-determining and employee owned (they don’t answer to shareholders and they don’t answer to a parent company), they tend to do better. All the Focus 6 firms are independently owned and operated. They are employee owned—in some cases, very deeply employee owned (perhaps 70 percent is in the hands of the employees and only 30 percent in the hands of the top two or three people). These firms have a sense that everybody is an owner.

I had a conversation with someone in a big European financial company. It had a boutique in the United States, and we were trying to sort out differences between the big parent and the little boutique. The real question for the boutique was, “Are we seen as employees of the mother ship—the big firm in Europe—or are we seen as partners?” The answer was employees. And there was a chill that came over the room—literally. And everybody kind of got it, that this was not going to work because that is not how investment people want to see themselves. They don’t want to be employees. They want to be independent operators, partners that get to choose their own future, choose their destiny.

How else can you “leverage talent?”

Our rule of thumb is you want to have 80 percent of individuals’ time in their area of genius and only 20 percent filing or filling out forms or whatever they need to do. We have worked with many, many investment professionals who, when they kept a log of their activities, found they are at 50 or 60 percent [time spent outside their area of genius]. We said, “That is not optimal. We really need to get creative and figure out how you can get to 80 percent.”

If you get there, it’s like a shot of adrenalin. That is what you want as a leader—you want to get your people aligned with responsibilities where they really feel, at the end of the day, that it was a great day. Warren Buffett has this great line: “I tap dance to work each day.” He just loves what he does. He loves it. It is not work for him.

This might be the heart of the interview.

It is absolutely critical. To people in the investment world who tell me they don’t really like investing, I very bluntly

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Lauren Topel

say, “Then get out of the field. Get out of the field and find something that you do well.” I’m not negative with these people, but find something you love. Don’t sit in this chair, because somebody would love to be in this chair.

What can you tell us about the “three tribes of the asset management firm” (investment, operations, and distribution)?

In some firms, you hear that the non-investment people are created as equals. But when we asked people in operations and distribution what they want, they said respect, appreciation, and empowerment. Why? Because they don’t feel they get it from the investment people.

We hear that the firm was started by investment people and that it is investment-centric, and the non-investment people feel somewhat disenfranchised in the organization. That creates friction. It creates almost a kind of class society, where you have the upper class and the lower class within the same firm. That can be a problem, because we asked rooms full of CFA charterholders, “Is it important for a firm’s success that the tribes work well together?” Absolutely, say 98 percent, “They have got to work well together for the firm to succeed.”

How do you bring the tribes together?

We work with organizations to show them the data. For example, is there a lot of turnover in operations and distribution? Are they losing good people? If you use our diagnostic tools, you might see that there is a lot of sludge in operations and distribution. Then you can hold up cold hard data to the investment leaders and say, “Guys, this is not just anecdotal and this isn’t just somebody complaining at lunch. This is a widespread phenomenon in your tribes.”

It’s not a malicious thing, and it is not mean spirited. It is an unconscious thing and lots of research shows that unless you carefully monitor it, it is very easy to develop a two-class society. It’s not easy to find the balance. I don’t think 10 percent of asset management firms do this well.

How important is having a language for all this?

When we talk about culture, language is hugely important. We always stress that one of the ways culture can become strong is to have shared mental models.

We discuss what we think are really important behaviors, such as curiosity, accountability, appreciation, and candor. Then we’ll say to the group we’re working with, “You find your own language that works for you.” One firm we worked with said, “We think it is powerful in meetings to look at someone and say: Tell the truth.” If a person is kind of stuttering and wanting to know what is

politically correct to say, they encourage their colleagues by looking at them and saying “Tell the truth.” Just get it out on the table. Whatever it is, tell the truth.

So everybody in the firm understands the language. “Green and red” is powerful because it’s so simple. Green means collaborative, win-win, I’ve got your back. Red is every man for himself and I don’t trust anybody here. We will have people say to one another, “Hey, that response sounded a little red to me.” Everybody in the room understands: “Hey, yeah, what do you mean by what you just said? Are you just looking out for you? Or do you have the team in mind, or what?”

What are other examples of language?

Another example is “above the line” and “below the line.” “Above the line” is green behavior. It is trusting, curious, and open. “Below the line” is reactive, fearful, distrustful. We’ll say to someone, “It sounds like you kind of went below the line.” The person might say, “You know what, you are right. I am kind of angry about what just happened, and I need a few minutes to get a coffee and take a little walk before I am back to my above-the-line mentality.”

“Fact and story” is another very powerful set of words. “Fact” is what everybody in the room would agree is a fact. So, for example, everybody agrees that $2 + 2 = 4$. “Story” is what we think but others may not. The problem is that so many people present their stories as facts.

Take the example of a portfolio manager I worked with a few months ago. In a room with distribution people, he said, “Performance is everything. You’ve got to be a moron if you don’t understand that it’s all about performance.” Well, he stated it like it was a fact, and you can imagine the impact that had on the distribution people: “So what, our jobs are meaningless?” Fact and story. Hold your story lightly. If it’s a story, don’t get a death grip on it. Just hold it lightly. **■**

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