New City Initiative

Alignment of Interest

How Culture Defines Boutiques

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of asset management..

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, a traditional "client-centric" approach has enabled entrepreneurial, owner-managed firms to emerge as an important force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author

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Jonathon is a Professor of Finance at Luxembourg School of Business, and has taught on the Masters in Finance program at London Business School. He has taught as a Fellow at Cambridge Judge Business School, leading courses at the MBA, MFin and MPhil levels, and as an Adjunct Professor at Columbia Business School in New York, where he has taught on the MBA and EMBA courses and supervised several research projects. Jonathon holds a Ph.D. from the University of Cambridge. He is a Chartered Financial Analyst® charterholder, holds the Certified Financial Planner™ and Professional Risk Manager certifications, and is a Chartered Financial Planner, Chartered Wealth Manager, Associate of the Chartered Insurance Institute and a Fellow of the Personal Finance Society.

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Foreword

When I talk to NCI's members, I am often struck by the commonalities. Notwithstanding different investment strategies and different fund sizes, there is always resonance when it comes to prioritising the client and acting in his or her best interests, building a symbiotic relationship that is prolonged and mutually beneficial.

These thoughts were the genesis of NCI and discussed at length in our earliest papers, laying the foundation for supporting a client-centric model of financial services that would help "fix a broken City" and herald the benefits of the owner-managed model within boutique active asset management. NCI has kept true to that vision, and thrived upon it.

This latest paper draws upon those core concepts, which we would summarize as 'organizational culture', and builds a foundation for the future, drawing upon NCI's past work and interweaving it with academic and practical authorities to draw a compelling conclusion: that the boutique active management sector is especially amenable to the development of positive organizational culture and that this leads to superior outcomes for clients.

To draw another analogy (and perhaps an investment idea for the truly long term!), planets that support life must be in a particular orbit around a suitable star: too far away or too close and you cannot have liquid water, a narrow band known as the 'Goldilocks Zone". NCI members, as boutique asset managers, inhabit a similar optimal zone: not too big and not too small, this paper shows that they are just right to support positive organizational culture and can do so in a way that larger active managers and passive funds cannot.

NCI supports truly client-centric asset management and invites new members who share that vision and 'culture'. I am pleased to be able to introduce this paper and hope that it acts as a catalyst for further work and discussion to advance the asset management and financial services industries that bring so much to the vibrancy of our economies.

Jamie Carter
Chairman, New City Initiative
Chief Executive, Oldfield Partners

Executive Summary

NCI considers how the organizational culture of its archetypal member – an owner-managed small or medium sized boutique active asset manager – can drive superior service and risk-adjusted outcomes for investors. A theoretical model linking organizational culture, by way of the firm, to positive investor outcomes is developed drawing upon academic sources: passive management cannot demonstrate such cultural linkage given the a priori absence of discretion and the transmission mechanism is attenuated for larger active managers. This model is considered further through the lens of empirical interviews with NCI members. NCI concludes that the owner-managed small to medium sized asset boutique active manager is especially disposed to the positive effects of organizational culture and the capacity for superior risk-adjusted investor returns.

Introduction

New City Initiative (NCI) has over fifty members collectively managing around £400 billion of assets. Predominantly owner-managed, NCI's members align their interests with their clients' in a transparent manner and, more broadly, seek to encourage competition, innovation and consumer choice within the UK asset management industry.

NCI has been a proponent of positive structural and cultural shifts within the asset management and broader financial services sector, both in the UK and elsewhere.[1] NCI's position is that the small and medium sized boutique asset management industry, epitomised by NCI's members, is key to this renaissance and must be encouraged to ensure innovation, consumer choice and broader economic benefit to society.[2] A core thesis of NCI's approach is the benefit of the owner-manager model and the effect that such a beneficial ownership structure has on alignment of interests with those of clients, acting as a natural catalyst for longer-term investment horizon, superior returns, co-investment and sensible risk management.[3] NCI supports well-conceived and proportionate regulation that works in the best interests of clients and avoids moral hazard: it does, however, consider that structural and cultural changes can be more effective and more sustainable than regulatory response.[4]

This paper considers the various strands of NCI policy through the nexus that underlies them all: the character of its members, their founders and staff, that leads to the pursuit of excellence for investors. NCI's member firms, notwithstanding differences in business models and size, share certain core elements of organizational culture that flow through their staff and drive superior investor outcomes in a manner that cannot be replicated by other elements of the global asset management industry. NCI submits that these cultural characteristics differentiate its members positively, offer a competitive advantage and should be more widely adopted and promoted within the asset management and financial services industries.

1 New City Initiative, Alignment of Interests: Fixing a Broken City (2010).
2 New City Initiative, Start-up Britain is Here in London: Why it is Crucial to Support Financial SMEs (2011); New City Initiative and Jonathon Read, Supporting Innovation and Entrepreneurialism in Asset Management (2017).
3 New City Initiative, Les Patrons Mangent Ici: A Practical Guide to Better Alignment in the Financial Services Industry (2013).
4 New City Initiative, How Regulation is Damaging Competition in Asset Management: Structure and Culture v Regulation (2014).

Challenges to Asset Management Start-ups

To provide a firm foundation for this, and later, work NCI argues iteratively as follows:

- Organizations such as boutique active asset managers have a definable organizational culture that is amenable to analysis and classification;
- Organizational culture can drive firm performance in the broadest sense; and
- Manager characteristics, defined and nurtured within that organizational culture, can drive underlying fund performance and hence returns to investors.

NCI therefore seeks to develop a theory of causal linkage between positive cultural characteristics of boutique active asset managers, usually owner-managed, and investor outcome, both in terms of performance and more broadly in terms of client engagement and service levels.

Organizational Culture

Understanding an organization's culture, its unique characteristics, can help predict how an organization will likely respond to different situations, allow assessment of the challenges that the organization may have in a changing future and identify priority issues that must be addressed for future success.[5] Notwithstanding such general agreement, defining organizational culture has proved elusive: yet, for an industry in which excess returns are posited to be linked to firm and human resource characteristics, definitional clarity is a necessary first step, and the theories of Edgar Schein provide a framework for analysis.[6]

Schein's conceptual clarification is to distinguish between the culture itself and its artefacts or visible manifestations. These artefacts can be tangible or intangible and may include the work output, dress codes, hours and patterns of work and much else: one organization may favour open challenge and discussion; another may not tolerate open criticism or disagreement. However, focussing on these manifestations may lead to a misdiagnosis of the underlying culture: they are not the culture. An ostensibly informal group, from dress and language, may really be very rigid about work processes and decisions: the focus must be on the processes and priorities that people instinctively employ when solving problems and making decisions.

Culture is a property of a social unit whose members share a significant number of common experiences in addressing external and internal challenges. Over time, the group forms a shared view of the external environment and the methods that will be effective in solving problems: the shared world-view has led to the formation of basic assumptions and beliefs that have worked well-enough and long-enough to be taken for granted. There comes a point at which members of the group have addressed tasks repeatedly such that when a similar problem arises it will be assumed to be solvable by the same process: culture is a learned result based upon successful solution of challenges by a definable group with a successful history of togetherness.

5 Clayton M Christensen, What Is an Organization's Culture? (Harvard Business School Teaching Note 9-399-104 2006).
6 Edgar H. Schein, Organizational Culture and Leadership (4th ed. edn, Jossey-Bass 2010).

Schein summarizes organizational culture as:

> *"…a pattern of basic assumptions – invented, discovered or developed by a given group as it learns to cope with its problems of external adaptation and internal integration – that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think and feel in relation to those problems…"*[7]

Boutique active asset management firms are thus seen to be especially amenable to the development of a positive organizational culture: a differentiator that cannot be replicated, for example, in passive investment owing to the lack of practical discretion in tracking a benchmark.

A small team of successful professionals must develop and maintain a successful investment strategy and process that works for a prolonged period: this is exactly the precursor required for the development of an organizational culture, and the owner-managed model enhances cultural development given that the successful founders have, through repeated successful application of initial process and discipline, exerted and perpetuated an extraordinary influence on the culture of the organizations. The investment discipline is a catalyst unlike that in most other industries and the constant monitoring and re-evaluation of the investment management process naturally mitigates the risk of over-socialization, when a team member can no longer help the organization see things differently because cultural assumptions cannot be challenged.

Given that boutique active asset managers, especially those with a smaller, close-knit team of long tenure, are more likely to develop a productive organizational culture, the next step in analysis is to consider if that culture drives business success and if that business success leads to excess returns for investors.

7 Ibid, p 18.

Culture and Success

Culture and Business Success

Empirical testing of the link between organizational culture and success, defined on whatever metrics, is challenging given the scale and number of underlying factors that must be considered in any multi-factorial analysis. Nonetheless, such a linkage is intuitively reasonable and can be rationalized by recognizing that culture has three components: the content of cultural norms ("norm content"); how widely members agree about the norms ("culture consensus"), and; how intensely organizational members hold particular norms ("norm intensity").[8] Firms characterized by higher cultural consensus and intensity about adaptability performed better three years later than those characterized by lower consensus, lower intensity about adaptability, or both.[9] Boutique active asset managers, with the previously concluded tendency to develop positive and intense organizational cultures, balanced by the natural adaptability required in the investment process, would seem to fit squarely within these findings.

The position relating to small and medium sized boutique asset managers is further supported given the unique interplay in such firms between a core team of senior leaders and a smaller overall team of empowered and skilled employees. Senior leadership team personality affects various organizational outcomes including financial results, form reputation and employee attitudes: those who were more curious and comfortable with new ideas had cultures that were more adaptive; those who were more conscientious were associated with more detail-oriented cultures, and; those who were more uncompromising were associated with more results-oriented cultures.[10] Such top-down cultural drivers are supplemented by those from the bottom-up: there is a significant relationship between internal process team culture and team task performance.[11] The underlying culture becomes more important as team-members are empowered and provided with significant autonomy.

Boutique active asset managers occupy a productive space in which organizational culture can be driven 'top-down' and 'bottom-up' and are naturally adaptable, with successful teams having performed successfully through bull and bear markets. These are the characteristics that empirically lead to positive organizational culture, driving superior returns for the firm itself: the final linkage required is that between firm and manager success and superior investment returns to clients.

Culture and Investment Performance

Fund managers are developed and exist within the organizational cultures posited in prior analysis: it would thus be reasonable to assume that their performance, and that of the fund, is affected by these cultural precursors. Manager characteristics do drive excess performance after adjusting for risk characteristics, expenses, survivorship bias and factor loadings: the mechanisms could be many, including inherent ability, education and the intersection of hiring-company culture with

8 J A Chatman and others, 'Parsing Organizational Culture: How the Norm for Adaptability Influences the Relationship between Culture Consensus and Financial Performance in High-Technology Firms' (2014) 35 Journal of Organizational Behavior 785.

9 Ibid.

10 C A O'Reilly and others, 'The Promise and Problems of Organizational Culture: CEO Personality, Culture and Firm Performance' (2014) 39 Group & Organization Management 595.

11 Y Shin and others, 'Does Team Culture Matter? Roles of Team Culture and Collective Regulatory Focus in Team Task and Creative Performance' (2016) 41 Group & Organization Management 232.

manager factors.[12] Both manager and firm characteristics continue to effect fund performance in contemporary markets: manager behavioural biases, which are rooted in organizational culture, affect fund returns, and organizational structure and strategies play an important role in influencing risk taking and performance.[13]

Two core elements influence investor returns and both derive from the interplay between organizational culture, firm and manager: the degree of activeness in fund management, and; the alignment of interest driven by co-investment and fees designed to mimic co-investment.

Degree of active management is traditionally viewed as tracking error to the benchmark index but this view must be supplemented by considering the share of portfolio holdings that differ from the portfolio's benchmark index, defined as "Active Share".[14] Plotting fund returns on a two-dimensional grid of Active Share and tracking error allows differentiation of true active management from strategies that replicate indices: a diversified stock picker is very active despite low tracking error because stock selection within industries can still lead to large deviations from the index; a systematic factor fund could show a large tracking error without large deviations from index holdings; a concentrated stock picker will combine both approaches; a "closet indexer" will score low on both dimensions although claiming to be active, and; a pure index fund will show almost zero tracking error and Active Share. Expressing degree of active management in this manner indicates that funds with the highest degree of Active Share outperform benchmark indices both before and after expenses; smaller funds are more active whilst larger funds tend to converge to "closet indexers". Boutique active asset managers, and NCI's membership, lie within these genuinely active and modestly sized bounds: they do so as their organizational culture leads them to this structure.

NCI believes that investors should pay for performance, that fees should be transparent and that interests should be aligned by co-investment or fees that provide similar incentives. Ownership stakes in funds by managers have been shown to be positively related to future risk-adjusted fund performance even for relatively modest levels of co-investment: fund performance can improve by around three basis points for each basis point of managerial ownership and this persists even after controlling for various exogenous and endogenous factors;[15] alignment may be further enhanced through further linkage of compensation to behavioural factors.[16] Design and acceptance of such a co-investment and performance structure flows from the organization's culture and the boutique active asset management industry has the natural fundamentals to develop and extend that culture.

12 J Chevalier and G Ellison, 'Are Some Mutual Fund Managers Better than Others? Cross-Sectional Patterns in Behavior and Performance' (1999) 54 The Journal of Finance 875.

13 K Cuthbertson, D Nitzsche and N O'Sullivan, 'A Review of Behavioural and Management Effects in Mutual Fund Performance' (2016) 44 International Review of Financial Analysis 162.

14 M Cremers and A Petajisto, 'How Active is Your Fund Manager? A New Measure that Predicts Performance' (2009) 22 The Review of Financial Studies 3329.

15 A Khorana, H Servaes and L Wedge, 'Portfolio Manager Ownership and Fund Performance' (2007) 85 Journal of Financial Economics 179.

16 C Jackson, 'Can Alignment of Active Manager and Investor Interests be Improved?' (2013) 14 Journal of Asset Management 376.

Culture and Performance: Conclusion

NCI maintains, and has always maintained, that the boutique active asset management model has advantages to clients. Through the analysis above, this position has been given a firm theoretical foundation: the boutique active asset management industry has characteristics that predispose to the establishment of a positive and adaptive organizational culture; this culture drives firm success, such firm characteristics being necessary for operation of the fund managers themselves; managers, operating within a productive organizational culture, are better able to produce, through genuine active management and alignment of interests with clients, superior risk-adjusted returns. NCI's members additionally offer other benefits to clients: an organizational culture that is dominated by client-outcome naturally leads to superior service on non-financial metrics, providing an overall service level that must be aspired to by the broader financial services industry.

Empirical Responses from NCI Members

Having provided a firm theoretical foundation for several of NCI's core precepts, it is interesting to approach matters from a more empirical basis: by viewing how NCI members conceive of, develop and maintain organizational culture. NCI's members are diverse in strategy, size and many other metrics but the responses show a commonality in organizational culture that may explain why these firms are members of long standing at NCI: it is hoped that others may be inspired to join and share their own organizational insights.[17]

Firm A emphasized that clients are part of their own culture given the longevity of client relationships and investment horizons. The principals view themselves as "stewards" of capital and note that the ability to act as long-term steward to client capital is itself rooted in broader cultural concepts being a "visceral thing…deeply inculcated". The firm has grown organically by providing excellent client service, remaining relatively small and ensuring employee share ownership to align interests over the long term rather than being driven by short-term returns. Hiring is managed in-house by the principals and cultural fit is an essential component: many employees join because they can better focus on what they enjoy, active fund management with "authenticity" and "integrity", further indicating the linkage between culture, firm success and manager behavior, which leads to investor returns.

Firm B underscored the importance of team longevity and the partnership structure, as well as non-financial rewards such as "openness" and "work-life balance". These are artefacts of an organizational culture, although not explicitly identified as such by Firm B, which posited that these factors led to: superior use of time and resources, and hence better investor returns; rewards that were not driven by short-term metrics, and; natural risk management since team members had an aligned interest to take intelligent and informed risks and consider the primacy of client interests.

17 The firms have been anonymized and are a representative sample across business models, size and various other metrics.

Firm C explicitly referred to the merits of being a smaller, owner-managed firm: with under 20 employees, each can “shape the business”, are attracted to something other than “a large firm with a global presence” with a “diversity of work” and have an “ability to influence” through off-sites and strategy papers. The recruitment process actively assesses cultural fit but also whether the hire could incrementally and positively develop the culture, a process of managed evolution. All staff are invested into the fund on the same terms as other unitholders, no personal trading is allowed and team longevity is emphasized.

Firm D provided a detailed response emphasizing fundamental firm values of integrity, transparency, responsibility, clarity of communication, attention to detail and economic alignment with clients: not all artefacts of organizational culture are tangible or perceived as such by the social group, yet are demonstrably so to the external observer. Economic alignment is provided through significant co-investment and capacity limits that aim to optimize returns; partners have long-term interest rather than being driven by short-term compensation or share price signaling. The firm has “never declined a client request [for information]” and provides client transparency of the portfolio, trades, proxy voting and engagement activity. The concept of stewardship of capital, mentioned by other respondents, was emphasized and the partners and senior staff “champion and protect” the long-term results given that their “personal capital and reputation [are] at stake”.

In inviting feedback from NCI member firms, this author provided no guidance as to the focus of this paper other than broad standard questions. Certainly, the foundational theoretical elements were not revealed nor the premise of linkage between organizational culture, through firm performance, to manager and fund returns. Yet, the responses all show an implicit underlying organizational culture along the lines of Schein’s fundamentals and the theoretically proposed linkage to client outcome: empirically, the boutique active asset management industry appears to offer an example of positive and effective organizational culture driving superior results for clients.

Conclusion

NCI supports positive structural and cultural shifts within the asset management and broader financial services sector, both in the UK and elsewhere. NCI believes that the diverse and strategically important boutique active asset management industry, with its focus on client service, alignment of interest and long-term horizon is an important component of the future of financial services and can act as a beacon of best practice in certain areas.

The structure of the boutique active asset management industry — its firm size, its investment processes, its owner-managed structure, aligned incentives and various other characteristics — means that organizational culture can develop in a way that is not possible for larger active managers and impossible, given the absence of discretion, in the passive sector. For boutique active asset managers, organizational culture has a natural transmission mechanism through the firm to the fund, providing superior outcomes to investors: these transmission mechanisms are strengthened by the degree of active management and co-investment, natural competitive advantages to NCI members.

Within this paper, NCI has proposed a theoretical foundation, confirmed by empirical sampling, that indicates that the boutique active asset management industry is uniquely placed for the development and incubation of a positive and adaptive organizational culture. In doing so, it not only provides a more rigorous underpinning of NCI’s policy positions but also, it is hoped, shows that this successful and vibrant sector is positively differentiated from other parts of the active management industry and the passive alternatives. NCI remains in dialogue with various parties, including regulators, working to promote its policy aims and support the strategically important boutique active asset management industry: like-minded members are always welcome – inclusion is part of NCI’s own organizational culture.

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