WCM INVESTMENT MANAGEMENT

WHY DO MONEY MANAGERS FAIL?

It's Not Why You Might Think

By Paul Black, Co-CEO and Portfolio Manager, July 9, 2021

Conventional wisdom often suggests that too many assets are the death knell for a money management firm, claiming that size hinders timely execution of portfolio decisions. Some link firm closures to style drift at precisely the wrong time. And in an industry that penalizes any form of change, others blame a lack of investment process discipline (see sidebar at right).

While these non-people-related reasons can contribute to manager failures, the primary culprit almost always relates to people and culture. Based on my experience, and WCM's postmortem case studies of failed investment companies, I believe money management firms close their doors for one primary reason: a toxic culture.

One of the great mysteries of my life is the fact that culture plays such an underappreciated role in the durability of one of the world's most people-driven businesses.

When times are good, bad investment company cultures can remain dormant. But in tough times, poisonous dissent, blame, and finger-pointing—long simmering just beneath the surface—all begin to percolate. For example, when a well-known international manager imploded years ago, the conventional wisdom narrative was that assets grew too far, too fast. Supposedly, this put liquidity constraints on the portfolio, making it impossible to sell in the face of negative market action. Rarely mentioned in this tale is the prolonged period of underperformance that occurred *prior to* the death spiral when liquidity issues had *zero impact* on results. In reality, the firm's death sentence was handed down long before a decline in performance. It all started with a toxic culture that only became visible (to the outside world) after assets fell. That's when the PMs turned on each other. This unhealthy culture led the owners to sell the business long after assets had peaked.

AN INDUSTRY THAT PENALIZES CHANGE

Our industry too often worships at the altar of process, process, process. "Don't change the process!" I find it bizarre: money management may be the only business where changing your process or belief system—*because you've learned from your mistakes and want to get better*—is frowned upon. Where else are you penalized for growing your knowledge base and making necessary improvements?

Our own company's path to success would not have occurred without a significant change in our investment process. During past dark days of underperformance, our portfolio failures taught us a priceless lesson about portfolio company competitive advantages ("moats"): it's not the size of the moat that matters, it's the direction of change. Every landmine in our portfolio was a company with an eroding moat. When the blinders of conventional wisdom finally came off, we painfully realized that, because every business is always either strengthening or weakening versus its peers, simply buying the widest moat—a rearview mirror perspective—is a fool's errand.

What do I mean by "the blinders of conventional wisdom?" I mean the false certainty of DCF models! Here's my challenge: Show me a DCF model from ten years ago, and I'll show you how wrong it is. Despite never losing that challenge, our industry is full of analysts who spend 90% of their time building elaborate, highly precise forecasts of a company's profits only to find that, years later, they were precisely wrong.

WCM has been fortunate to be given something rare in life and even more rare in investing: a second chance. Our company succeeded in changing our process for the better in an industry where any form of change tends to signal the beginning of the end.

THE SILENT KILLERS

Some firms also fail for another cultural reason: the founders do a poor job of creating a "founders' mentality" among the team. This can lead to several "silent killers," especially as the firm reaches critical mass:

Institutional bureaucracy. The once scrappy culture made up of entrepreneurs and risk-takers is replaced by entitled bureaucrats who believe in a fixed way of thinking—a mindset that values pedigree, politics, and positioning more dearly than hunger, scrappiness, and humility. In time, those responsible for the original success of the firm leave and the institutional bureaucrats take over, causing continued erosion of what once made the firm great.

Cynical factions. A group (or groups) gets together and cynically criticizes from the backseat. Candid criticism and disagreement is vital, but such dissent has to stay open; it has to be guided by respect for all, and it has to be clear who makes the crucial decisions upon which everyone stacks hands.

Ulterior motives. People blindly/selfishly fixate on their own career progression, on building out their résumé, on acquiring a title or rank as a means of status/monetary rewards, or on creating their own fiefdoms and protecting their turf (by, for instance, not hiring people better than themselves).

The failure to create a second generation. Ultimately, few firms endure if they fail to create a second generation with both a founders' mentality and the financial incentives needed for healthy growth.

IT DOESN'T HAVE TO HAPPEN THIS WAY

Of course, the reason finger-pointing is so tempting after poor performance is that there generally *is* someone (or some people) to blame. That's the reality of this profession. To be different requires a certain mindset—humility, self-awareness, and respect for one another—to recognize that we are all fallible, that it could easily be me next time, and that the primary thing is to learn from the mistakes and get better together.

I believe that all these unhealthy cultural issues can be alleviated through focus on three big actions: (1) make sure your people know they matter, (2) make sure your people know that you, as leaders, care about them, and (3) foster an environment where your people care about each other.

Sounds easy, right? Just care about your people, don't be selfish, and everything's great. Then why don't more leaders focus on the people aspects of running a successful money management firm? Because these cultural achievements are hard won and tend to go against most people's natural inclinations.

It's easy to talk a good game about caring and candor, but the reality is that doing it well is exhausting.

Not only are most investment professionals not good at the people aspects of this business (it's not why they were attracted to the industry), but doing this type of work day in and day out is taxing. And that's why it so often goes quickly out the window once a firm is successful.

OUR EXPERIENCE

Our own firm's history offers a textbook case on the role culture plays in living successfully beyond difficult times. In 2001, WCM had an embryonic but vibrant business running large-cap US growth portfolios. We were a small team, and performance was off the top end of the quartile charts. That allowed us to raise several billion dollars over the next few years.

In 2002, we brought in a portfolio manager who ran a small-cap value portfolio. The future was exceedingly bright. We had two portfolios with brilliant performance managed by aligned and engaged small investment teams. Money was easy to raise.

But a storm was gathering. From 2005 to 2011, the tragic, untimely death of our small-cap value PM and the protracted underperformance of our flagship US large growth strategy contributed to the near demise of WCM. We now understand how our underperformance was the result of overreliance on the false certainty of "intrinsic value," arrived at through elaborate DCF models, which in turn blinded us to what really mattered: the importance of portfolio company competitive advantages that were getting stronger.

During 2006–2007, WCM added some great new talent intended to bolster our returns. But too many mistakes around our misunderstanding of company competitive advantages ("moats") were already baked into the portfolio. So performance continued to suffer. The new talent never had time to positively impact the numbers. Still, their enduring presence set the stage for our resurgence several years later.

HOW TO BUILD A $100 BILLION MONEY MANAGEMENT FIRM

Manage a $4 billion large-cap domestic growth firm. Underperform dramatically for five years. Get fired from almost all $4 billion of assets. Never fire an employee or lower their compensation. Take all the income hit at the principal owner level. Launch an international growth strategy, which your firm has never done, and have it run by a PM straight out of operations with no portfolio management experience. Figure out how to trade foreign ordinaries and currencies for the first time. Add an inexperienced analyst after three years to join the inexperienced operations PM. Tell the new international PMs—with no experience crafting or telling a story and only a few years of experience managing money—to get on the road to tell the story. To make it more difficult, only have $3 million in the three-year track record. For fun, add a new analyst who dropped out of Columbia Business School thinking he ought to just open a hamburger stand. Don't expect any help from the founders; they're all experiencing PTSD. Go for it!

With assets dwindling from about $4 billion at year-end 2005 to less than $900 million in early 2011, conventional industry wisdom would say that WCM was done. Few would have believed there was any value left in our business. How could a firm with such poor performance in its flagship strategy, and the unfortunate death of one its key portfolio managers, live to fight another day? Much less become a company with $100 billion AUM? Why didn't we just close up shop and admit defeat?

WHY WE KEPT SHOWING UP

We survived, in spite of all our mistakes, because caring for each other means we almost didn't know how to fail. Ultimately, *we didn't fail because we never gave up*. We never gave up individually, and we never gave up on each other. In fact, from all these experiences we have, developed a motto at WCM: Keep Showing Up! To be sure, as my colleague Kurt Winrich likes to say, showing up does not guarantee success. But what we can absolutely guarantee is that we will never succeed if we don't keep showing up for each other.

Here are a couple of telling questions we ask ourselves:

By the end of 2010, the new PM on the small-cap value strategy was running virtually all the assets in the firm. Why didn't he leave? He could have easily formed his own firm, transferred all the assets, and made all the money.

Why didn't the two young portfolio managers and one new analyst on the international strategy pack up and form their own firm? As 2011 dawned, that international portfolio had passed the magic five-year milestone with a superb six-year record, and their equally amazing global strategy was just about to hit the three-year mark. If I told you how little money they each made, you'd really wonder why they didn't set off on their own, or at least sell themselves—especially when you consider that we have no employment contracts, zero non-competes, and no golden handcuffs.

According to industry logic, we had no right to live to fight another day. And yet we did. We lived on because of the power of deep personal relationships. We survived because we had all lived in the trenches for so long that we forged enduring bonds. None of us wanted to disappoint the others, to let one another down. And, of course, that started at the very top. From the firm's earliest days, it has never been about a few people at the top with many minions below grinding out the work. We've always been about hiring the best talent, regardless of pedigree, and then creating an environment where they can become the best versions of themselves.

Bad times ultimately reveal the culture of any enterprise, whether that culture is unhealthy (which almost always leads to failure), or whether it is healthy, where intense stress will test and refine the best cultures into gold. While our own experience as a company has been instructive, we've learned to take nothing for granted. By virtue of our company's history and experience surviving together, we work hard every day to keep our culture alive and learn from our mistakes.

For many years, we thought we had all the ingredients of a healthy culture. We had created a flat structure, empowered our people, and would do almost anything for one another. Anything. After a few difficult personnel issues throughout the years, however, it became clear we were missing one important ingredient: truth-telling. In fact, while we thought we were caring for people, we were actually failing them by not being honest about their performance. We weren't systematically, consistently having the necessary tough conversations—conversations, for example, about how investment research reports should not merely regurgitate the obvious and how team members should work harder to develop differentiated insights.

Evasion masked as politeness led to internal confusion, lack of alignment, and, ultimately, a lot of unnecessary drama. Eventually, we formed the WCM Leadership Team and articulated the core values that guide our everyday actions. This does not mean we indulge in incessant, potentially distracting analysis of ourselves and one another; it means we talk frankly, even when it might be painful, because not talking frankly is bad for one another and bad for WCM. The results have been dramatically positive.

Performance and engagement improved based on telling the truth. As a firm we now appreciate that caring for our people means being honest.

Sadly, this type of people work is exceedingly rare in the industry, largely because there are horrendous starting conditions. Most of the individuals attracted to investment management are exceptionally intelligent, have achieved a great deal academically, and (when successful) are highly compensated. Naturally, this bolsters the human ego, which makes it difficult for people to exhibit vulnerability about their mistakes and areas in which they need to improve. There is also a lack of trust in most firms. People worry that exposing their own shortcomings will alter their career trajectories. And they have a hard time separating themselves from their ideas. Any challenge against a recommendation can be received as a personal attack.

At WCM, we've taken the opposite approach. In fact, we often say that you'll go farther faster in our firm by being more open about your mistakes. The performance of our strategies has also been greatly enhanced because we work hard at understanding our personal biases and how they may adversely impact our own decisions as well as the performance of the team.

And that means there is no fear about hiring teammates who raise the bar—who, because they care for each other, make everyone around them better, too. It all results in freedom—the freedom to be who you are and, more importantly, the freedom to become great. Where else would someone with no experience take over an exceptional strategy where the founding lead manager was terminally ill? Where else would an operations guy start an investment strategy in markets where the firm had never invested? Where else would you add a portfolio manager and analyst with zero experience in global markets? Where else would you hire a Columbia Business School dropout who wanted to open a hamburger stand? At WCM, that's where.