The Frontier Line

Thought leadership and insights from Frontier

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What lurks in the shadows?

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over twenty five years and provides advice over more than $450 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purposeis to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Sarah Cornelius

Consultant

Sarah Cornelius is a Consultant at Frontier and is a member of Frontier's Investment Governance Team having joined Frontier in May 2010 and the Governance team in January 2015. Sarah has considerable experience providing governance advice to investment committees and boards, reviewing and preparing investment policies, as well as undertaking reviews of investment beliefs and internal investment capabilities across a range of institutional investors. She is also a member of Frontier's Responsible Investment Group and Frontier's investment consulting team, providing consulting support to clients and involvement with investment and manager research. Sarah holds a Bachelor of Commerce (Commercial Law) from Swinburne University and a Masters of Applied Finance from Kaplan Professional.

Paul Newfield

Director of Sector Research

Paul Newfield is Director of Sector Research, having joined the firm in July 2019. Paul has a primary focus on driving innovation and client alignment in our research program and works closely with our Global Investment Research Alliance (GIRA) partners. Paul joins Frontier from Willis Towers Watson where he held the role of Senior Consultant for over eight years and was involved in a number of governance and strategy areas, including liability driven clients and retirement incomes. Prior to that, Paul spent twelve years at Mercer where he held a variety of senior roles in both Australia and New Zealand, including leading Mercer's retirement business in New Zealand and was Board Chair of their trustee company. Paul is a Fellow of the Institute of Actuaries and holds a CIMA certification as well as a Bachelor of Economic Science.

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Introduction

Recent high profile cases of major cultural issues within some funds management organisations have caused concern for investors and a re-assessment of relationships with those businesses. Frontier has long understood a link between a strong culture and performance and this has driven our commitment to complete our own face to face due diligence on managers. However, we have recently developed a clear framework to add further depth in assessing culture as part of our process.

Based on our experience, developed over twenty-seven years, most fund managers market a convincing overall corporate story, but it is only when we develop an understanding of the intricacies of culture within each organisation that we can truly assess and flag the potential risk of poor culture to a manager, and in turn to their investors. Equally, we seek to elevate those with good culture as a contributor to strong outcomes.

Historically, non-financial risks have not received the same ongoing scrutiny from investors as financial risks. We are starting to see this shift in a meaningful way, particularly as we continue to see examples of poor culture rise to the surface resulting in significant reputational damage (for all parties concerned) and subsequent value destruction. Cultural issues can manifest over time so it is equally important to consider culture before rating a fund manager, on a regular and ongoing basis, and after a specific event. To more formally lock this assessment into our due diligence process, we have developed a set of culture principles to set a standard as well as a culture assessment framework to identify and deal with a variety of culture-related issues as they arise.

We believe implementing a more rigorous, repeatable framework for assessing and monitoring culture will enhance our existing fund manager research program. While this more rigorous framework is not failsafe, it does allow us to consider the likelihood of undesirable behaviours manifesting and ideally, avoiding the risks that can result

What is culture and why is it so important?

Culture is the set of values and behaviours of an organisation - it is the unwritten rules of how the organisation operates.

Culture is “what” people do.
It is “how” they do it.
Most importantly, it is “why” people do what they do.

Formal definitions of culture describe the collection of customs, attitudes, values, and beliefs that characterise one group of people and distinguish them from other groups. Culture includes the products of a group of people.

It is important to acknowledge that culture is complex and dynamic. Indeed, it is challenging to both establish and to maintain good culture in any business. Regardless, it is our experience that the right culture can be a key tool in achieving differentiation in a competitive environment. In addition, there are also numerous academic studies that show causality between culture and performance.

More recently we have seen examples of shareholders voting with their feet in relation to poor culture, be it by voting against management recommendations at shareholder meetings or by reducing/exiting their holdings. Many corporate social responsibility failures occur because society shifts and the organisation does not shift with it. A desire for continuous improvement is an important trait. In particular, as the understanding of the impact of ESG, culture and diversity factors have risen, so too has the priority they are given by institutional investors. Today, investors and shareholders generally have a far lower tolerance for inappropriate management of ESG, culture and diversity factors than would have been the case a decade ago.

Culture is broad and covers many dimensions. For a funds management organisation it incorporates how a manager treats clients and employees and the manager’s general willingness to go the extra mile. Culture also includes how fund managers treat communities and act as socially responsible corporations within the communities in which they operate (i.e. behave ethically and morally in a way consistent with regulation, international law and broader societal expectations).

Recent corporate scandals, and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, have highlighted that merely aiming to ‘obey the law’ just doesn’t cut it anymore. Community expectations have increased dramatically, outpacing regulatory change.

Given the nature of the work being completed, and the scale of rewards, building a strong culture at a fund manager level, just as with an asset owner, can be challenging. And, having one which endures once an excellence plateau has been reached requires constant effort, focus and a deep level of commitment to the importance of culture. This is one of the reasons we believe it is important to explore culture before any engagement but also on a regular ongoing basis.

How do we embed culture into manager research?

When Frontier assesses governance and culture, we are assessing the fund manager and its processes and procedures. This is different from the manager's process where they assess governance and culture at the company/asset/security level. There are elements of that component which are also assessed by virtue of our ESG lens, modern slavery as an example, however, the focus of our culture assessment is on the former component.

Culture can be difficult, but not impossible, to measure. Just because you can't always put a tangible 'number' on culture doesn't mean it can't be measured – we just need to think outside the box. Defining principles and building an assessment framework, so the process is defined and repeatable, adds consistency and credibility to culture assessments.

We believe it is important to define and embed the key cultural traits being sought from fund managers into our research and assessment approach. Consequently, our research and due diligence process has now been enhanced to formally incorporate eight key culture-related characteristics and traits that we proactively test and seek from fund managers, and which will serve as signals that may point to a review of the manager being warranted.

Frontier's culture principles

In using our principles, Frontier firmly believes each of the eight elements play an important role in developing an environment which enhances the likelihood of optimal outcomes being achieved. Of course this is the aim of any manager research endeavour – finding fund managers with traits which increase the probability of sustainable superior performance. Culture is simply another hurdle for fund managers to clear in our overall assessment process and we feel is a trait which does reflect an enduring competitive advantage.

We are now proactively collecting data on culture via our technology platform (which has had significant investment and uplift in capability in recent times). This data includes statistics on turnover, diversity, incidence of harassment and the use of non-disclosure agreements (NDAs) etc. Some fund managers are more willing than others to disclose this information but we believe managers who have nothing to hide ought to have a natural motivation to share relevant information openly and enthusiastically with researchers. This aligns with both principle 6: *courage and a desire for continuous improvement from a cultural perspective* and principle 7: *Transparency in regard to structure, disclosures and conduct.*

01

Value client partnerships and proactively seek to genuinely engage and communicate with clients particularly where unexpected events arise.

02

Proactively engage and take action when an event occurs which is detrimental to a client and expeditiously move to address the matter/s raised.

03

A strong and inclusive culture in the organisation with a deep sense of belonging and team focus with all employees.

04

A diverse culture – managers that are broadening diversity within the key decision making and executive levels and have explicit plans to achieve this outcome.

05

An embedded fairness and equality principle in the way people are treated regardless of age, gender, ethnicity, sexual orientation, seniority. (This is more than what the manager says and really seeing this manifest in actions on the ground).

06

Courage and a desire for continuous improvement from a cultural perspective – managers who courageously identify and call out issues, rectify those issues and learn and grow from those issues.

07

Transparency in regard to structure, disclosures and conduct – managers who have a great culture, who have nothing to hide ought to have a natural motivation to openly share relevant information.

08

Free of a pattern of systemic behavioural and cultural issues – since where there is a pattern of such issues (within a team or across a firm) that is likely to point to more fundamental cultural issues (noting these issues may be broad and varied).

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Dealing with issues as they arise

Like any element of business, culture is not static. Equally, any form of assessment and subsequent rating is not a guarantee of success, or in this case assurance against a future failure. Incidents can occur against expectation, especially given human involvement.

In order to deal with culture related incidents clearly and consistently as part of our fund manager monitoring process, we have also developed a *culture incident assessment framework*.

A review of culture is often triggered by a specific event, or series of events. These might be disclosed by the manager or brought to light by other means (including the press). In this situation, a starting point is to consider what facts can be verified. From that investigative foundation, our approach then helps provide clarity about what we are looking for via a clear and repeatable process. It also eliminates perception of bias of the treatment of each individual incident.

It is important to consider what information is required to make an assessment. The information may vary depending on whether the assessment is part of an initial/ongoing assessment or is event driven. Equally important is establishing what outcomes and goals are being sought from the review.

The assessment criteria below shown in Chart 1 provides an example of how we approach culture assessments.

Ultimately, our assessment is made on the balance of probabilities – by nature there will always be an element of judgement involved but that does not mean that we, as asset consultants, should shy away from forming a clear view.

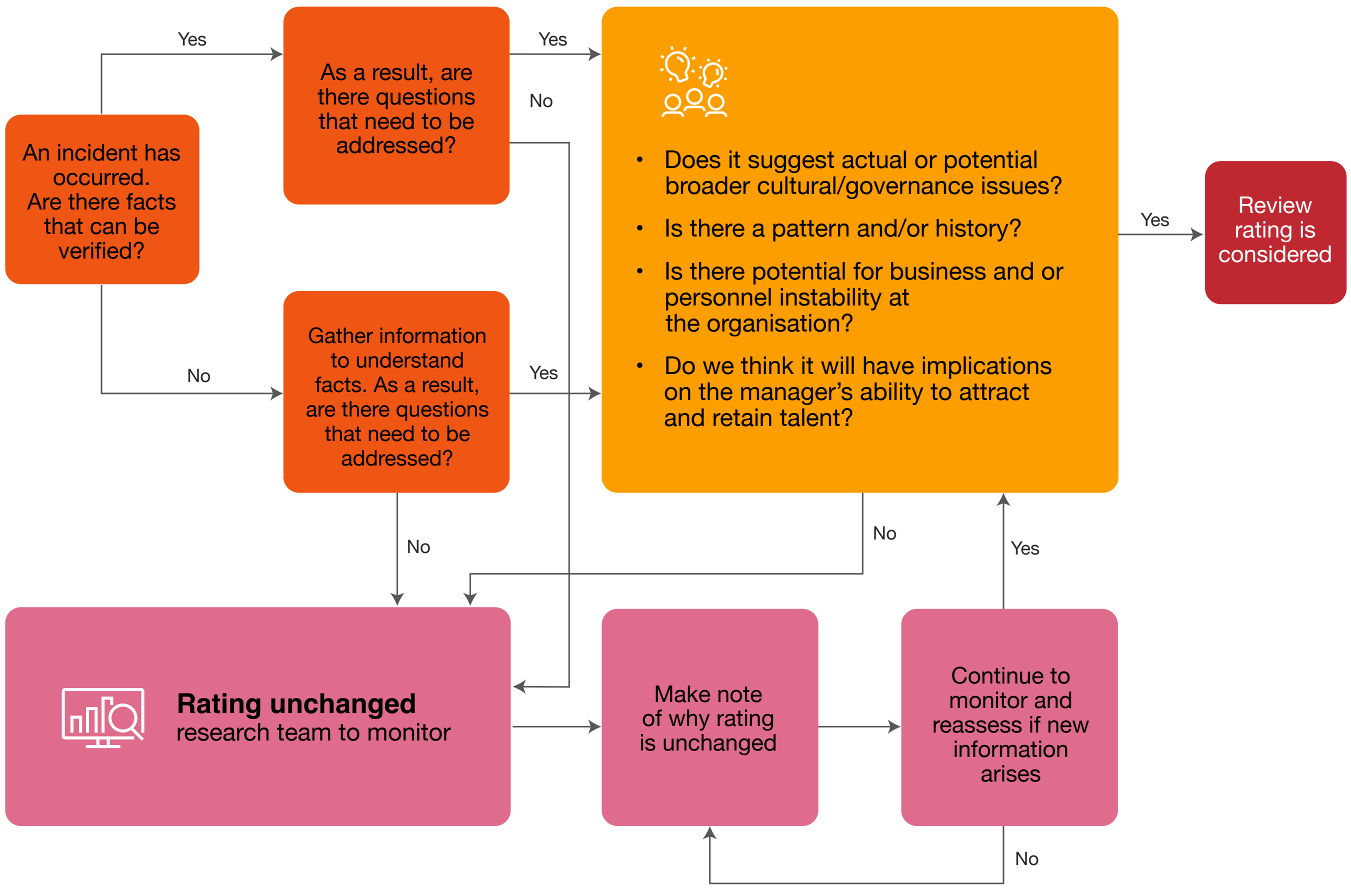
Chart 1: Frontier's culture assessment criteria

Key areas of focus	Risks	Evidence
Governance and cultural issue	Low High	
Loss of talent	Low High	
Ability to attract talent	Low High	
Loss of funds under management	Low High	
Ability to raise capital	Low High	
Overall assesement	Low High	

Source: Frontier.

Chart 2 shows a high-level summary of our culture incident assessment framework. The framework also considers the required next steps and meetings (who to meet with and what types of questions to ask), the policies to request, and data to collect.

Chart 2: Frontier's culture incident assessment framework



Source: Frontier.

When making an assessment of a fund manager, based on a specific event, we think the key focus should be on how the organisation has handled the issue/s, the processes and procedures they have in place, what they are doing to instigate change (if necessary) and how they seek to improve.

When it comes to cultural issues, accountability is crucial, this is embedded in principle 6. We want to see managers acknowledging the issue and laying out a clear plan to remediate it and mitigate the risk of similar future issues. A failure to do so indicates a poor culture.

A key focus from the manager when issues arise should be one of proactive engagement with its clients, this is embedded in principle 2: *proactively engage and take action*.

One bad apple?

When we talk about culture and misconduct, we are dealing with people, who are fallible. As a result it is generally (except for extreme cases) more important to understand how organisations deal with incidents and what steps are being taken to improve, rather than focus too much on the incident itself, after the fact.

For example, in the case of bullying, discrimination or sexual harassment, too often the complainant leaves the organisation and the perpetrator remains with little to no real penalty, particularly when there is a power imbalance in favour of the perpetrator, as is typically the case. The message this sends to employees and investors is that firstly, the perpetrator's behaviours are tolerated and secondly, complainants should be prepared to leave their job and the organisation for raising the issue. This is not indicative of a safe working environment with equal opportunities or one that values courageously calling out issues. The impact this can have on culture should not be understated and it is a pointer to a lack of contemporary and professional business practices more broadly.

We fully appreciate good fund managers are not immune from experiencing problems, and having a good culture is not a guarantee issues will not arise from time to time. But, it is how the manager deals with things when they don't go well that is most telling.

Good culture stands out

Given the recent number of poor culture examples, which are often easier to identify, it is important to remember there are also positive examples of culture to be found. Indeed our culture principles define the positive traits we are proactively seeking from fund managers.

Not all successful cultures are the same, but they do need to be fit for purpose.

Good culture tends to permeate interactions and strengthen conviction in a team's ability to work well together.

Each person within the organisation plays a role in the evolution and maintenance of the culture. Staff from all levels should be both accountable and empowered to call out behaviours that do not align with the culture. Accountability is important such that employees at all levels are accountable for their actions, having understood the core values of the organisation. Communication between employees and the ability to challenge one another is paramount.

In looking to gauge culture within an organisation, we believe a key element is an obvious and identifiable involvement of everyone in the organisation. This translates into all business practices, including recruitment, training, and incentives, and in aggregate contribute to the ultimate measure of optimal performance.

Fund managers can have strong culture elements in some respects, while being weaker in others. For example, some managers that show strong and positive team cultures can be less aligned from a client standpoint (e.g. have lower transparency). To receive a strong endorsement of culture, which is a contributor to a positive overall rating, we need to see good practice and examples across all of the principles we assess in our framework.

Actions for investors

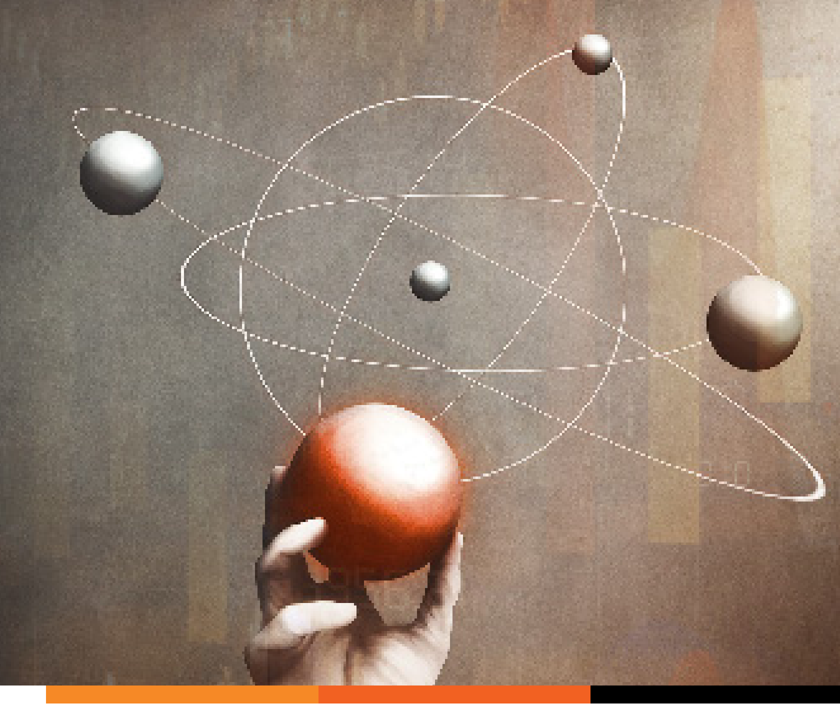
A sharper focus on culture and non-financial risks more broadly in corporate environments has been driven in part by the previously mentioned Hayne Royal Commission and in some ways a general shift in consideration of, and attention to, some of the 'less-computable' metrics of progress and success.

Boards and management teams need to play a collaborative and clear role in developing agreeing, nurturing and taking accountability for an organisation's culture, attitudes, and behaviours. Appropriate culture must be clearly recognised as a business imperative in the success measures of both boards and management. This applies not just within the asset owner's organisation but also in finding assurance that good culture is present in suppliers and partners.

With an increased global focus on culture-related issues, the appointment and retention of fund managers by asset owners continues to be in the spotlight. So, what actions can asset owners consider taking right now?

- Consider the Frontier culture principles and how they might apply to your organisation.
- Assess managers (and where applicable, internal teams) using this lens.
- Consider the process for when a culture incident(s) occurs at a manager (or within an internal team) and define your steps and tolerances before an event occurs.
- Speak with Frontier about how we can assist by providing an independent perspective and one informed by our broad industry awareness.
- Consider initial and ongoing training and education for staff, and in particular the board and senior management/executive staff (as they set and lead the tone). Training topics might include how investors can lift education around culture (how to assess it) and impacts if this is ignored or misaligned with the investor. Frontier is experienced and well placed to assist with workshops and training in this area.

The final word



Frontier is placing an increasing weight on culture as part of our ongoing fund manager research program. We believe implementing a rigorous and repeatable framework for assessing and monitoring culture will elevate our existing manager research program. It will also provide an environment for fund managers with a strong cultural fit to better partner with institutional investors.

Frontier's culture principles and framework have been developed in parallel with a number of live, high profile, culture-related cases and we believe they provide a practical means of dealing with a variety of culture-related issues when/as they arise.

While this more rigorous framework does not guarantee perfection, it minimises the likelihood of undesirable behaviours manifesting and increases the probability of both superior long-term returns and genuine and aligned long-term partnerships.

Since the development of the culture indecent assessment framework, there have been a number of fund manager incidents and utilising the detailed framework combined with internal engagement with Frontier's investment governance team enabled the cases in point to be thoroughly examined and the ratings of the managers assessed. This in turn has delivered insight and assurance, or in some cases informed action, for our clients.

Frontier has always sought and will continue to seek fund managers who we believe have clients' interests first and front of mind, who can be strong partners with clients and who can deliver superior risk adjusted returns. A strong culture contributes to all of these endeavours.

Want to learn more?

We hope this paper has generated lots of ideas for your own portfolios. If this is the case, please reach out to Frontier to discuss how we can work with you to use in this space.

Frontier

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Frontier is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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