

Why Culture Matters

This post by Michael Lee has been excerpted from a letter of [Hypotenuse Capital](#). Mike is a participant in [The Zurich Project](#).

Why does culture matter when it comes to investing? My perspective on this is simple. A business in its most abstract form is an entity that provides products and/or services to its customers. If we are looking for great businesses, then it is reasonable that we should be looking for great products and services. However, no product or service has ever spontaneously materialized out of thin air. Products and services are the output of significant collaboration and teamwork; it takes many people — employees, suppliers, engineers, designers, craftsmen, programmers, accountants, and myriad other individuals — to operate a business successfully. If this is the case, how can one expect a business to produce exceptional products or services without employing exceptional *people*? How does a business attract and retain these exceptional employees? Some companies attempt to do this simply by throwing vast sums of money at their employees. Truly outstanding organizations think outside the box of mere compensation and build deeply passionate cultures; these cultures exert much more powerful forces when it comes to attracting and retaining talent than financial compensation alone.

Great cultures are dynamic, inspiring and engaging. They attract the best and brightest minds and dedicated workers who go on to develop and provision great products and services. These employees take good care of their customers because they love what they do and are passionate about their work. Customers exposed to this great care return for repeat business; they become “net promoters” and refer friends. Word spreads allowing the business to grow organically. This economic success feeds a virtuous cycle that allows a business to continue to invest in its people, culture and future prosperity.

Building a good culture requires more than simply posting motivational messages on cubicle walls and putting foosball tables in the employee lounge. Like so many other things in life, a vibrant culture involves many little things executed consistently and thoughtfully. For starters, it helps to have a strong sense of purpose, a calling that unites the organization in a common objective. Another critical component is healthy communication: information needs to flow from those who have it to those who need it, thereby enabling effective collaboration. If employees are excited to show up to work, are engaged with their colleagues and feel respected for their ideas and efforts, amazing things can happen. There is no one thing that defines a great culture; rather it is the synergy between many interlinked variables that weave together to form a cohesive social microcosm. Unlike the cumbersome bureaucracies and stifling office politics of typical organizations, thriving cultures liberate their employees to operate with optimal efficiency and creativity towards a shared purpose.

Culture matters because good culture is good for business. Exceptional leaders recognize the importance of a good culture and deliberately seek to nurture and cultivate one within their organization. Consider Costco co-founder Jim Sinegal who said, “Culture is not the most important thing; it’s the only thing.” Costco employees are intensely loyal and leave the company infrequently; the company has a 96% annual retention rate for employees who stay with the company for more than one year. This implies an average tenure of about 20 years. Beyond the above-average pay (the average hourly wage at Costco is about \$24) and benefits, Costco employees also rave about flexible work schedules, opportunity for career advancement, and leadership’s openness to trying new ideas. Today, Costco thrives as a resilient business and its shareholders have been handsomely rewarded over the decades. Look also at the successes of Facebook, Google, and Southwest Airlines: all companies that are well-known for their exceptional and dynamic corporate cultures. Each of them

have attracted and retained very strong workforces that are passionate about their work; these organizations have developed highly compelling products and services that have handily left their competition in the dust.

Bear in mind that culture is not the only thing we look for in a good investment but one of many attributes. A company with a great culture but a poor product or competitive position is unlikely to work out very well over the long-term. So we also look for businesses with a winning business proposition, i.e., a product or service that is higher quality or lower cost (preferably, both) than its competitors. We seek business leaders who are disciplined capital allocators. Of course, we want to invest in securities trading at attractive prices, ideally at high cash flow yields. Admittedly, trying to find a company with a wonderful culture and a great business that is also trading at a low price is difficult and requires significant patience. Thus, when we find companies with strong cultures we pay attention because they might possibly become great investment opportunities, even if we might have to wait a few years to have a chance to invest at a reasonable price.