Marshfield Associates

Letter to Clients
December 2021

Game of Thrones

"The band's on stage and it's one of those nights, oh yeah
*The drummer thinks that he is dynamite, oh yeah"**

The Rolling Stones

In his 2010 memoir, Keith Richards praised Charlie Watts, the late, great Stones drummer, for having "always been the bed that I lie on musically." As Watts fans, we're happy to see "Keef" pay such deference to his bandmate, but we also think this comes as close to describing the relationship between an organization and its culture as we can find. Culture is frustratingly metaphor resistant. And yet, as the invisible substrate on which all else is built and around which all else takes place in a corporation, we think the image is apt. Like a groove, culture is persistent but reticent—both everywhere and nowhere all at once. It's consciously constructed but also extemporaneously embellished. It accretes and evolves over time but once in full swing, it maintains its basic beat. A masterpiece of improvisation, corporate culture weaves together the stories told, the interactions experienced and observed, the successes enjoyed, and, perhaps most important, the failures and challenges sustained and met. It imparts a code to all employees, telling them how to engage with one another, with customers, with suppliers, and with the world in general. It allows Margo in accounting and Virginia in Hong Kong to riff without fear of being out of sync with the C-suite or the home office. Though culture rarely calls attention to itself (except in an especially juicy solo à la Theranos), it is, by turns, essential to the harmonious functioning of an organization when it's good, and destructive to it when it's bad.

In our experience, cultures tend to be formed early and reinforced over time. That which is discordant may not stick, especially if the culture is well established, while that which is in sync with it may be quickly absorbed. While cultures can be strong or weak, good or bad, they tend to operate as a synchronous whole. To be effective, a culture needs to penetrate a company; management can't simply play air drums from the corner office and expect the beat to reverberate throughout the organization. In addition, culture is both durable and fragile—revamping one is extremely difficult, but disrupting one disturbingly easy. It's the worst of both worlds: the most negative elements seem to decay slowly, even with vigorous attempts to dampen them, but the best elements can be set off-tempo with relative ease. Like an elaborate drum kit, there are just too many toms, cymbals, and snares that have to work together seamlessly in order for a culture to really rock. And, for us, rock it must. Of all the things we look for in analyzing a company, culture is not only one of the most important but also one of the hardest to pick out and without a doubt the most difficult to grasp.

There are two main axes along which cultures fall and for which we try to assign values: the good-bad axis and the strong-weak axis. We have no room in our portfolio whatsoever for bad culture, whether weak or strong. And unless there are extenuating circumstances such as monopoly-like power, anything that falls squarely into the good but weak quadrant is likewise of no interest to us.

The Holy Grail, of course, is a culture that is both good and strong. Clearly, therefore, our foremost job on the culture front is to find companies with good, strong, dependable cultures. Rhetorically at least, many in our business profess to do the same thing. Mostly, when others talk about culture, though, they mean things like shareholder orientation (yes, good) and do no evil (ditto, though "evil" is notoriously definition-dependent).[1] What gives us the chops to do it better? First, we think we listen better. It takes a practiced ear to distinguish the quarter notes from the half notes and the half notes from the whole notes. And second, we've learned a few tricks in our time, both about where to look for the tracks of a culture and also how to think about it. After many years of teasing out and examining often elusive corporate cultures, we've come to a few conclusions: (1) good cultures aren't necessarily strong and strong cultures aren't necessarily good; (2) corporate cultures are about the rhythm, not the lyrics; (3) given how difficult it is to retune a culture, business strategy needs to take its cues from the pre-existing culture, not the reverse; (4) a tempered focus on failures is often the best way for outsiders (and insiders!) to pick up on the "ghost notes"[2] being played; and (5) a great culture can be unappetizing—sometimes it's more Keith Moon than Charlie Watts, but if it slaps, it slaps.[3]

Start Me Up

At the highest level, a good culture is more about the "what" than the "how": the culture must be appropriate to what it is that the business does or purports to do. More specifically, it must be in harmony with what the company's value proposition is and to whom that value is meant to appeal. How an enterprise actually goes about executing its mission are its strategic and tactical choices. This might seem

[1] Obviously, companies with little or no regard for human life and decency are of no interest to us. We long ago decided not to invest in tobacco companies. As fiduciaries with responsibility for protecting and growing our clients' money, however, we have few strict limitations beyond that, preferring instead to let our philosophy do the talking—and the choosing. We have not yet been interested, purely as a matter of either the fact that they're lousy businesses, outside our circle of competence, too highly priced (!), or all of the above, in companies that engage in businesses that produce arms, needlessly damage the planet, or distort human discourse.

[2] See https://drumambition.com/jargon-busting-understanding-drum-terminology/

[3] Apologies to our children.

like a very fine distinction, and at a certain point the concepts blur together, but we believe it's an important point. In the case of a company like **Fastenal**, for instance, the firm's job is to provide companies with the small components (literally, the nuts and bolts) required in the manufacturing process. Fasteners, hand tools, safety gear, and the like are their bread and butter. By their own lights, Fastenal's culture is "kind of Midwestern". Located not far from Rochester in Winona, Minnesota, their pulse is in sync with the farming communities they once served: steady, hard-working, honest, and forthright. No flashy headquarters for them; their new four story office building is set to feature such "amenities" as a laminated timber floor and a locker room.

When we first visited the company some years ago, we spent time with a guy on the warehouse floor who was operating a conveyer belt, packing items in boxes for distribution to their retail stores. He explained that the conveyor had been built facing the wrong direction for proper work flow, but because they were aware of that and worked hard to compensate for the defect, it was the most productive one on the floor. That conveyer belt and the employee operating it embody the culture of hard work and old-fashioned pioneer spirit that has allowed Fastenal to transform challenges into successes. Continuous reinforcement of those traits through recruitment of people from the local branches of State U who have hustle and drive without hubris helps maintain that up-tempo beat. Given that getting screws and safety glasses is all about eliminating drama and simply getting the logistics right and on time, this culture is well suited to the rhythm and demands of the business and the customers the company serves.

There are too many types of bad culture to call each of them out individually, but suffice it to say that if a culture is at odds with its purported purpose or ill-suited to meet the customer where he or she is, then it's not only not supportive of the company's mission but actively working in counterpoint to it. Among the categories of poor cultures, the ones we see most often are companies that really have no culture at all ("I guess you could call us entrepreneurial")[4], those where customers are taken for granted or discreetly mocked ("That deal is ridiculous…. It could be structured by cows and we would rate it")[5], and those where what's central to the production of the product or provision of the service is undermined. To the last point, a manager at a pharmaceutical company much in the news lately, to whom we spoke one or two CEOs ago, described the corporate culture at his firm as being one of "accountability". He illustrated his point by recounting the time a new drug was developed by a team of scientists, sailed through the various trials, then went to market…and completely flopped. The CEO gathered the team responsible for the drug in a room, asked whose idea it first was and then proceeded publicly to dress him down. Accountability, sure. But to our eyes, drug development is an inherently creative process, with risks of failure inextricably involved. While

[4] Far too many companies to name.
[5] Per an instant message sent by an analyst at Standard & Poor's pre-financial crisis, revealed during a House Oversight Committee hearing (full instant message transcript a quick internet search away for any gluttons for punishment).

accountability sounds nice (and is good, in appropriate measure), instilling fear in creators is antithetical to the very process required to come up with blockbuster hits.

Let it Bleed

The strength of a culture has to do with both its pervasiveness and its hold on the individual employee. To be strong, a culture needs to bleed through all layers of the organization—to be both broad and deep. It also needs to be dynamic in the face of pressures for it to buckle when the going gets tough. It's not easy, however, to pick up on how strongly a culture permeates an organization and how fully "in the pocket" each member of a firm is in playing his or her role. Many is the corporate headquarters where we walk in and emblazoned on the wall is a list of core values—values that are in evidence nowhere except that nicely printed list. Truly, a strong culture is about the rhythm, not the lyrics.

When you look at a company like **Expeditors**, you can see what we mean: they've always emphasized that, despite being headquartered in the capital of grunge (shoutout to Dave Grohl!), they expect all of their employees to dress in business attire and to present visually and otherwise as thorough professionals. We met with the CEO and CFO over Zoom recently and, true to form, both were rocking ties. While no stranger to fancy technology, their freight forwarding business is also heavily dependent on the savvy relationship building of their personnel. Business dress is their way of saying, both to the customer and to themselves: "we've got this". As the industry fills with too cool for school tech bros trying to take the humans out of the logistics business, Expeditors' dedicated team of people able to tap connections, change course on the fly, and see a package through to its destination sets it apart. Their compensation structure reinforces the accent placed on problem solving and getting it done: each office around the globe has a bonus pool taken from that office's profits and distributed by the office head according to his or her view of relative contribution. We would argue that it is this culture of getting it done smoothly and professionally and in partnership with their network of transportation providers that has allowed Expeditors to perform during this period of container shortages and carrier constraints better than the on-line only folks.[6]

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[6] Jeff Musser, Expeditor's CEO, recounted to us a story about their thoughtfulness in dealing with the carrier capacity restraints currently plaguing the marketplace. Once the company commits to move freight, the team does pretty much whatever it needs to in order to follow through, up to and including chartering planes. But because they value their relationships with the scheduled air carriers, they're very careful to first make sure no belly or seat space is available, as they want to make it clear they're not in competition with their providers. By flagging this, they maintain good relations and remain top of the list once space becomes available.

Beast of Burden

It's important to note that a good culture can be a burden, as well as a source of strength and grounding, for the company whose ambitions are not fully in sync with that culture. Many is the CEO (typically a new one, trying out some new boss moves) who believes that by shaking up a culture, he or she can supercharge a company's potential. But more often than not, trying to introduce elements that are discordant will not only fail to produce a new, shinier culture but so badly undermine the preexisting one that any elements the CEO might want to preserve will have been thoroughly undermined.

An excellent recent book review in the Wall Street Journal highlights the dangers of trying to pivot a culture rather than work within its existing parameters.[7] Another Seattle company, Boeing, had been known for years as a company that emphasized quality, with excellence in engineering at its core. After its merger with rival McDonnell Douglas and its perhaps consequent enthusiasm for engineering of a different kind—that is, financial engineering—the new management team explicitly sought to shift the culture away from its historical rhythm of top quality to a faster pace of bang-for-the-buck: the new CEO wanted to quintuple the stock price in five years, with one of his sidekicks promising to run Boeing "like a business rather than a great engineering firm"[8]. Choosing to privilege short-term profit over longer-term excellence, the company attempted to tweak the 737 rather than design it anew. Known defects in the remodel were corrected through a software overlay that relied on a single sensor that was itself vulnerable to failure. While a pilot could in turn correct for a flawed sensor, that needed to happen within 10 seconds of being alerted to the failure and required training in advance—training that the company was loathe to provide. The rest is tragic history.

Fastenal, once again, proves instructive here. As the company has grown, its strategy has evolved to take advantage of such opportunities as establishing an on-site presence in the plants of large manufacturing clients as well as installing industrial vending machines that supply safety equipment and small tools to folks working on a plant floor. But while that strategy might look quite different from their traditional one of small stores in small towns, it's more syncopation than dissonance, taking fully into account and making good use of their hands-on culture. The same no-drama hustle that enabled them to become a mainstay in the hinterland, where businesses looked to them to assist with the annoying bits and pieces of their business, actually facilitated this evolution because its employees understood their role to be that of consigliere to the client: to understand what it is that the client needs, to procure it, and to dispense it as quickly and seamlessly as possible. The manner of doing so was less important, in cultural terms, than the underlying ethos of staying close to the client.

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[7] Roger Lowenstein, reviewing Flying Blind: The 737 MAX Tragedy and the Fall of Boeing by Peter Robison, Wall Street Journal, November 28, 2021.
[8] As quoted in Useem, Jerry, The Long-Forgotten Flight That Sent Boeing Off Course, The Atlantic, November 20, 2019.

Torn and Frayed

As Leonard Cohen wrote in his magnificent song Anthem, "There is a crack, a crack in everything. That's how the light gets in."[9] All cultures have glitches and even a good and strong culture inevitably encounters an event that reveals its cracks and limitations. For a company that values its culture, such an event provides the opportunity to shore it up for the better and to guide it in the right direction. For an investor, such a crack provides insight into the contours and limitations of the culture. A company that ignores such fissures or continues to pursue strategies that widen them, is likely to see the crazing multiply across the organization; an investor that ignores them is in for potential trouble down the line.

We recently heard a story from a friend with a successful start-up. He and his co-founder saw eye-to-eye on every critical business matter, including who they saw as their customers, how they planned to grow, the strategic initiatives that were most important, and who they sought as employees. One day early on, though, our pal overheard a conversation in which his partner was speaking with a potential client, and while not misrepresenting anything overtly, she was subtly shading the truth through evasiveness and omission. That sparked a healthy conversation, and he never again heard her be anything other than direct and truthful, nor has he seen any other members of his team attempt to be other than forthright. Nipping something like that in the bud is critical: employees tend to be exquisitely attuned to and model their behavior on that of management. It is out of experiences like this that the tracks of a culture are laid.

Closer to home is the example of Wells Fargo. Once a mainstay of our accounts, Wells was possessed of a potent culture when it came to shielding the company from underwriting risks. While for years one could make out the distant drumbeat of disgruntled retail customers, it was easy to dismiss those complaints as a byproduct of the company's brisk, no-nonsense approach to lending: not for them the no-doc, low-doc, subprime mortgages that sank the likes of Wachovia (whom Wells later acquired), Bear Stearns, and Countrywide. They had the discipline (which we love to see) to pull their punches and not reach for the last dollar in the go-go mortgage market of the late 2000s. But not, apparently, the discipline to prevent themselves from exploiting the very customers whom they purported to help "succeed financially".[10] A combination of poorly constructed incentives for their bankers and financial advisers, who were paid per "service" to which the customer subscribed, and a top management that relished cross-selling, they were oblivious to both the reputational risk from such exploitation and the regulatory boom that would be lowered when the base notes became audible. By the time top brass recognized the issue publicly, the problems had become so pervasive that even today, years after the initial discovery, news stories continue to appear about new corners of misconduct within the institution. It's become clear to us that once you countenance—and in this case, actively incent—corruption, it's extremely

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[9] "Anthem", *The Future*, Columbia 1992

[10] Really, who doesn't want an extra checking account or two without having been asked?

difficult to root it out. This is more emphatically true when you've in effect made it impossible for honorable people to succeed in an environment where the dishonorable ones get rewarded (and retained).[11] While, happily, we saw the writing on the wall pretty quickly and were able to extract ourselves from our investment with little or no harm, this remains a case study in listening to the tap strokes, not just the crash cymbals.

Sympathy For The Devil

Good cultures are not all rainbows and unicorns. They can be hard-driving, abrasive, and intolerant of those who can't keep up or fit in. What makes for a good culture is not warmth or collegiality but the appropriateness to the job that needs to get done. And sometimes that job requires a culture with edge and bombast, a John Bonham or Tommy Lee driving a loud but tasty groove rather than a more laconic Ringo and his chill fills. Cultures like this are tough to evaluate, as they flirt pretty closely with the dark side. But they can be extremely effective and, as long as shareholders' interests (and the law) are respected, they can still fit our bill.

The closest we come at present to owning a company whose culture can at times be alarming is **Goldman Sachs**. As an investment bank, asset manager, and global trader and market-maker, Goldman's sometimes razor sharp elbows can get it into trouble, both as a reputational and regulatory matter. But without the capacity to beat others to the punch, take quick and savvy advantage of market intelligence, and leverage its reputation for toughness, it would not be the leading investment bank in the world. Does it sometimes cross the line? Yes. Is it a "great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money"[12]? We think (mostly) not. Its relatively new CEO, David Solomon, is making some attempt to soften the offbeat groove it's been in for decades by making working conditions (somewhat) more humane and by capitulating to the regulatory reality that life will never return to the free-wheeling times before the financial crisis. Its efforts to start a retail franchise will be an interesting test as to whether it can blunt its edges without undermining what has made it such a powerful force over time.

In looking for new companies to add to our "buy at a price" list, we run the various traps that you've heard us talk about in the past: we look at the structure of the industry and whether it allows participants to earn good returns over time; we examine the company itself to see what makes it tick and whether it has sustainable competitive advantages, good management, and good culture; and, if we decide we think it passes all of our quality tests, we determine what we believe the company is worth and then establish a price we would pay for it that imbeds a

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[11] As Charlie Munger memorably opined in a 1995 speech to an audience at Harvard University, "Bad behavior is intensely habit-forming when it is rewarded". *The Psychology of Human Misjudgment,* transcript available on the internet.
[12] Matt Taibbi, "The Great American Bubble Machine", Rolling Stone April 5, 2010.

substantial margin of safety. Our shopping list is not very long, and it is (as you well know) not very often that something from it shows up in our portfolios. Our price discipline has, for better or worse (we think better), caused many of these names to remain wallflowers, forever waiting to be chosen.

Two recent additions to that list, United Health and Disney, may never get the chance to make an appearance in our portfolios, but we've added them to our dance card nonetheless so that we're ready to take them for a spin if and when the price is right. Yet both of them feature cultures that, viewed from a certain angle, could be seen as problematic. United Health is an insurer that has the reputation among those enrolled in its health plans for being, to put it delicately, parsimonious in its coverage. The reason this works, however, is what we call "the agency problem": the real customer of United Health is the employer that purchases the policy, not the employee covered by it. And employers love the penny-pinching approach that makes the coverage relatively more affordable. United mints money. It has breadth and depth in a sector that today accounts for nearly 18% of US GDP, and its expertise in healthcare is such that it has a strong relationship with the government in providing Medicare and Medicaid services.

With respect to Disney, whose franchise spans not just the eponymous kid-oriented entertainment empire but also the Marvel franchise, the Star Wars franchise, and the Pixar, Touchstone, and 21st Century Fox studios, the culture is less sharp elbows than evil step-mother. Disney is well known as a demanding, low-paying employer with some executive arrogance, politics, and back-biting sprinkled in.[13] Tales of newbies crying over a sandwich in their car during lunch break are not uncommon. The "but" here is that it's their culture of perfectionism that causes them to drive people so hard. And that hard-driving culture pays off in the quality of what they produce: they create content that the world wants to see, they have a library that continues to stand the test of time, and, notwithstanding their nose-to-the-grindstone ethos, they attract some of the best talent around. Disney on your résumé is a golden ticket (to borrow from another studio's film franchise), and many talented new film school grads fight to go there despite knowing what they're in for.

Each of these decisions was tough for us, and we wrestled with whether the cultural drumbeat was too ragged, too loud, too at odds with certain of the stakeholders' interests. But, on balance, we felt that not only were they consistent with the value proposition offered by each, they actually furthered and supported it, producing a more harmonious whole than on first hearing.

[13] According to a pithy review on the job rating site Ivy Exec: "[If] you're willing to work tirelessly in pursuit of cost-effectively producing joy, it is for you."

Time Is On My Side

As most of you know, we're patient here at Marshfield. We're of the firm belief that time is, in fact, on our side in its ability to drum up good investment opportunities. But we also take our time when considering a company; our process is specifically designed to satisfy all key elements of fitness for inclusion in our portfolio, however elusive those elements prove to be. Culture, in particular, has a way of receding into the background, producing a palpable but tough to isolate time signature. But if we keep listening for the light feather strokes, we will usually find the groove. It's almost always there somewhere. We do this not because we're obstinate (though we are), but because culture, even one that's largely absent, drives so much of what a company is, what it does, and whether it has the chops to stand the test of time. In our world, culture is king. It's no wonder that the seat occupied by the drummer is called the throne.

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* "If You Can't Rock Me", *It's Only Rock 'n Roll*, Rolling Stone Records 1974

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