# Measuring the Quality of Management and the Integrity of Corporate Culture for Profitable Investing

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*Analyzing the words and linguistic patterns of executive communications, such as in a CEO's annual shareholder letter, earnings teleconference scripts, or other corporate messages, provides valuable insights into a company's corporate culture. Reading carefully between the lines can reveal the trustworthiness of the financial accounting as well as the integrity of the leadership. Each year, Rittenhouse Rankings codes and scores candor in company shareholder letters and ranks companies in a culture and candor survey. Over the past nine years, this research has shown that the shares of companies whose executives exhibit a high degree of candor have outperformed shares of candor-deficient companies. In other words, investors who take the time to evaluate the integrity, authenticity, and candor of executive communications will be more likely to make insightful and profitable investment decisions.*

Investors can improve their analyses of investment opportunities by identifying the values and behaviors that shape a corporate culture. The narrative a CEO tells about his or her company in the letter to shareholders can reveal a great deal about the corporate culture. In fact, investors and analysts who use tools to systematically measure the degree of management candor, such as those developed by Rittenhouse Rankings, can gain a competitive advantage over investors who dismiss these intangibles.

Does the integrity of leadership and culture as measured by candor rankings matter in market performance? Research indicates that it does. **Figure 1** shows the average price change for companies in the top quartile and bottom quartile of the Rittenhouse Rankings Candor and Corporate Culture Survey from 2005 to 2013. In eight of the past nine years, the returns of candor-rich companies have outperformed their candor-deficient counterparts. Also, in all nine years, candor-rich companies have outperformed the S&P 500 Index.

## Challenging Financial Dogma

Our research shows that traditional financial analysis is handicapped by three widely held and questionable beliefs:

1. Companies need to be more transparent.
2. Numbers are more trustworthy than words.
3. Only seasoned analysts can effectively evaluate corporate culture.

Although each of these beliefs contains an element of truth, they also can blind investors and management to other truths that challenge these assumptions.

**Transparency.** After the Enron debacle and the subsequent passage of the Sarbanes–Oxley Act of 2002 (SOX), companies have been pressured to become more transparent. But we have found that companies are more transparent than they even realize. This insight comes from carefully reading between the lines in shareholder letters and comparing what they report and fail to report. Following are two case studies.

■ *Case study 1: Enron's 2000 Annual Report.* Astute readers of Enron's 2000 shareholder letter, published in 2001, would have noted that CEO Jeffrey Skilling reported early in the letter about how the company was "outdistancing the competition in all of its major businesses." At the end of the second paragraph, readers learned that Enron's net income had reached $1.3 billion, exceeding $1.0 billion for the first time in company history.

But an examination of Enron's financial statements in the annual report revealed that Enron's net income in 2000 was $979 million.[1] It had not exceeded the billion dollar mark. The reconciliation of this discrepancy was found in a financial footnote in which the company reported a net income of $1.3 billion by including $326 million that represented the decline in the value of Enron's investment in the water company Azurix.

This simple test of matching the earnings or earnings per share in the shareholder letter with the relevant numbers in the income statement can signal the

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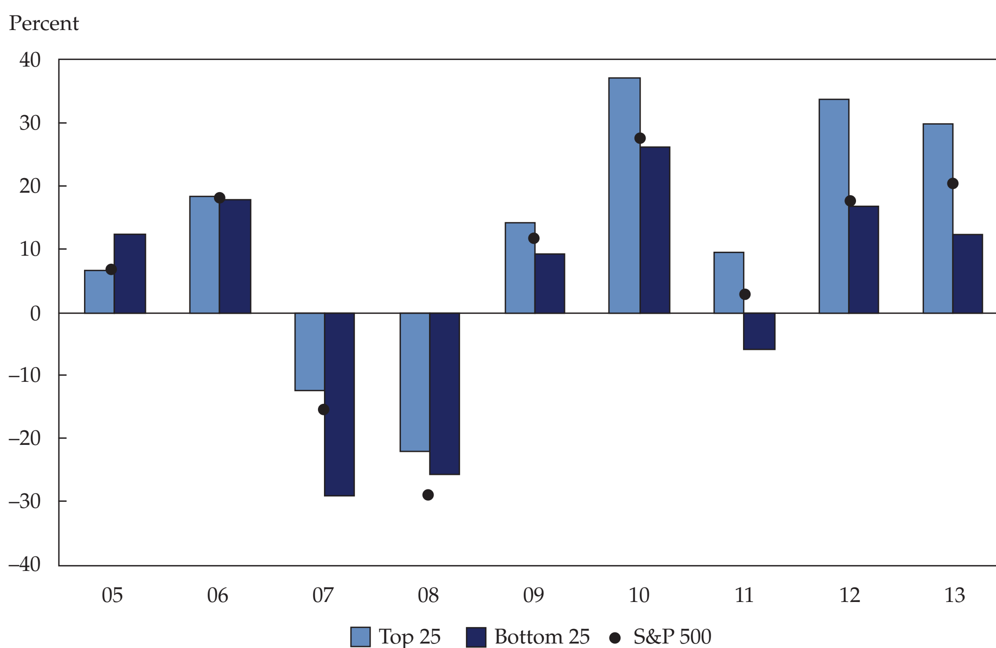
[1]Enron, *2000 Annual Report* (2001): http://picker.uchicago.edu/Enron/EnronAnnualReport2000.pdf.

**Figure 1. Average Price Change for Top 25 and Bottom 25 Companies and S&P 500, 2005–2013**




strength or weakness of executive candor. A company that cannot accurately report its net income in a shareholder letter requires greater scrutiny. Consider that when Enron's 2000 annual report was published in early 2001, the stock was trading at about $60 per share. By the end of 2001, it had fallen to 60 cents per share.

*Case study 2: AIG's 2007 Annual Report.* In February 2008, American International Group (AIG) released its 2007 annual report.[2] The following passage clearly states that the company was experiencing problems but ones that did not hamper its "important advances in key markets":

> The U.S. credit crisis, recession fears and record-high oil prices caused economic disruption and uncertainty. In addition, some of our businesses did not meet expectations. Nevertheless, the fundamental strength of our core operations is intact, and we made important advances in key markets. (p. 2)

An astute investor reading between the lines of this passage might ask, If the "core operations" (not defined in the letter) were intact, what has happened to the company's noncore operations? What businesses are included in these noncore operations? Were these also intact?

Later in the letter, CEO Martin Sullivan reported that the company's financial results included a "pretax charge of $11.47 billion for unrealized market valuation losses related to the AIG Financial Products Corporation's (AIGFP) super senior credit default swap portfolio." And although he never explained what caused these unrealized market valuation losses, he did describe how investors should treat the impact of these unrealized losses:

> Based upon its most current analysis, AIG believes any losses that are realized over time on the super senior credit default swap portfolio of AIGFP will not be material to AIG's overall financial condition, although it is possible that realized losses could be material to AIG's consolidated results of operations for an individual reporting period. (pp. 2–3)

This passage raised several questions: Was the AIGFP portfolio a noncore operation? What was the "super senior credit default swap portfolio"? What was it insuring, and what triggered these "unrealized losses"?

To his credit, Sullivan did admit that it was possible that the realized losses could be material to AIG's consolidated results of operations for an individual reporting period. But what did "material" mean? Would it cause a significant drop in income? All of these questions raised issues requiring explanations. Several pages later, Sullivan reported on the outlook for AIG's derivatives business:

> We continue to believe that AIGFP will not realize significant losses from this derivatives business, which insures against the default of certain securities. Since its creation, AIGFP has been a strong performer and is an important component of AIG's diverse portfolio of businesses. (p. 7)

[2]AIG, *2007 Annual Report*, American International Group (2008): www.aig.com/Chartis/internet/US/en/2007annualreport_tcm3171-440907.pdf.

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Readers learned that the AIGFP portfolio was created to insure "against the default of certain securities." But what *are* these securities, and *why* are they not described? In addition, Sullivan reported that this "derivatives business" was "an important component of AIG's diverse portfolio of businesses." This statement seemed to contradict the previous paragraph, which stated that any realized losses from AIGFP *will not be material* (author's emphasis) to AIG's overall financial condition.

Six months after AIG's annual report was published, the stock had lost 50% of its value. On 16 September 2008, the company received an $85 billion bailout from the US government. In short, Sullivan's letter actually offered a transparent picture of the problems and potential problems facing the company, which was revealed through the confusing and convoluted statements cited here. This obfuscation signaled management's discomfort with its disclosures. We code such commentary as "FOG"—an acronym for fact-deficient, obfuscating generalities.

**Numbers vs. Words.** Analysts and investors tend to trust numbers more than words because words can have multiple meanings. For example, the word "two" has three spellings—two, to, and too. In contrast, 2 + 2 + 2 = 6 has a precise definition. But this difference can blind financial analysts to a basic truth: Precision does not necessarily lead to accuracy. Although numbers can be precise, they may not be accurate.

Remember how financial statements are produced. The process begins with the countless judgments made by people in a company about when to count cash, where to report it, and when to turn it into earnings. These judgments will be shaped either by such values as those practiced at Enron or by the values of a company where candor and accuracy are expected, such as at Berkshire Hathaway. In other words, the values that shape and define a corporate culture will determine the trustworthiness of corporate accounting.

Knowing whether a CEO chooses to confuse, or worse, deliberately lie to investors is vital information. The words and actions of a CEO—the tone at the top—will determine the integrity of corporate culture and behavior of employees throughout a company, which, in turn, will reveal the strength or weakness of corporate execution and performance.

**Financial Analysts.** Seasoned investors and analysts understand the importance of corporate culture. Over the years, they learn how to spot cultural clues that determine performance. But the Rittenhouse Rankings methodology offers an opportunity for people without business training as well as experts to make astute judgments about corporate culture. By learning how to analyze, code, and score words, phrases, and other commentary in executive communications, investors will gain insights into the strength or weakness of a CEO's commitment to building a culture of candor and trust.

## What Is Candor?

The words "transparency" and "candor" are often believed to have the same meaning. They do not. To understand the difference, consider the origins of each word. The root Latin word for transparency, *parere*, means to appear to be free of deceit or to be easily seen through, as in making a transparent lie. In contrast, the root word for candor is *candere.* It is also the root word for candle and means to shine or illuminate. Candor defines personal traits, such as the quality of being honest and straightforward in attitude and speech. It describes the ability to make judgments free from discrimination or dishonesty.

The best example of corporate candor is the Berkshire Hathaway Owner's Manual. This document lays out the principles that CEO Warren Buffett champions and uses to run the company. These principles give investors confidence that they can count on management to choose stewardship, not entitlement, in managing their money. Principle 12 in the manual is especially important:

> We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less. Moreover, as a company with a major communications business, it would be inexcusable for us to apply lesser standards of accuracy, balance and incisiveness when reporting on ourselves than we would expect our news people to apply when reporting on others. We also believe candor benefits us as managers: The CEO who misleads others in public may eventually mislead himself in private.[3]

## Quantifying and Ranking Candor

After reading hundreds and hundreds of shareholder letters over the years, I was able to identify patterns that revealed the seven key systems that make up a corporate culture. The seven systems included in the three-vector corporate culture model are capital stewardship, strategy and accountability, vision and leadership, and stakeholder relationships and candor.

The center of Rittenhouse Rankings' taxonomy of culture—the hub of the dynamic wheel that drives our explanation—is the system of capital stewardship. This system is defined by such topics as cash and cash flow, goals, capital discipline, and operating

[3]Warren Buffett, "An Owner's Manual," Berkshire Hathaway (June 1996): www.berkshirehathaway.com/ownman.pdf.

metrics. If commentary is found in a communication related to these topics, we award specific, predetermined points whenever this topic is described or mentioned. By adding these points together, analysts can measure the breadth and depth of content in an executive communication.

The first vector in our corporate culture model includes the strategy and accountability systems. Strategy is defined by topics that include business opportunities, positioning actions, competitive advantage, and how a CEO highlights key markets. Accountability topics reveal how a company executes its strategy. These include commentary to set expectations, provide a near- and longer-term outlook, and report financial and business results. Accountability supports the strategy system. Without understanding a company's accountability system, investors will find it difficult to determine how and whether the corporate strategy is being effectively executed.

The second vector in our model is composed of the vision and leadership systems. Vision topics include descriptions of the corporate purpose and value proposition as well as statements of innovative practices, ideas, and beliefs. Leadership commentary supports the corporate vision. It is defined by commentary that educates investors about the business and reports on company missteps and investor skepticism. Strong, forthright leadership is needed to support a credible and inspiring vision. Without strong leadership, the corporate vision will be shaky and the company is likely to waste capital.

The third vector in our model is made up of the stakeholder relationships and candor systems. These two systems form the backbone of a company. The stakeholder system is identified by topics about what customers want from a company and commentary about how management balances stakeholder needs and imagines their experiences when interacting with the company. Candor topics may include business jargon, confusing statements, clichés, and contradictory explanations. These are scored differently from the topics in the other systems. Instead of assigning positive point values as is done when scoring the six systems just presented, points in the candor system are deducted from the total content score. The reason is simple: Candor is difficult to observe, but the absence of candor is not. Collectively, negative candor topics make up FOG.

Executives who lack a commitment to candor will be handicapped in creating trusting relationships with stakeholders. And without trust, the business cannot perform at optimal levels. Executives with trust-deficient cultures can expect to create confusion and even fear—internally and externally. These qualities are toxic to creating sustainable shareholder wealth. When fear dominates a corporate culture, expect to find poor execution and thinking and, ultimately, substandard results.

## Candor and Stock Performance

How can candor determine market performance? Consider the turnaround at Ford Motor Company engineered by Alan Mulally. Coming from Boeing, he was named the first non-family CEO of Ford at the end of 2006. Arriving at the company, Mulally found a culture of fear that shaped conversations and affected decisions. Managers staked out turf and stayed in their silos.

One of the first actions Mulally took was to institute weekly mandatory meetings for all of the executive teams. At first, managers resisted and manufactured reasons why they could not attend. Mulally was not interested in reasons or excuses; mandatory meant "be there." When they arrived at the meeting, each manager was expected to bring a report showing their progress on important projects using a color-coded dashboard. Green was for projects moving along as expected, yellow for projects showing slower progress, and red for troubled projects.

For the first few weekly meetings, everyone brought reports coded in green. Mulally finally got angry when he saw a room awash in projects coded in green. He shouted, "We're going to lose billions of dollars this year. Is there anything that's *not* going well here?"[4]

At the next meeting, Mark Fields, head of the North American business, arrived with a project coded in red. As he described a problem with the soon-to-be released Ford Edge, all eyes turned from him to Mulally. How would the boss react to this announcement? In the past, admitting problems could jeopardize or even end a career. The room went very still. Suddenly, Mulally began to clap loudly. "This is wonderful," he shouted, "Great visibility, Mark. Now, who can help him? Who has had experience with this problem?"

Within weeks, that problem was fixed and executives started bringing project reports coded in yellow and red as well as in green. The rest of Ford's story is well known. It was the only large US auto company not to accept a government bailout. It even began posting profits and resolved long-standing labor and product issues.

**Figure 2** shows the trend line in Ford's candor ranking and stock price compared with the S&P 500 from 2008 to 2013. The connection between increased candor and rising stock price is clear.

In early 2009, after Ford's 2008 annual report was published, I read Mulally's letter to shareholders and found that the content and vocabulary were quite different compared with previous years. I called a colleague who knew people who worked at Ford

[4]Bryce G. Hoffman, *American Icon: Alan Mulally and the Fight to Save Ford Motor Company* (New York: Crown Business, 2012): 122.


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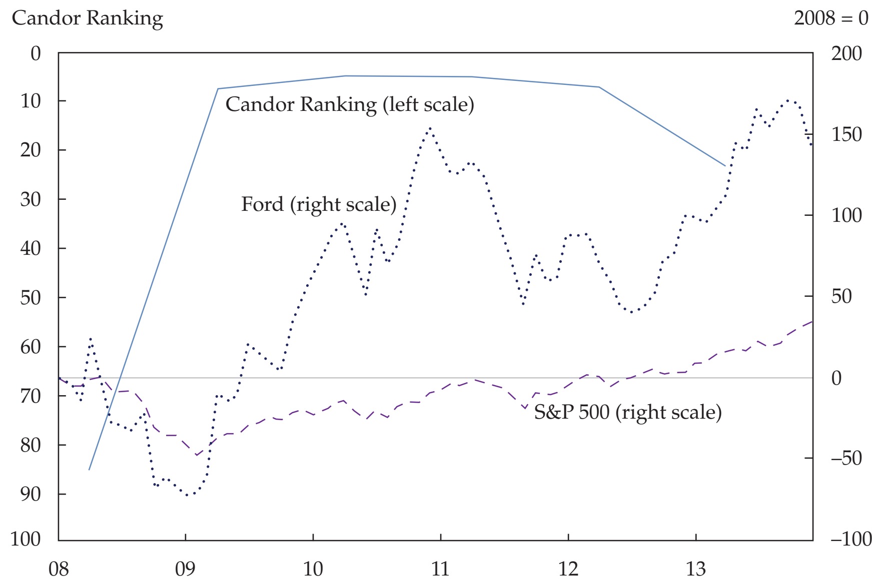
and asked what he was hearing them say about the company. It was startling to hear the words of these employees as reported to me from my colleague. They were nearly identical to the words in the shareholder letter. It seemed that Mulally's culture changes were being internalized. At that time, Ford was trading for about $5 per share. It seemed to be an opportunity for investors who believed in the power of positive culture change to buy the stock. They were rewarded for this belief.

Our analysis of Ford's candor scores showed significant improvements in accountability and vision. In addition, the business opportunity scores almost doubled in that 2008 shareholder letter. The letter also reported on a new financial strategy with clear actions laid out to show how the company would execute that plan.

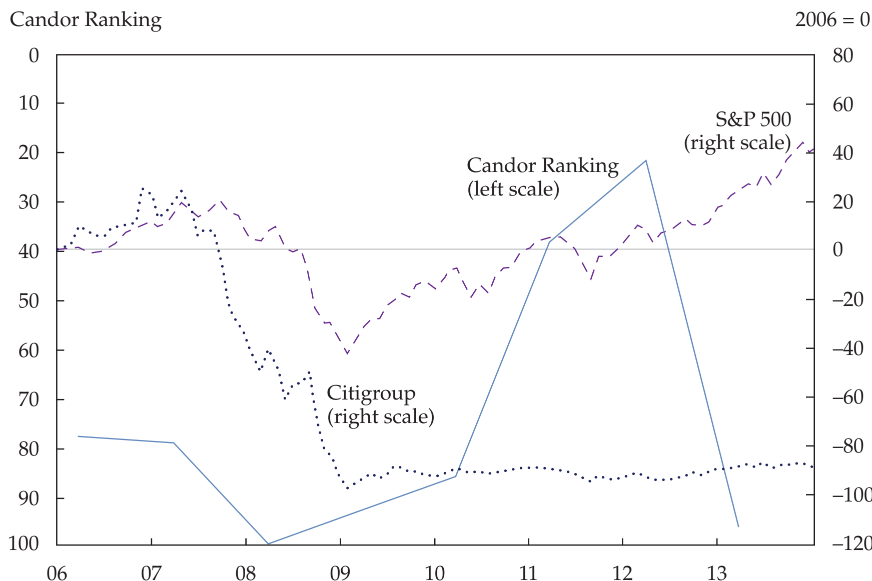
In contrast, **Figure 3** shows the relationship between Citigroup's candor ranking and stock price from 2006 to 2013. With the exception of the 2011 and

**Figure 2. Ford's Candor Ranking and Stock Price and S&P 500 Stock Price, 2008–2013**




*Note:* Ranking is 1–100, best to worst.

**Figure 3. Citigroup's Candor Ranking and Stock Price and S&P 500 Stock Price, 2006–2013**




*Note:* Ranking is 1–100, best to worst.

2012 culture and candor surveys of Citigroup's 2010 and 2011 letters, which were written by CEO Vikram Pandit, the company has consistently ranked in the bottom quartile of the 100 companies in the survey.

In fact, CEO Michael Corbat's 2012 shareholder letter revealed substantial FOG. The following excerpt from the letter of that year's annual report[5] illustrates the type of FOG we coded and scored:

> More and more people are moving into cities, and every year the share of GDP produced in urban centers grows. Today, fully 80% of the world's GDP is generated in urban centers. And cities are not reflected just in our name—they're in our blood. We've identified over 150 cities—which together produce 32% of global GDP—that fit our business model and represent where we think many of the coming opportunities will emerge. (p. 4)

In this passage, Corbat fails to explain why the increase in the share of GDP produced in urban centers is important to Citigroup. Instead, he connects this growth to Citigroup's "blood." Further on, he mentions that there are 150 cities that represent opportunities for Citigroup's business model, but he never names actual cities. In fact, the company's business model is never described in this letter.

**Figure 4** presents candor rankings for four banks from 2002 to 2012: Wells Fargo, Bank of America, Wachovia, and Merrill Lynch. Over this period, Wells Fargo's candor ranking was always at or near the top quartile of the annual culture and candor survey. In contrast, Bank of America's culture and candor measures were consistently ranked below Wells Fargo's rankings. When Bank of America's 2008 letter was published in 2009, we saw a precipitous decline, with Bank of America dropping from 48 to 77 in the survey rankings. Now consider Wachovia and Merrill Lynch, whose rankings had fallen to new lows by 2007. They did not survive the economic crisis. In 2008, Wachovia was acquired by Wells Fargo and Merrill Lynch by Bank of America.

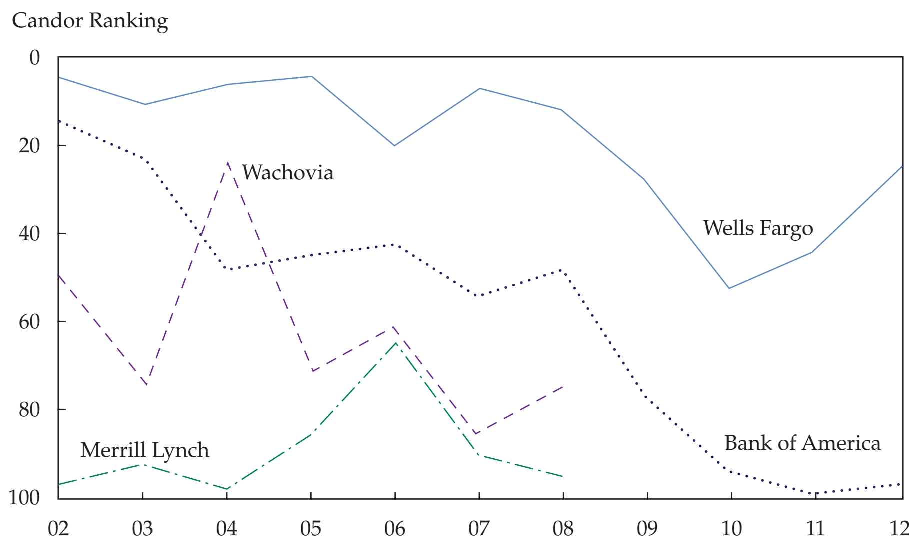
As illustrated by the Ford and Citigroup examples, a company's candor rankings can change over time. **Table 1** shows companies that experienced the most significant changes in candor rankings, along with their stock price performance, between the 2012 and 2013 culture and candor surveys. Note that Hewlett-Packard moved up 79 places in the candor rankings while its market value increased 88%. Pitney Bowes's candor ranking also improved significantly, up 75 places, and the company's stock market value also increased 88%.

In fact, the average increase in value for the five companies with the largest improvement in candor ranking during this time—Hewlett-Packard, Pitney Bowes, Dow Chemical, Fiat, and CSX Corporation—was 62%. In comparison, the five companies with the greatest ranking declines—Citigroup, Travelers Companies, Harley Davidson, Motorola, and IBM—had an average market value increase of 13.5%.

**Figure 5** shows an increasing trend in FOG among all the companies in our survey since 2002. In fact, between 2003 and 2004, the survey companies registered the greatest percentage increase in FOG scores over the entire study period. These two years coincided with the passage of SOX,

[5]Citigroup, *2012 Annual Report* (2013): www.citigroup.com/citi/investor/quarterly/2013/ar12c_en.pdf.

**Figure 4. Candor Rankings for Four Banks, 2002–2012**




*Note:* Ranking is 1–100, best to worst.


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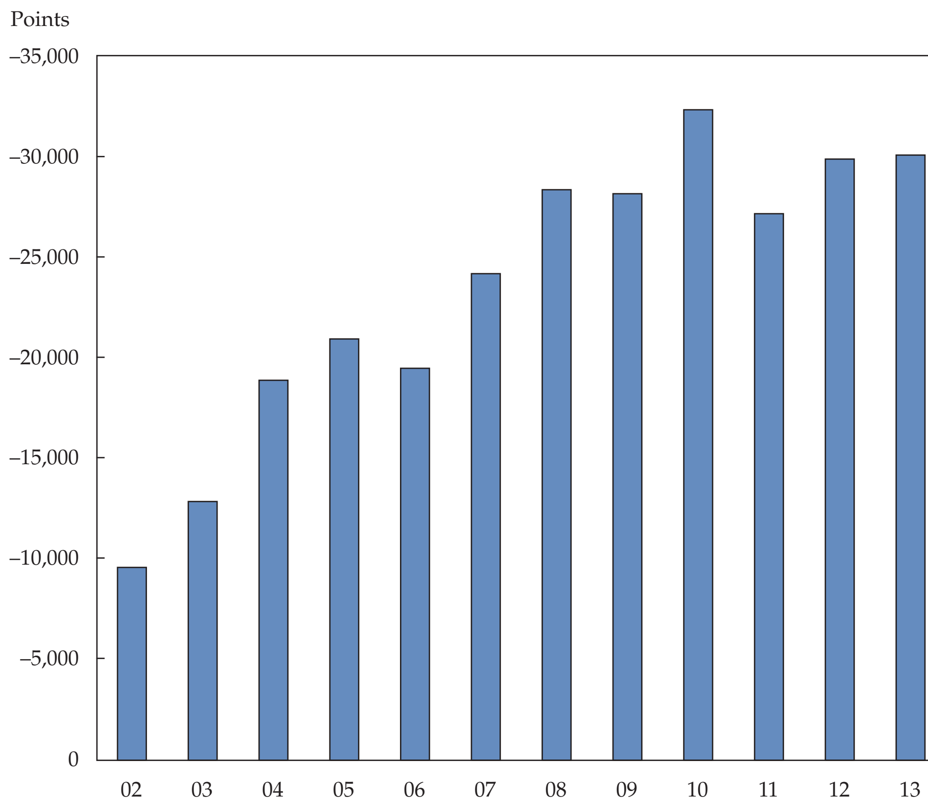
**Table 1. Companies Increasing and Declining the Most in Candor Rankings, Q2 2012–Q2 2013**

| | Changes in Rank | Market Price Change |
|---|---|---|
| *Companies Increasing the Most* | | |
| Hewlett-Packard | 79 | 88.2% |
| Pitney Bowes | 75 | 88.1 |
| Dow Chemical | 51 | 57.7 |
| Fiat | 49 | 44.8 |
| CSX Corporation | 48 | 31.3 |
| Average | | 62.0% |
| *Companies Declining the Most* | | |
| Citigroup | –74 | –1.8% |
| Travelers Companies | –60 | 19.0 |
| Harley Davidson | –56 | 38.2 |
| Motorola | –53 | 19.3 |
| IBM | –48 | –7.3 |
| Average | | 13.5% |

**Figure 5. Total FOG Point Deductions for Survey Years 2002–2013**




which was created in reaction to the Enron scandal. Intended to increase transparency and inspire greater trust, this act ushered in an era of increased FOG because it resulted in expanded legal oversight of shareholder letters and other public corporate reports. Note also that in 2010, the year after the Dow Jones traded down to its lowest level since the 1970s, the survey recorded the highest number of FOG point deductions ever.

## Financial Linguistics and Corporate Trustworthiness

Culture and candor analysis is part of an emerging new field in investing—financial linguistics. Language reveals the values and practices of management and the corporate culture, which, in turn, can lead to more definitive, insightful, and profitable investment decisions. Corporate executives can

improve corporate performance by exhibiting a high degree of candor.

Never forget that words reveal the integrity of leadership. They can signal the existence of fear-based corporate cultures or reveal creative problem-solving cultures. Investors can learn a great deal about a company's CEO by looking at his or her vocabulary. Does he or she draw from a rich vocabulary, or is it pedantic and full of jargon? By studying executive candor, investors and other stakeholders can gauge the presence of corporate trustworthiness. George Orwell once said that if thought corrupts language, then language can also corrupt thought. Excessive use of jargon and poor communication can spread within a company like a virus. When people start talking in jargon, then others will answer in jargon.

Great leaders understand the power of words. In 1940, when the Nazis were bombing London mercilessly day and night, England was unprepared for war. Prime Minister Winston Churchill had only his words at the time to fight back, and he used them explosively. His speeches inspire us even today.[6] Using words rhythmically, simply, and emotionally, Churchill rallied the people to face the deadly assaults with courage and resolve.

If you go to London, visit the Churchill War Rooms, where a picture of Churchill, hung near his Nobel Prize Award for Literature, is graced by a simple quotation: "Words are all that last."

[6]For example, see www.winstonchurchill.org/resources/speeches/1940-the-finest-hour/we-shall-fight-on-the-beaches.

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# Question and Answer Session

L.J. Rittenhouse

**Question:** Are certain sectors or industries more or less trustworthy?

**Rittenhouse:** Over the years, companies that typically score in the bottom of the candor rankings are those that are relatively regulated, such as pharmaceutical companies, health insurers, and financial institutions, including banks. Companies ranked at the top of our survey represent a wider range of industries.

For instance, General Mills has been a consistently solid performer in the top of the candor survey over time, along with Amazon, Costco, and Sherwin-Williams. The common thread among them appears to be that as market-facing companies, they must be faster and quicker to succeed. The clarity and integrity of their communication helps them to execute efficiently for success.

**Question:** How many companies do you rank?

**Rittenhouse:** The Candor and Corporate Culture Survey includes 100 companies, most of which were chosen when the survey began. They are a representative distribution of companies and were selected based on their standings in financial performance, corporate reputation, market capitalization, and industry category.

Over time, about a third of the original companies have been dropped because they were either acquired, declared bankrupt, or stopped writing letters. They have been replaced with comparable companies based on the same criteria used in the selection of companies in the original sample.

**Question:** Have you done any work with investment managers?

**Rittenhouse:** I have not. It is partly from wanting to avoid the appearance of a conflict of interest that could result from consulting with a company and also working with an investment manager who follows that company. We are now beginning to scale up the number of companies in the survey and are adapting natural language text searching software to automate much of the candor analytic process. Eventually, we intend to offer the candor rankings as an investment product via subscription to investment managers.

**Question:** What are your views on environmental, social, and governance (ESG) investing, and could similar results of qualifying companies be achieved using ESG factors?

**Rittenhouse:** Some companies provide information on their environmental and social investments, which can offer deeper insights into the corporate culture. But we have not seen any association between ESG investing and candor. I would expect that a company ranked high in candor is likely to have more effective ESG investments because candid companies typically execute more rigorously, have more comprehensive strategies, have a more credible vision, and care sincerely about stakeholder relationships.

**Question:** Can a CEO who demonstrates a lack of trust in his or her personal life—for example, marital infidelity—be trusted to run a company?

**Rittenhouse:** Marital infidelity is not in the model. Your question raises an important question: Where does the public draw a line between a leader's personal life and public life? If such behavior becomes a public media event and puts a company at risk, then the board would be expected to take decisive actions.

Fundamentally, candor is based on respect, including the respect for keeping one's promises. Leaders who act with integrity in both their business and personal lives will inspire similar behavior in the people they lead.

**Question:** Can management that shows a lack of candor be reformed?

**Rittenhouse:** Yes, it can. Candor can be infectious. Recently, I spoke about corporate candor at a meeting with a company's executives. One of the vice presidents was curious about our candor findings and practices. He wanted to know how to "operationalize" it and described a difficult issue in the company.

The issue was widely known throughout the company, but no one in the meeting wanted to discuss it. They were afraid. But as he talked about the issue, I felt the tension in the room change. People began to relax. Discussion was more open and free-flowing. Finally, I looked at the vice president and said, "You just operationalized candor."