



the essential
roles of **culture**,
philosophy, and
technology

winning at
active
management

william w. **priest** • steven d. **bleiberg**
michael a. **welhoelter** *with* john keefe

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Further praise for *Winning at Active Management*

“The chances of success in fund management, as in professional sports coaching, are inversely proportional to time. The longer you are in the game, the greater your chance of having a poor run over a measurable window (say, three years), and involuntarily exiting the field. So the thoughts of a manager with 50 years’ experience are worth reading. This book, unlike many written by active managers, does not claim to have found El Dorado and a path to untold riches; indeed, it acknowledges that passive investment may be appropriate for some applications.

The reason Bill has succeeded for so long comes across well in his and his co-authors’ approach to culture, and in their dismissal of the Price-Earnings Ratio – a figure that whilst discredited, and never used in private markets, remains a mainstay of most active managers’ processes. Economies and markets do not stand still, and yet many active and quant managers believe that what worked before will work again without the need to change and evolve their processes. It is in this area, more than any other, that 50 years of experience is invaluable.”

Robert Waugh
Chief Investment Officer
The Royal Bank of Scotland Group

“One of the most difficult aspects of consulting to institutional investors is finding active investment managers who will produce consistent results over a long period. While an investment process that is both sound and repeatable across different market environments is critical, it is insufficient unless implemented in a thoughtful way by an investment team that possesses the skills and values, and is offered the right incentives, to make optimal investment decisions. To my mind, a firm’s leadership

must inculcate and manage this sort of culture within the entire team in order to remain successful over a long period, and the first part of this book highlights that cultural challenge.

Technology has become a game changer in the investment industry, and the organizations that apply it most effectively will be the long term winners. Given the incredible amount of information that is now available, winnowing the critical insights to a manageable amount and sharing them among the investment team has become essential to an investor's success. In addition, using technology to better understand the factors behind market behavior can help an investment firm to evaluate its own performance. Again, the book speaks effectively of the need to make better use of technology within all parts of the investment industry."

David Service
Director, Investment Consulting
Willis Towers Watson
(Retired)

"Bill Priest, a leading practitioner of free cash flow-based investing, explains why that philosophy has been so successful. And much more: he and his co-authors tackle the most difficult issue in the investment management business – culture – and demonstrate how to maintain it in challenging periods. The book also addresses the industry's latest challenge, the proliferation of quantitative algorithms in every corner of the investment world, and describes how the value of judgment has increased as machines have come to exploit the short-term relationships that can be tested. Recommended reading for this generation of investors, and the next one."

Michael Goldstein
Managing Partner
Empirical Research Partners

WINNING AT ACTIVE MANAGEMENT

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The Essential Roles of Culture, Philosophy, and Technology

William W. Priest
Steven D. Bleiberg
Michael A. Welhoelter
with John Keefe

WILEY

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To Jack L. Treynor – the Albert Einstein of Finance, a man of great principle, a co-author, and a friend, from whom I learned more finance and economics than any other person.

And to my family – wife Katherine, Jeff, Karen, Amanda, Jack, Jacob, Hayley, Spencer, Joan, and Steve, who provide support, questions, and the occasional “what in the world were you thinking!” – William W. Priest

To Terri, Ben, Katie, and Ellie, and to my father, Lawrence Bleiberg, in whose footsteps I have followed – Steven D. Bleiberg

To my wife, Leslie, and my children, Christopher, Megan, and Lindsay – Michael A. Welhoelter

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Active Management is Not Dead Yet

During a writing project like this one, once the key ideas are established, a question nags at the authors: What should we call it? Early on we came up with a working title “Not Dead Yet.”¹ It was meant as a tongue-in-cheek response to the stream of reports over the past few years on the decline of active management of equity portfolios flowing from financial journalists and market observers—as well as the marketers of index funds, exchange-traded funds and other products that compete with actively managed strategies. To an extent, they make a valid point: the performance of active managers as a group has been less than desired. But there are several reasons to explain managers’ underperformance: some are cyclical, as markets of recent years have been affected by new sorts of macro influences, while others are secular, and related to how managers carry out their investment processes (Chapter 6).

However, the markets have not changed inalterably, at least not in our view. The essence of active management is a well-designed investment process that measures the relative value of individual stocks, and takes advantage of the many mispricings that result from less-than-optimal actions of investors, both individuals and professionals (Chapter 5). Granted, the stock market may have become harder for many managers to beat for several years. But inefficiencies in the pricing of stocks are timeless, and

we believe that active equity management still works, and that the best managers can deliver excellent performance over the long term (Chapter 7). *Active management is not dead.*

This book is a second installment to a volume that I authored in late 2006 with Lindsay McLelland, *Free Cash Flow and Shareholder Yield: New Priorities for the Global Investor*, published by John Wiley & Sons in early 2007. A few years after the founding of Epoch Investment Partners in 2004, I wanted to share views on what we saw as crucial investment issues of the day, and relate insights from the perspective of the firm's investment process. The factors that would lead to the global financial crisis had just started to surface, and while we weren't prescient on every topic in the book, we got many of them right as evidenced in white papers Epoch published at the time. (For example, see "The Canary in the Coal Mine: Subprime Mortgages, Mortgage-Backed Securities and the U.S. Housing Bust" from April 2007, reprinted in Appendix A.) More important, Epoch's strategies fared well in the markets that followed, so the firm and its clients came through the global financial crisis in good stead.

A couple of years ago, I decided to write a second book. People that I talked with assumed it would take the form of a memoir about my 50 years in the investment industry. That idea had some appeal, as the markets of those years were varied and dynamic, and I have been "in the room" at critical junctures of market volatility with important and colorful people, and have plenty of stories and lessons to share.

But I am not a historian—I am an investor, and as such I am much more oriented to the future than the past. Of course, history is often the best guide to the future, but the "present" that today's investors are facing—which includes the recent unusual period of the global financial crisis, and how governments, corporations, and markets have contended with the world since—make the further past of my career seem less and less relevant going forward.

Still, my experience has been pretty interesting, so I will share a bit. I joined the industry cavalcade in July 1965 at a mutual fund management firm, working as a research analyst initially and eventually a portfolio manager. I joined BEA Associates in New York, as a portfolio manager and partner of the firm, in July 1972. That November the Dow Jones Industrial Average closed above 1,000 for the first time. (The 1,000 mark on the Dow presented a challenging summit for equity investors: the average broke through 1,000 in intraday trading three times in early 1966, but did not end the day there.²) The firm's staff numbered 11, and BEA managed less than \$300 million in client assets—pretty small even in 44-year-old dollars. Not only was BEA a minor force in the market; the firm also had a weak balance sheet and at the beginning operated hand-to-mouth.

Shortly after I joined the firm, there was a significant collapse in stock prices—from its peak in December 1972 through December 1974, the Dow dropped 44 percent.³ My timing in leaving a large firm for the entrepreneurial excitement of a startup could not have been worse: the resulting decrease in assets and management fees led to a few BEA staff (of whom I was one) having to forego cash compensation for several weeks. However, BEA was fortunate to have a strong culture—one based on personal integrity, the motivation for the work that lay ahead of us, and the drive to provide superior performance for our clients.

There's a saying in the stock market, which applies to life in general: *Timing Is Everything*. For BEA Associates, it was everything, and more. In 1974 Congress passed the Employee Retirement Income Security Act—ERISA—for the protection of employee pension funds, requiring employers to adequately fund them, and segregate the assets in formal pension plans. (The expanded requirements for recordkeeping, regulatory compliance and investment mandated by ERISA were so sweeping that those in the business jokingly called it the “Accountants,

Lawyers and Money Managers Relief Act.”) The resulting flow of contributions from corporations to the pension funds they sponsored launched a new era for institutional asset management. The passage of ERISA was prompted by “the most glorious failure in the [automobile] business.” In 1963, after stumbling financially for many years—a strong postwar market for U.S. car sales notwithstanding—the Studebaker-Packard Company closed its plant in South Bend, Indiana. Workers aged 60 and over received their expected pensions, but younger workers received a fraction of what was promised or nothing at all. The shutdown helped advance a growing debate on pension reform into the national legislative arena, leading to the passage of ERISA in 1974.⁴

The new regulations forced the financial analysis underlying pension funding to a higher level, and to meet some of that need, I was fortunate to co-author, with financial scholar Jack L. Treynor and fellow BEA partner Patrick J. Regan, *The Financial Reality of Pension Funding Under ERISA*, published by Dow Jones-Irwin in 1976. Our conclusions grabbed the attention of legislators, and I testified before a congressional committee that influenced later regulations on the viability of insuring pension plans via the Pension Benefit Guaranty Corporation (PBGC). My co-authors and I were concerned that under certain circumstances, the PBGC could go broke, and Congress did indeed repeal and amend the section known as CELI—Contingent Employment Liability Insurance.

BEA expanded rapidly in the new era: by 1980 our managed assets had climbed to \$2 billion, and the firm was recognized as a leader in U.S. institutional money management. In 1989, I became the CEO of BEA Associates, but continued to manage institutional portfolios. A year later the firm entered into a formal partnership with global bank Credit Suisse, although BEA Associates maintained its name until early 1999, when it became Credit Suisse Asset Management-

Americas and I continued as the CEO. We then acquired Warburg Pincus Asset Management in spring 1999, at which point the fully built-out CSAM-Americas managed assets of nearly \$60 billion. In 2000, Credit Suisse purchased the brokerage firm Donaldson, Lufkin & Jenrette, and its asset management arm also joined CSAM-Americas, bringing total assets to about \$100 billion.

Over the course of those 30 years, as BEA Associates grew from a startup to the cornerstone of a large global institutional firm with offices in New York, Tokyo, London, Zurich, and Sydney, I witnessed the full life cycle of an asset manager—from the diseases of infancy that infect and threaten all new companies, to the limitless potential of vibrant middle age, to the comfortable but sclerotic bureaucracy that constrains complex global firms that grow too large.

Then in 2001, Credit Suisse's corporate policies caused me to "retire": the bank had a policy of "60 and out" for executives at my level. I was always aware that such a policy existed—I just didn't think it would apply to me! Having no desire to retire, in March 2001 I joined Michael Steinberg, an excellent investor I had known for some time, and we formed Steinberg Priest Capital Management. The firm's managed assets grew from \$800 million to over \$2 billion in three years, but the partners had differing ambitions and we disbanded the structure in 2004.

But I still had a desire to build a firm of substance, and in 2004 three partners—Tim Taussig, David Pearl, and Phil Clark—and I started once again, creating Epoch Investment Partners with 11 employees and initial managed assets of \$640 million. As of the end of 2015, less than 12 years after its founding, Epoch oversaw nearly \$50 billion in long-only equity strategies, and employed over 100 people.

So much for the memoir. In this book I have assembled a discussion that I hope will prove interesting and valuable to people in investment management—what's happening today,

and what the industry might look like in 5 or 10 years, both in the “investing business” (that is, the selection of securities and the managing of portfolios), as well as “the business of the investing business” (managing the many non-investment functions—product management and client services, and a firm’s information technology, operations, and compliance functions).

To be successful, an investment firm must clear three hurdles—its clients must reap superior investment performance; its employees must find desirable long-term employment; and its owners must earn fair financial returns. In this book, I have tried to share what I believe to be the required and essential elements to achieve these goals. Two of these are timeless, while the third reflects the growing dominance of information technology in every aspect of today’s personal and business life.

The first is firm culture, which is the bedrock of success for any firm, regardless of its industry. (Management theory pioneer Peter Drucker is supposed to have said, “Culture eats strategy for breakfast.”) In investment management—a people business based on shared efforts and rewards—culture is the *sine qua non*. The first section of this book is devoted to culture and includes a number of rough-and-ready observations on its importance in investment management.

As of early 2016, investment managers as a group are faring well but face challenges—like any other incumbent industry in a world moving at a rapid pace. After several slow years following the financial crisis, growth in new business has resumed in the industry, such that the total pool of assets available to managers in the United States is well above its 2007 precrisis highs. Since then, however, the center of gravity of the industry has shifted: whereas traditional defined benefit pension plans were once the largest source of new business, today’s inflows of assets are dominated by defined contribution retirement plans, as well as insurance companies, sovereign wealth funds, and high-net-worth investors resident in emerging markets. In

the market for individual investors in the United States, market share is slipping away from large old-line wirehouse brokerage firms, in favor of independent investment advisers. (And lately, a wave of low-cost “robo-advisory” firms has been challenging them both.) These changes in the landscape are forcing traditional investment managers to reorient their marketing efforts, and contend with a new layer of costs.⁵

The focus of this book, however, is more the business of investing—managing client assets. While the business of the investing business has experienced an evolution, traditional active portfolio management has been under full-out assault. Many investors have favored passive investment products, such as conventional index funds and exchange-traded funds (ETFs) tracking market indexes, over active strategies trying to outperform the general market. A more recent marketing idea known as “smart beta” represents another group of semi-active products; like index funds and ETFs, they are able to deliver concise portfolios at fee rates below those of active managers.

This displacement, amounting to many billions of investment dollars owned by both institutional and individual investors, has occurred in part as the result of a shortfall by active managers in delivering market-beating performance. As the book discusses, it’s partly a cyclical phenomenon, but a great proportion of active managers have underperformed common benchmarks, and many of today’s investors seem willing to trade off the potential upside that active managers may provide in exchange for market performance and the certainty of lower fees.

Therefore, the second section of this book offers background on the debate over the merits of active management versus passive alternatives and points out that active investment managers have been challenged by an array of difficult market conditions. Among active managers, however, the industry also has become increasingly competitive: people are highly trained and talented, and armed with more relevant and timely data

than I might have dreamed of in the 1980s, or even 10 years ago. (The competition is only growing, and becoming smarter: the CFA Institute, which confers professional certification on people in the investment business, counted about 135,000 members in 2015; during that year, an additional 80,000 new candidates sat for the qualifying exams.)

The second section also discusses Epoch's view of the investment world, and what the firm sees as the most effective investment process for outperforming the general equity market. In brief, Epoch believes that the source of value in a company is its free cash flow, and that superior returns to stocks come from identifying those companies that generate substantial cash flow, and then allocate it wisely—reinvesting in the business when it is sufficiently profitable, and distributing the remainder to the owners. The philosophy can be expressed simply, but executing it effectively requires intensive fundamental research and insightful forecasting from analysts that know their companies well.

The human effort required for the analytical process is increasingly being supplemented by information technology, which is the focus of this book's third section. For years, investors have applied scientific rigor to investing, whether from using mathematical frameworks for valuation, to borrowing models from the physical sciences for insights into the functioning of markets. As a result of their increasing power and decreasing cost, computers have taken over much of the burden of raw data analysis, and the widespread digitization of information of all kinds—economic reports, corporate financials, market prices, and the growing analysis of real-time consumer and business data, as well as the traffic on social media—has broadened and deepened the research process. At the same time portfolio management has become a global undertaking, and it demands from practitioners a grasp of many more markets, companies, and economic forces.

The changes in the investment business over 50 years have been monumental: the increased speed and complexity of the

markets; how managers react to them; and managers' understanding of the factors behind investment returns. The industry has more sophisticated tools for analysis and forecasting, but these have been matched by the volume and variety of information to be dealt with. The book concludes with our thoughts on how an optimal investment management process should be dominated neither by human judgment nor computer algorithms, but by an informed combination of the two—*racing with the machine*. Indeed, the last section previews an investment strategy that Epoch has developed over several years—one that likely would not have been possible without today's rich resources for gathering and processing information.

Thank you for this opportunity to share my views.

William Priest

Notes

1. With a nod to the movie *Monty Python and the Holy Grail* (Michael White Productions: 1975).
2. Jason Zweig, "The 11-Year Itch: Still Stuck at Dow 10000," *The Wall Street Journal*, June 12, 2010.
3. S&P Dow Jones Indices. McGraw-Hill Financial. Accessed at: www.djaverages.com/?go=industrial-index-data.
4. Wooten, James A., "The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA. *Buffalo Law Review*, Vol. 49, p. 683, 2001. Available at SSRN: <http://ssrn.com/abstract=290812> or <http://dx.doi.org/10.2139/ssrn.290812>.
5. These observations have been measured and documented by consultants McKinsey & Company in their 2015 industry review, "Navigating the Shifting Terrain of North American Asset Management." Accessed at: http://www.mckinsey.com/client_service/financial_services/latest_thinking/wealth_and_asset_management.

WINNING AT ACTIVE MANAGEMENT

PART I

Culture

Culture at the Core

Every organization—whether a business, a not-for-profit entity, or government—reflects and operates from a unique culture. It’s an inherent and essential element that brings order to the internal and external environments¹ and reduces uncertainty² among members of the group. The quality and strength of cultures explain many of the differences in organizational performance. But culture often operates below the surface of an organization, so that studying the abstraction of culture is elusive.

Organizational culture is especially important to the workings of a knowledge transfer business, such as investment management, because much of the work produced is intangible, and the environment changes so rapidly. Accordingly, culture is a critical component of any professional service firm, and we have made culture the introductory topic for this book.

Culture is a subject that has occupied management consultants and academics since the 1950s. One definition that we have found useful was put forward by Edgar Schein, an early scholar on culture and leadership, and today professor emeritus of MIT’s Sloan School of Management. He writes:

“The culture of a group can ... be defined as a pattern of shared basic assumptions learned by a group as it solved its

problems of external adaptation and internal integration, which has worked well enough to be considered valid and, therefore, be taught to new members as the correct way to perceive, think and feel.³ ... Culture is to a group what a personality or character is to an individual.”⁴

Schein adds that culture often is those principles and beliefs a founder or leadership set has imposed on a group—and which have worked out well: “[The] dynamic processes of culture creation and management are the essence of leadership, and make you realize that leadership and culture are two sides of the same coin.”⁵

The owners or managers of an organization might consciously work at developing a culture, or a culture may evolve on its own as the result of years of decision making, but a culture is present in any setting where people are working toward common goals. In a new organization, culture can be very strong, as it is one of its few assets, and crucial to its early efforts.

Employees have a hand in corporate culture as well. “Not all of corporate culture is created from the top down,” wrote Andrew Lo, a professor of finance at Massachusetts Institute of Technology, in a paper on corporate culture in finance. “A culture is also composed of the behavior of the people within it, from the bottom up. Corporate culture is subject to compositional effects, based on the values and the behaviors of the people it hires, even as corporate authority attempts to inculcate its preferred values and behaviors into its employees.”⁶ Indeed, an organization benefits from a diversity of opinions to prevent “groupthink.”

“Most companies’ culture just happens; no one plans it. That can work, but it means leaving a critical component of your success to chance,” wrote Eric Schmidt and Jonathan Rosenberg, executive chairman and adviser to the CEO, respectively, at