

Blind Investment

by Robert J. Grossman

If people are a company's biggest asset, why don't Wall Street analysts pay more attention to them?

What makes a company a blue chip investment? For most business leaders, it's really not much of a secret. From GE's former CEO Jack Welch to consultant Jim Collins, the message is clear: It's the value of the people and what they do. In fact, a variety of experts agree that as much as 80 percent of a company's worth is tied to human capital.

Somewhere along the line, however, most of Wall Street's stock analysts didn't get the memo. Because when analysts evaluate the potential worth of a company's stock—a move that can lure investors or send them running in the other direction, with resultant effects on a company's stock price—human capital plays at best a bit part.

So why are analysts missing what everyone else seems to intuitively understand? There are a number of reasons, some more valid than others. For example, some point to the absence of universally accepted metrics for numerically capturing the value of an organization's human capital. And while it's true that there is still work to be done in this area, the HR profession is considerably further along than analysts seem willing to give it credit for.

In fact, the reasons why human capital, and the effective management of that capital, are not more widely appreciated by analysts seem to have more to do with their own particular blind spots—caused by a narrow view of corporate worth and a lack of familiarity with strategic HR—than with any shortcomings in HR metrics.

Capturing the Value of HR

Successful companies manage their human capital well. They hire the right people and train them in the skills they need to help the company perform spectacularly. They develop compensation systems that incent the right behavior and performance so that the best workers stay and move up—and the worst ones move on.

These concepts are not new, but they do become more widely accepted and vital in a knowledge-based economy, where intellectual property and human capital account for more of a business's worth than physical capital.

"Everyone understands that the quality of people is the key differentiating factor—whether they're great as individuals or because they've set up systems that work best," says Peter Cappelli, professor of management and director of the Center for Human Resources at the Wharton School at the University of Pennsylvania. "The hard part is how do you measure it? There aren't best practices that work across the board. It's about fitting people practices and management to the strategy. In some companies, it's smart to invest in people; in others, it may make sense to just churn them through."

But some experts, like Jim Hatch, principal with PricewaterhouseCoopers/Saratoga, a leading source for HR metrics and benchmarking, believe that there already are important human capital keys Wall Street should be paying attention to, keys that can be useful indicators of good HR management and of potential corporate profitability.

For instance, Hatch says that Human Capital ROI (return on investment)—the amount of money you get back in profits for every dollar invested in human capital—is a good predictor of mid- and long-term success. (To see the formula for determining Human Capital ROI, and four other ratios that Hatch believes HR can draw on to demonstrate cost savings and efficiency, see "Five Human Capital Measures," below)

Five Human Capital Measures				
Metric Name	Formula	Description	2003 All-Industry Median	Sample Size
Human Capital ROI	$\frac{\text{Revenue} - (\text{Operating Expenses} - (\text{Compensation} + \text{Benefits Costs}))}{\text{Compensation} + \text{Benefits Costs}}$	Illustrates the relationship between human capital investment and productivity and profitability. Human Capital ROI is the pretax profit an organization generates for each dollar invested in regular employee pay and benefits after non-human expenses are removed.	1.48	168
Revenue per Employee	$\frac{\text{Revenue}}{\text{Full-Time Equivalent (FTE)}}$	Looks at how much revenue each regular employee generates and is a basic measure of productivity.	\$312,738	222
Profit per Employee	$\frac{\text{Revenue} - \text{Operating Expenses}}{\text{FTE}}$	Takes the pretax profit an organization generates and attributes this to each FTE. This measure provides an integrated picture of productivity and expense control efforts.	\$39,164	217
Labor Cost as a Percent of Revenue	$\frac{\text{Compensation} + \text{Benefits Costs}}{\text{FTE}}$	Looks at the percentage of revenue dedicated to compensation and benefits costs for regular employees. This metric provides insight into an organization's compensation and benefits programs. Over time, this metric can show if the organization is obtaining a higher or lower return on dollars invested in people.	26.10%	180
Voluntary Separation Rate	$\frac{\text{Total Voluntary Separations}}{\text{Total Head Count}}$	Looks at the percentage of regular head count that voluntarily left the organization. High turnover may impact the organization's stability, profitability and productivity.	9.10%	277

Source: PricewaterhouseCoopers/Saratoga

Laurie Bassi, chair of Bassi Investments Inc. in Washington, D.C., also believes that human capital keys can predict future corporate profitability—and she has years of solid research to back up her claim. Bassi, a former economics professor at Georgetown University and former vice president at the American Society for Training & Development, says the chief indicator is Training Expenditures per Employee.

"We're looking for firms that spend between 3.5 percent and 4 percent of their budgets on workforce development. That translates into the top 5 percent to 10 percent of the [best performing] companies within a sector," she says. She also has worked on additional metrics that further analyze where and how companies spend their training dollars, and the connection of such investments to the health of the business.

Bassi back-tested her theory against sample portfolios for five years, then went live with her own mutual fund in December 2001. So far, Bassi's theory is proving to be a good investment strategy. "We've beaten the market consistently, doing better in upturns than downturns, but always coming out ahead," she says.

In fact, Bassi's method is at least as predictive as the price-to-earnings (P/E) ratio, a commonly accepted Wall Street indicator for analyzing potential company performance.

Why the Blinders?

Even as the validity of metrics like Bassi's and Hatch's gain wider acclaim, they've failed to impress most stock analysts.

"There's a big disconnect between the figures you see in a balance sheet and the market value of the company," says Steven Gates, CFA, principal researcher for The Conference Board in Paris and a former investment and securities analyst. Wall Street analysts, he says, are missing the big picture by failing to take employees into account. "How can they defend themselves," he asks, "when they're not accounting for the majority of the company's value?"

Part of the problem is that when analysts evaluate a company, they focus their attention too narrowly on a few factors—to the detriment of others, says Cappelli. "They pay attention to the immediate financials [and] the strategy story and hear from the top executives. They don't have very deep information and don't want to talk to people who might give them a more nuanced view," such as HR professionals.

Harry A. Ikenson, managing director and a senior retail analyst at First Albany Capital in New York, confirms that most analysts are not interested in the HR "nitty-gritty."

"Dealing with the minutiae of how people are managed to get results is not our concern," he says. "When I visit a company, I meet the director of stores, the person in merchandising, the CEO and CFO. I want to talk to the line people—not HR. They know compensation, but aren't the best source for what's really happening."

Gates explains that what analysts are most concerned with when evaluating a company is short-term cost control, even when the way costs are managed is not good for a company's human capital or long-term financial health—for instance, with massive layoffs. "They don't care too much about how you arrived at your numbers if the financials look good," says Gates. "They react positively when you're going to fire a lot of people. Announce a major downsizing and they're happy."

Ironically, this kind of narrow perspective may not pay enough attention to the costs of turnover, lost intellectual capital or decreased productivity that can result when large numbers of employees are let go.

Analysts' fixation with costs means they also can easily miss the big picture on investments such as training, which are fundamental to Bassi's understanding of company value. Under current accounting methods, training and development costs are dumped into a company's balance sheet along with all the other expenses. Therefore, if one firm is investing a lot of money in development, to an analyst it will look like a more costly, less attractive investment opportunity than another that reports lower expenses.

So unless a company chooses to report its workforce development expenditures separately—and there's no uniform reporting standard for doing so—there's no way analysts can get at Bassi's ratios.

Gates says the fact that there is no standard format for reporting such data is a valid concern. "It's not official, not audited, not clearly comparable from company to company," he says. "And there are justifiable doubts about the consistency of the data."

But even if companies were to report such data consistently, many analysts would be leery of going out on a limb to take those numbers into account. Burned by the dot-com bubble and debacles surrounding Enron, MCI and others, they are less likely to pursue new theories or perspectives.

"Back then, analysts came up with all kinds of reasons why inflated [stock] values made sense," says Jim Holincheck, an industry analyst at Gartner in Chicago. Afterward, they were criticized, he says, and "they went back to fundamentals."

They're sticking within the safety zone, engaging in what Boris Groysberg, assistant professor at Harvard Business School, describes as "maintenance research," following the same quantitative formulas and analytic techniques as their peers.

"There's no downside to doing what everyone else does," Bassi says. It's safe. But "if you do worse because you did something different, you can be blamed."

A Skewed View

In addition to looking at a narrow data set, analysts can be blinded by their own experience—or lack of experience. While they generally have strong backgrounds in finance or accounting, they typically have limited exposure to strategic HR, which affects their ability to gauge its importance to the health of an organization.

"It's like a doctor giving advice about nutrition," says Hatch. "If you had only one course in a subject, would you use it? They [analysts] don't, because they really don't know much about it and aren't that interested."

Part of the reason they may not be interested in HR is that analysts aren't exactly typical of the workforce at large, which benefits from HR's efforts in many areas, including training and development.

By contrast, those who survive and thrive in Wall Street's high-pressure environment tend to be extremely self-confident risk-takers who focus on winning big and are supremely motivated by their own bottom line—a fat paycheck. They don't want a handout or a hand up—which is good because it's something they won't get on Wall Street. "It's sink or swim," Groysberg says of the Wall Street culture. "You either have what it takes or don't. Why spend money on training and development when it can be spent on bonuses for peak performers?"

Groysberg says for the past 20 years or so, investment firms have favored nature over nurture, churning over continuity, an approach to hiring and promotion that seems to suit analysts just fine.

So where Bassi sees a value in helping employees to develop their skills and become more effective, analysts live and breathe in an environment where top-notch performers are expected to be self-made, to pull themselves up by their own bootstraps. Little wonder, then, that Bassi's metrics have had little success taking root on Wall Street.

Another reason analysts may not be interested in human capital and may not have a better understanding of its value is that they work in an industry that, overall, has not exactly been a shining example of top-notch HR. In fact, critics say the investment industry is rife with HR problems.

Heavily populated with white males, and with a relatively small number of women, highly publicized lawsuits have thrown a spotlight on the skewed racial and gender breakdown of the industry's workforce. (The Securities Industry Association, or SIA, reports that in 2003, 78 percent of brokers were white males, 14 percent were white women, 6 percent men of color and 2 percent women of color.)

Among the highest-profile suits involving Wall Street firms:

- Last July, Morgan Stanley settled a class action sex discrimination suit for \$54 million; at least \$2 million of the settlement will be spent to enhance promotional and compensation opportunities for women. The suit alleged that the firm systematically denied women equal pay or opportunities to advance. It also alleged that male workers scheduled meetings with clients at strip clubs and subjected women to inappropriate comments.

- In 1998, Smith Barney settled a class action sex discrimination suit that allowed employees' claims to be resolved on an individual basis. To date, more than 1,900 claims have been resolved, says Mary Stowell, partner in the Chicago law firm of Stowell and Friedman, which represented many of the plaintiffs. Stowell estimates that more than \$100 million has been paid out to plaintiffs thus far. A handful of cases remain unsettled.

- Also in 1998, Merrill Lynch settled a sex discrimination class action in the same manner as Smith Barney—allowing individual claims to be resolved separately. Stowell, whose firm was involved in the suit, says that, like Smith Barney, Merrill Lynch also has paid plaintiffs in excess of \$100 million.

Says Cappelli, "HR [at investment firms] spends much of its time cleaning up problems and implementing sophisticated compensation packages. They don't play a strategic role or do a lot of employee development and job design work." Of course, some HR professionals on Wall Street firms are more strategic and adept at managing their human capital than others. (See related short features on T. Rowe Price and Legg Mason.)

What Goes Around

For those investment firms that fail to practice good HR, however, the chickens may be coming home to roost. Not all institutional investors have chosen to turn a blind eye to the effective management of employees.

In fact, a small but growing portion of investors is taking human capital into account. And they are refusing to invest in any firm—including those on Wall Street—that does not have demonstrable, high-quality HR practices.

Most notably, the California Public Employees' Retirement System (CalPERS)—which invests \$169 billion on behalf of more than 1.4 million employees, retirees and their families—is one of the leading proponents of socially responsible investing.

The efforts of such investors are aided by investment funds that take into account socially responsible HR practices, such as those run by the Calvert Group in Bethesda, Md., and Walden Asset Management in Boston. The Calvert Group in particular is especially critical of the financial services industry as a whole.

"This is one of the industries that hasn't moved as much as others in diversity, flexibility toward workers, and promotion of family-friendly benefits and policies that help women," says Nikki Daruwala, Calvert's manager for shareholder advocacy and social policy.

To fill its \$10 billion portfolios, Calvert screens the 1,000 largest publicly traded companies, qualifying about 600 companies for possible investment. Calvert favors companies that:

- Actively hire and promote minorities and women.
- Compensate workers fairly.
- Strive to achieve and maintain good labor/management relations.
- Provide programs and benefits that support workers and their families.
- Provide a safe and healthy place to work.

How many investment services companies make the cut? "You're not going to find too many on the list," Daruwala says. In fact, of the 50 publicly traded investment services companies with the largest market capitalization (according to Yahoo Finance), only six appear on the Calvert list. (For a listing of all financial services institutions on the Calvert Social Index, go to www.calvert.com).

Heidi Soumerai, director of social research at Walden, a division of Boston Trust and Investment Management Co., says Wall Street firms have been slow to adopt progressive HR policies and have been unwilling to discuss or share information about their policies and practices. "We've found some companies, like Lehman Brothers, to be candid but, overall, many companies have a long way to go; they're still dinosaurs. Just look at the managing partners and directors. You don't see too many women and minorities."

In 2003, the SIA reported the following race and gender distribution at the executive management level: 79 percent white males, 15 percent white women, 4 percent men of color and 2 percent women of color.

Today, T. Rowe Price is the only major investment company with a significant presence in Walden's Social Equity Fund. The company also cleared Calvert's social responsibility screening, as have Legg Mason Inc. and A.G. Edwards, among others. These companies are proving that progressive human capital policies are a plus, not a minus.

For example, the P/E ratios for T. Rowe Price, Legg Mason and A.G. Edwards were all above the industry average at press time. (The P/E ratio for any company can change daily as share price fluctuates.) As a result, by one of their own measures, Wall Street analysts would have to admit that the firms that are practicing good HR also are outperforming the market. (For more information, see short features on T. Rowe Price and Legg Mason.)

By contrast, some of the investment firms not on Walden's or Calvert's list are underperforming the market.

Change Is Coming

Now, with T. Rowe Price and Legg Mason among the positive role models, others are taking stock. "There's a continuum from Neanderthal to progressive," Calvert's Daruwala says. "We want to move more toward the progressive and hopefully bring others along with us. There's real urgency, but so far the industry has been slow to respond."

Others dispute this view of the industry. They contend that critics are caught in a time warp, and that the "bad boy" image is more memory than reality, more about five years ago than today. Pam Faber, vice president and managing director of the SIA, which represents 600 companies in the industry, reports significant progress. Spurred by top management, especially at the larger firms, there is mentoring and training, work/life balance programs and, in companies like Lehman Brothers, progressive domestic partner policies.

"Increasingly, those who celebrate and applaud the approach of business that was in vogue in the 1980s and 1990s are in the minority," says Kyle Maldiner, senior vice president and director of employee relations at Lehman Brothers in New York and chair of the SIA's Diversity Committee. "The people who are not in tune with the new culture are viewed as outliers; they have become marginalized."

At the very least, some investment firms are starting to take HR lessons—such as the value of training and employee development—to heart. Companies like Lehman Brothers, Merrill Lynch and Sanford Bernstein are committing to formal and ad hoc training and mentoring programs. Peter Handal, president and CEO of Dale Carnegie Training in Hauppauge, N.Y., who has many Wall Street clients, estimates that since Sept. 11, 2001, 60 percent of the larger firms in New York have bought in. The larger they are, the more they spend on training, he says.

It's an investment that should pay off: Groysberg's research (with colleague Ashish Nanda), shows that star analysts who move laterally to a new firm underperform in their new jobs for up to three years compared to similar-level analysts developed from within. Groysberg says best practices companies recruit outside only as a last resort. "There is no substitute for developing your best and brightest," he says.

Getting Through to the Analysts

Just as some investment firms are starting to demonstrate a greater appreciation for human capital management, so are some analysts, especially in the knowledge and service sectors—at least informally.

"I think about human capital a lot more than other analysts," says Andrew Steinerman, who covers temporary help and search firms for Bear Stearns & Co. in New York. "I believe that nothing can make a bigger difference. When I visit a company, I speak to local branches and individual partners, ask them how they feel, are the incentives aligned properly?"

Steinerman recalls visiting Iron Mountain Paper in Houston last year on the company's Analyst Day and hearing a presentation from the HR director. "I said to myself, 'What am I going to learn from her?' But her description of the amount and apparent quality of training that was going on impressed me. Someone asked her if she was fearful with all this great training that employees

will take the knowledge and go to a competitor. Her answer really impressed me. She said, 'I'm more concerned that they'll stay and not get the training.' "

The big question for HR professionals is how can they convince more analysts—whose main interest in human capital often begins and ends with their compensation packages—to see the light? What will it take to convince them that human capital is not only an expense, but also a critical capital investment?

Change may continue to creep across Wall Street as investment houses like Calvert and Walden reward the finance players who show they value human capital management. But HR can't just sit back and wait.

"We can complain about the shortfalls in analyst thinking, but they are who they are, and they're not particularly interested in talking to us," Cappelli observes. "They're not going to seek us out, so we have to figure out how to get to them."

Accept the fact that, in the short run, there's a significant communication barrier between HR and the analyst community, Groysberg advises. "The best way for HR to reach the analysts is to promote the case in the executive suite. Use your CFO and CEO as your conduit."

Until recently, Hatch says, HR has had little substantive proof to offer. "The marketing guys come in with sales statistics and monthly and yearly comparisons, the CFO tracks the financials, and the HR guy was left with reporting on the increasing costs of health benefits. Now HR has the tools it needs to demonstrate the relationship between HR metrics and stock market success."

Shining Examples

The following is a sample list of companies that currently meet the investment criteria of Bassi Investments Inc. These companies are listed in alphabetical order and were selected based on the level of their scores on Bassi Investments' proprietary selection and weighing model.

- Capital One Financial
- A.G. Edwards*
- Eli Lilly
- SEI Investments*

* A.G. Edwards, SEI Investments and Zions Bancorp also have been screened by the Calvert Group in Bethesda, Md., and approved as potential investment candidates.

The Great Divide

Stock analysts are the toll-takers on the bridge that links companies to potential investors. They examine a company's performance and prospects and give it either a thumbs-up or thumbs-down. They compete 24/7 against the market and each other, tracking their buy and sell recommendations against industry averages and company stock performance.

If they beat the market consistently, they achieve star status. If they get it consistently wrong, they're out the door.

There are two types of analysts—sell side and buy side. Each follows specific companies or business sectors. Sell-siders are short-term players, focusing primarily on predicting performance for the next quarter. They provide grist for brokers, the industry's salesmen.

"Their goal is to churn, to encourage people to buy and sell," says Steven Gates, principal researcher for The Conference Board in Paris and a former investment and securities analyst.

In contrast, buy-side analysts work for organizations that manage stock funds or other large pools of investments. They perform similar functions as their sell-side counterparts, but since their funds may hold investments longer, they may take a longer view and enjoy more time for their recommendations to pan out.

T.Rowe Price

T. Rowe Price's strong stock market performance over the past 10 years seems to bear out the view of Laurie Bassi, chair of Bassi Investments Inc. in Washington, D.C., about the value of investing in training and development. Melody Jones, director of HR at the 4,100-employee investment management company, headquartered in Baltimore, oversees programs that are funded at the "best-in-class" level in the benchmarks from PricewaterhouseCoopers/Saratoga.

Expenditures for tuition reimbursement are especially noteworthy: The amount the company spends on tuition reimbursement is three times the amount designated by the American Society for Training & Development as its best-in-class figure.

"We seem to have hit on a formula for stock performance that has a lot to do with the care and feeding of people," says Jones, who reports directly to the chairman and president, George Roche. "We want talented people, but they have to buy into our approach, which is grounded in integrity and the belief that collaboration yields the best decisions. The selection process is arduous, but when they sign on, they stay."

People who are underperforming receive training, coaching or a chance at another job. "If they don't make it, they need to be nudged out," Jones adds. "But we don't do it without giving them some chances before we conclude they can't do a good job. Nonperforming analysts are a rarity because our initial screening is so careful."

In a recent diversity survey, 92 percent of workers at T. Rowe Price said the company's efforts to sustain an environment free from fear, intimidation and harassment, and to treat workers equally regardless of ethnicity, gender, religion or age, "exceeded their expectations." That's far ahead of the benchmark average for all industries, which is 83 percent.

Notably, in an industry where litigation and whistle-blowing is never far away, T. Rowe Price has found a better way. Its formal grievance process allows people to grieve up through the line or to go to HR directly. "The incidence of employees feeling the need to engage outside support is negligible," Jones says.

Legg Mason

At Legg Mason, the Baltimore-based investment firm, the 5,200 employees share a collegial culture built around teamwork and client service. HR mirrors the culture, offering a wide array of training and self-development opportunities on a voluntary basis.

"We're good relationship builders, partners and facilitators," says Joseph Timmins, SPHR, senior vice president of HR.

In a recent survey, 97 percent of Legg Mason's workforce said they were satisfied or highly satisfied with the firm's services and programs. Even those who leave sometimes have a change of heart. "We have a growing boomerang club," Timmins says. "People discover the grass wasn't greener elsewhere after all."

Timmins says HR deserves some credit for Legg Mason's excellent stock market performance. "If you have good HR practices and stable management, their value will be reflected in the P/E [price-to-earnings] ratio. If you're looking at organizations over time, if they don't treat their human capital well, they won't be able to sustain high performance levels."

Legg Mason appears on Forbes' list of best-managed companies, which is based on an assessment of a company's management and financial performance.

Robert J. Grossman, a contributing editor of HR Magazine, is a lawyer and a professor of management studies at Marist College in Poughkeepsie, N.Y.

<http://www.shrm.org/hrmagazine/>

[before Feb. 1, 2005]

or

<http://www.shrm.org/hrmagazine/archive/0105toc.asp>

[after Feb. 1, 2005]

From the January 2005 issue of *HR Magazine*, published by the Society for Human Resource Management.