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THE HUMAN FACTOR

TAKING A LESS SUBJECTIVE APPROACH TO INVESTMENT DECISIONS

EQUITY ANALYSTS AND BANKERS ALIKE CAN BENEFIT FROM LOOKING FURTHER AFIELD FROM THE FIGURES WHEN MAKING A SHARE RECOMMENDATION OR ASSESSING A DEBT PROPOSAL.

The recent global corporate governance problems have put the issue of securities analysts and their independence – or lack of – squarely in the spotlight.

But while politicians and regulators debate the desirability of reforms to instill such independence another issue has also emerged: whether the information used to assess corporate performance can be relied on.

In the US, more than half of the shares issued by public companies are controlled by institutional investors, who are becoming increasingly concerned about internal performance. Their staples of trade are measurement methods such as economic value added, cash flow return on investing or activity based costing.

For commercial bankers, the story is similar. Lending proposals are either accepted or rejected on the basis of set financial ratios such as debt to equity and loan to valuation.

But should they be looking further afield? We argue that such quantitative techniques are only 'lag' indicators of performance. We argue that lead indicators, such as human capital analysis, should be used side by side with financial quantitative data to glean a more transparent picture of an organisation.

The analysts' role

Generally, securities analysts are employed by a brokerage firm, bank or investment bank and their role is to conduct thorough research into all aspects of the current and prospective financial condition of a listed company. This usually results in a research report, forming the basis for an investment recommendation.

Analysts' main source of data is the financial variety, drawn from publicly available accounts and their own modelling. This suits the skill set of most analysts, who overwhelmingly have undergraduate qualifications in finance and business, or in specialised fields such as engineering or actuarial studies.

But the game is changing. Looking to the future, qualitative research skills will become increasingly important in making those all-important earnings forecasts.

These skills include an understanding of sustainable human resource management practices, organisational change and organisational behaviour. Appropriate analysis methods include case studies, observing participants, surveys, oral histories and document analysis. These are foreign to (not systematically used by) most analysts.

What's driving the trend is increasing evidence that the way in which a company manages its human resources does have a tangible impact on share price.

In a survey last year carried out by US researchers, it was found that non-financial insights made up a large proportion of investment decisions. The survey, of 275 active US institutional investors, found that about one-third of investment decisions were based on non-financial data, of which more than half was human resources based.

Other commonly used non-financial data related to marketing, strategy and quality aspects. Of the respondents, more than 60 per cent said between 20 per cent and 50 per cent of decisions were non-financial.

Another study, by Watson Wyatt Worldwide Research, links specific human resource management practices to above average returns to shareholders. The data indicates that human capital significantly affects current and prospective financial future performance.

Furthermore, superior human capital management is a leading – rather than lagging – indicator of improved financial success.

So, analysts and indeed corporate bankers need to have access to both qualitative and quantitative tools to do their job properly.

In fact some academic researchers have gone further, suggesting that financial research on its own can distort the analyst's true understanding of an organisation's performance.

Quantitative financial data often shows that properties shared by all organisations in an industry sector such as banking may be superficial, obvious or unimportant.

What's more, standard financial measures applicable to all organisations in an industry sector may ignore or understate sectoral differences, or the quality of social, ethical and management practices.

Conversely, qualitative human capital research has a wide appeal for assessing organisational performance.

When used in conjunction with quantitative financial data, it can produce a more powerful and more valid analysis of current and prospective financial performance.

Indeed, some financial market participants are starting to appreciate the limitations of purely financial measures as an indicator of future performance.

This has been manifested in new measures focusing on intangible assets, including 'customer capital'. The move to triple bottom-line accounting – recently adopted by Westpac Bank – could also be seen as part of this process. But given the financial-based primary competencies of securities analysts, practices may be slow to change.

The primary source of data for securities analysts is financial data. This is consistent with the prominence of financial models such as the Capital Asset Pricing Model (CAPM) and its variations, as well as the significance of the analysis of the beta (market volatility) of a stock. As a result, analysts have tended to rely more on their own, largely mathematical models of earnings forecasts, rather than a broader corporate analysis. Companies are seen largely through the lens of risk and return.





Richard Bernstein, who is a respected quantitative investment strategist and commentator, describes the recent increase in the level of reporting in the listed company sector as increasing the 'noise', or extraneous data, available to investors, but without a concomitant increase in genuine analysis.

When analysing knowledge-intensive firms, in particular, securities analysts and bankers need to be able to value the intellectual capital of the firm in order to provide earnings forecasts. After all, the workers truly own the capital – and therefore the means of production – within these operations.

What is human capital?

Intellectual capital can be divided into three main areas: competence (such as average duration of employment, hours of training per employee, IT literacy), attitude (such as leadership skills and motivation levels) and intellectual agility (such as savings from employee suggestions).

The second area of intellectual capital is often seen as invisible assets and processes, or 'non-thinking' capital, such as relationships (customer retention, length of supplier relationship); internal efficiency (e.g. revenues from patents, processes completed without error); renewal and development (percentage of business from new products, new patents filed, training costs per hour per employee).

These types of measures can be combined into a weighted intellectual capital index, which, on the surface, has meaning and rigour. Yet these measures also tell only half the story. They are mistaken for knowledge itself but knowledge genuinely exists only when it is used in the context of communication processes between people.

Our recent research defines human capital as being sustainable people management systems which are likely to have an impact on the share price of a firm. They define sustainable human resource management systems as those which are internally consistent, consistent with the firm's corporate strategy and consistent with the broader context in which the firm is operating. Human capital analysis looks at selected human resource management practices, such as recruitment, training and career paths. The reality of the practices are distinguished from the rhetoric espoused by the firm.

Human capital analysis requires a high level of understanding of organisations' cultural issues, such as interpersonal communication, both formal and informal, particularly in knowledge-intensive, network organisations.

Genuinely sustainable organisations need to demonstrate financially, environmentally and socially sustainable practices to prosper in the long term. But, as discussed, the competencies of traditional equity research securities analysts rely heavily on figures to derive a numeric forecast of future earnings.

Better people management = better bottom line

According to several pieces of human capital research in a variety of industries including investment banking, the organisations which adopted people-centred practices and emphasised long-term relationships with their employees performed better in regard to product development and innovation, attracting and retaining good staff and, ultimately, financial performance.

In one study, Jim Collins compared successful US companies in a particular industry with those that were not. He found so-called 'visionary' companies put a greater percentage of year's earnings back into the company, returning less in cash dividends to shareholders.

Visionary firms invested more heavily in management practices and human capital – specifically in training, recruiting and the professional development of staff – and in research and development, property and plant.

These companies were also early adopters or innovators in their industry and were six times more successful than the comparison companies. Other studies have detected a higher return on equity for those companies adopting innovative human resource practices.

Securities analysts who fail to include these insights are missing opportunities to add value to their clients' investment choices. They strongly indicate the value of using human capital alongside the traditional financial approach, resulting in more transparent stock recommendations.

As a result of her study in the Australian investment banking industry, Dr Carol Royal devised a model for the drivers of sustainable people management systems.

While it is unlikely that one can ascertain exact casual relationships, the application of this qualitative model will provide a level of analysis which would form the basis of a complementary equity research product.

Using this model, securities analysts and commercial bankers would be able to identify emerging patterns in human capital that ultimately affect financial performance and market valuation.

This would go some way to providing the investing public with more accurate and transparent information about the nature of a publicly listed company's current and future financial performance.

To varying degrees, fund managers assess 'quality of management' and/or 'company culture' when making investment decisions. But most see issues such as human resource management practices as 'third order' concerns. This is partly because of the perceived lack of a simple framework to allow clients to achieve above average returns. The view from the human resource academic literature is that quality of management and company culture are manifestations of human resource management practices. Issues of leadership and culture are actually human resource issues, just as much as recruitment, training, career strategies, remuneration and development activities.

Three options are available to create better rounded equities research and lending decisions. The first is that securities analysts and bankers involved in corporate lending undertake additional formal qualifications in fields such as sustainable human resource management, organisational change and organisational behaviour.

The second is for banks and broking houses to buy in the skills; and the third is to buy an appropriate qualitative product from an independent research house.

For human capital analysis to be effective, companies will need to provide access on human resource management practices to analysts so they have valid data on which to base their human capital recommendations.

This is likely to change the type of relationship typically existing between analyst and company management.

Whatever way it is done, what is certain is that financial markets would benefit from such analysis. ■

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