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RATING THE HUMAN FACTOR

WHY IT MATTERS IN THE INVESTMENT PROCESS

HOW COMPANIES MANAGE THEIR PEOPLE SHOULD BE A KEY COMPONENT OF ANY INVESTMENT AGENDA, BUT IT IS OFTEN OVERLOOKED IN FAVOUR OF OTHER FACTORS SUCH AS ATTITUDE TO THE ENVIRONMENT. BY CAROL ROYAL AND LORETTA O'DONNELL.

These days, much equity research is becoming commoditised, with analysts across the finance sector working with similar tools on similar data provided by companies at similar times.

At the same time, there is pressure on fund managers and equity analysts from stakeholders to understand more complex "soft" variables such as management quality, leadership, remuneration and corporate governance.

This has resulted in behavioural finance overtaking technical analysis in many areas.

The trend to commoditisation of equity research creates a market for new, differentiated research products which go some way towards meeting the relentless pressure for continuing high performance.

On a broader level, the demand for hard analysis of soft variables creates further questions:

- How can qualitative data on corporate behaviour and other soft variables be made available to analysts, given the continuous disclosure rules?
- How can corporate behaviour be analysed systematically?
- Do analysts have to be devious or simply creative when gathering soft variable data?

One solution is for finance industry professionals to use a structured form of human capital analysis.

Human capital analysis, also known as the sustainable human capital classification (SHCC), should be able to distinguish between corporate rhetoric and the reality of practice.

The purpose of the classification process is to highlight, on a company by company basis, evidence of sustainable people management practices. This is defined by the level of internal consistency of practices, and their alignment with the broader context in which the company is operating.

Analysing human capital is extremely important for general managed funds and securities analysts. By providing insights into patterns of human capital practices, such analysis allows an observer to better anticipate future events within that organisation.

The current system of analysing financial data typically relies on historical financial data, in essence a lag indicator of past performance.

Choosing the right measure

Choosing the right measures and processes is fundamental to the integrity of human capital analysis.

In essence, most metrics consider the effects, rather than causes. Andrew Mayo (author of *The Human Value of the Enterprise: Valuing People as Assets – Monitoring, Measuring, Managing*) says most existing approaches to people measurement fall into five categories. These include:

- valuing people as assets by applying accounting valuations;
- deriving an index of good human resource practices and relating those to business outcomes;
- producing statistical reports for measuring productivity and output of people; and



- assessing return on investment by measuring the efficiency of human resource functions and processes and integrating people-related measures in a performance management framework.

Mayo notes that accounting-based measures are often presented as static numbers, when the dynamic nature of contemporary business requires trends, comparisons and directions.

Given the plethora of measures, there can be confusion between accounting-based measures, such as those used for intangibles, and the deeper issue of the creation of value.

All these approaches are useful analytical tools, but cannot be systematically adopted by analysts and fund managers without breaching the regulatory boundaries.

This is because such metrics rely on an in-depth understanding of an organisation which could only be gained by access to privileged and confidential company data.

Even if such access was permitted, the metrics that have been presented indicate that little attention is paid to measuring and identifying the underlying causes, not effects.

In their book *Built to Last: Successful Habits of Visionary Companies*, James Collins and Jerry Porras remark:

“individual leaders, no matter how charismatic or visionary, eventually die and all visionary products and services eventually become obsolete.

“Yet visionary companies prosper over long periods of time and do not have perfect unblemished records but display a remarkable resiliency, an ability to bounce back.”

Timeless human capital systems and practices can highlight differences between companies.

Even though it is difficult to isolate exact casual relationships, the SHCC approach could form the basis of a complementary equity research product.

Using this model, securities analysts and fund managers would be able to identify human capital systems that ultimately affect financial performance.

Evaluating companies

Laurie Bassi, a leading US researcher, found that even though a large percentage of decisions made by fund managers were based on non-financial data, the models used were not transparent.

There was therefore a lack of relatively systematic analysis of non-financial data, creating an unacceptable variability of analytical tools and outcomes.

One feature of the current system is the “celebrity analyst” who often does not document his/her approach to analysis. When he or she leaves the firm the insights go as well, again increasing variability of analysis and analytical techniques.

The current system often is not able to highlight the complexity and variety in organisations often neglected by primary financial analysis.

The SHCC involves analysis of the drivers of sustainable people management, including changing internal and external pressures and managerial beliefs and perceptions.

These variables interact and shape management, ultimately resulting in the adoption of appropriate sustainable people management practices.

The model compares, on a company-by-company basis, the strategic rhetoric on a company’s human resource practices versus the reality, based on other published company information.

Table one: Ideal types of human resource practices:

| | |
|-------------------------|---|
| Traditionalism: | Human resource practices which encourage a long-term employment relationship, security and career progression based on junior level entry and career movement within the one company. |
| Professionalism: | Human resource practices which encourage an employment relationship in which recruitment and career progression is across all levels of the company (senior and junior entry level hires). Senior hires have a career progression which spans across several companies in the industry or associated occupations. |
| Individualism: | Human resource practices which closely support short-term, subcontract labour market arrangements. The employment relationship lacks security, there are no differentiating career levels or progression and frequent staff turnover. |

Table two: Classification – the Star Rating system

| Sustainability gradation | |
|--------------------------|-------------|
| ***** | High |
| **** | Medium/High |
| *** | Medium |
| ** | Low/medium |
| * | Low |

The SHCC process classifies each company from one to five. Companies can be ranked within an industry sector.

Star rating system

*****Five star:

- Best practice for its own industry sector.
- Human capital practices are internally consistent and consistent with corporate strategy and encourage long-term commitment and organisational membership.
- HR systems of recruitment, training, career planning and performance management are highly sustainable.
- Human capital practices are highly consistent with rhetoric espoused in public documents.

****Four star:

- Approaching industry best practice for its own industry sector.
- Human capital practices are relatively internally consistent and consistent with corporate strategy on key long-term elements.
- HR systems of recruitment, training, career planning and performance management create a medium to high level of sustainability.
- There appears to be a high correlation between the rhetoric of public documents and the practices demonstrated by the organisation.

***Three star:

- Interested in becoming industry best practice for its own industry sector, currently mid-range.
- Human capital practices are not well integrated into corporate strategy and may be internally inconsistent. Key long-term elements are not always well articulated and executed.
- HR systems of recruitment, training, career planning and performance management are not yet as sophisticated as others in the industry, but operate at a medium level of sustainability.
- The gap between rhetoric on the value and primacy of human capital and the practices may be relatively large.

**Two star:

- Not operating within the formal or informal guidelines for industry best practice for its own industry sector.
- Human capital practices are internally inconsistent and not structured to efficiently execute corporate strategy. Practices focus on the short term.
- HR systems of recruitment, training, career planning and performance management are embryonic, or working at odds with corporate strategy and are operating at a low level of sustainability.
- The gap between rhetoric on the value and primacy of human capital and the practices may be quite large.

*One star:

- The organisation is not aware of, or is operating outside of, the formal or informal guidelines for industry best practice for its own industry sector.

- Human capital practices are internally inconsistent and not designed to be able to execute corporate strategy.
- HR systems of recruitment, training, career planning and performance management are unsophisticated relative to the pressures of the industry sector. They are likely to be unsustainable in the long term.
- A very large gap exists between human capital practices and the rhetoric of public documents.
- There is a high risk of unwanted turnover of staff or staff working at less than optimal levels.

For practices to be sustainable, a two-thirds weighting is given to the recruitment, training and career opportunities indicators, as per the "traditionalism" and "professional" types.

The dangers

This star summary provides an application of the SHCC process. By examining all publicly available data on these listed companies, it is possible to derive a summary of the firm's relative position on human capital.

This analysis can be applied to all the main industries represented by the top 200 Australian Stock Exchange companies.

Analysis needs to be done regularly, monthly for example, to keep observers up to date on human capital changes within a company.

This process is in contrast to the tables provided by such services as Corporate Monitor, published monthly in *Ethical Investor* magazine, which presents data on corporate governance social and environmental issues.

In contrast, the SHCC incorporates some environmental data, but is based on a more detailed definition of human capital.

The SHCC should not be taken as an indicative measure of corporate sustainability, or investment merit. The SHCC must be used in conjunction with traditional financial, social and environmental data, as well as other human capital people management measures.

But it provides an increase in the degree of transparency used in the evaluation process of investments.

It is only one tool, although an important one. It provides no short cuts to successful investment outcomes and companies and their analysts should seek professional advice before making any decision.

Inevitably, there is a cost to applying human capital analysis to investment decisions. Yet there is potentially a greater cost in terms of transparency to the investment community if human capital is ignored. ■

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