

Investing in Companies that Invest in People

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Published on HR.com, February 2002
<http://www4.hr.com/HRcom/index.cfm/134/>

Do a company's investments in its people pay off? Do they create future value? If so, how much? These questions are part of one of the longest-running discussions in the HR field. By making at least some investments in employee education and training, most companies implicitly indicate that they have faith that the answer to the first two questions is "yes." Hard evidence and a definitive answer, however, have remained elusive – in part due to the general absence of standard information that enables statistical comparison across firms.

We've spent years, along with the American Society for Training & Development (ASTD), developing standard measures, collecting data, and analyzing the relationship between companies' investments in formal training and their financial performance. The result? Strong evidence that the stocks of companies investing above-average amounts on training per employee tend to subsequently outperform the market.

The impact of this finding for companies and for investors? Not much - yet.

The clearest implication of our research would seem to be that investors who know what firms are investing in education and training could significantly improve the performance of their portfolios. But don't bother rushing to your broker or to the Internet to get this information. Information on corporate spending in areas such as training and learning for employees – factors that clearly drive future wealth creation – is basically not available publicly. But we're getting ahead of ourselves.

First, the evidence on training's effects. Through the efforts of ASTD, comparable data on the education and training investments made by thousands of firms (in dozens of countries) have been collected for the last few years. The resulting database included information on more than 500 publicly-traded companies in the United States, which are required to periodically report financial information to the public. We combined financial and training information for these companies and conducted a series of analyses, including multivariate regressions to determine the relationship between training expenditures in one year and financial performance the following year.

The findings are quite remarkable. In general, we found a clear relationship between training expenditures per employee and financial performance in the following year. Almost all financial measures (stock performance, income per employee, gross profit margin, market value per employee) are significantly higher for those companies that spend an above-average amount per employee on training.

The most important finding came, however, after we sharpened our analysis by conducting a series of multivariate regressions that allowed us to examine these relationships in additional detail – while controlling for other potentially important factors. Because the stock market is, at its core, a continually updated assessment of the expected value of a company’s future performance, we focused particular attention on a company’s stock market performance (total stock return, defined as annual change in stock price, plus dividend yield).

We developed a quantitative model based on regression analyses that used the four years of training data (1996 to 1999), and tested them on market performance in the following year (for the final year of the sample, we actually tracked the portfolio performance for two years, to ensure that we had examined the model in multiple bear market years). This model allowed us to develop hypothetical stock portfolios, comprised of companies that we would expect to outperform the market (based on their training expenditures) and weighted based on their expected future returns, as indicated by the model.

We then examined the performance of the hypothetical back-tested portfolios that had been created by the rigorous application of the model rules. These portfolios performed well in both the bull market of 1997-1999 and the bear market of 2000-2001. Overall, this hypothetical portfolio had a cumulative return of 137 percent for the five years (excluding any fees that might be applied), compared with a cumulative return of 55 percent for the S&P 500 for the same period. It outperformed the market in four of the five years examined, including by at least nine percentage points in each of the two bear market years.

Overall, our analysis found that a firm’s current training investments are the single most important statistical predictor of its total stockholder return (stock price change plus dividend yield) for the following year – more telling than other key investments that *are* publicly-reported, such as R&D.

Particularly remarkable is that fact that we’ve found such strong results despite the fact that our measure of human capital investments is clearly imperfect. It captures only “quantity,” the raw number of dollars spent per employee, when we’d really like to know the “quality” of that spending – potentially a better measure of its likely effect on the bottom line. Quality, however, is notoriously tricky to capture – and even our simple measure of quantity is extraordinarily difficult to obtain on a systematic basis. For those reasons, we’re currently comfortable relying on quantity measures, while working toward developing better information on quality in the future.

Now back to the problem of the (lack of) availability of such information. As mentioned above, investors currently have almost no way of incorporating information on training into their investment decisions. Little is known about which of the companies that declare “our people are our most important asset” are actually making the investments to back up that declaration. And until companies are *required* to make disclosures of their investments in human capital management, most are unlikely to do so. In the U.S., not a single *Fortune 500* firm includes in its annual report the amount it spends on employee

training. Further muddying the waters, there are no public guidelines on how information on such investments should be reported (currently, it's just another cost of doing business).

Nevertheless, it is increasingly clear that this absence of public information directly reduces the efficiency of the market, since relevant information (on firms' training expenditures) is generally not publicly available. The absence of this information results in less well-informed investments. That's market inefficiency.

Further, because training and education are treated on a firm's books as costs, not as investments, those firms that make such investments must do so in spite of the pressures of the market (to reduce costs) rather than because of them (as might be the case if the market had the information necessary to recognize such expenditures as worthy investments). This leads to a collective tendency to under-invest in human capital – more inefficiency that affects society as a whole. It's bad for stockholders and firms, and it's bad for the people who work in them, since research has found that workplace training is an important determinant of workers' future earnings capacity.

Currently, it's a lose-lose situation. But it is correctable.

On one front, a significant improvement would occur if the public agencies that regulate financial disclosure were to change existing reporting and accounting requirements to reflect the reality that investments in human capital are a significant value creator for corporations, and therefore is worthy of disclosure to investors and markets.

On another front, we believe that some progress can be made by investors themselves – who should start asking new questions of the firms in which they invest – “if people really are your most important asset, then how much are you investing in them?” and “why don't you measure and manage your human capital investments in the same way that you treat other strategic investments?”

In fact, we are so convinced of the value in this that we've formed a new money management firm designed to do just that. We ask companies how much they spend on training, we take that information and apply to it the lessons and formulas that we've derived from our ongoing research on the effects of training, and then we select and invest in a portfolio of those firms that we believe will perform well in the future. We've been doing this for two months now, with encouraging early results.

PLEASE NOTE: This article does not constitute investment advice, nor does it represent a recommendation to purchase or sell any specific securities.

ABOUT THE AUTHORS: Laurie J. Bassi, Ph.D. and Daniel P. McMurrer founded Knowledge Asset Management, Inc. (KAM) in 2001. KAM is a money management company that is putting their research into action by investing in companies that invest in their people. Dr. Bassi is Chair of the Board at KAM, while Mr. McMurrer is Chief Research Officer.

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