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PREDICTING STOCK PRICES: WHAT CEOs NEED TO KNOW ABOUT "HR STUFF"

Over the mid- to long-run, the stock market penalizes firms that make *below-average* investment in developing their human capability (through investments in formal training, for example). In the short-run, however, the stock market actually penalizes firms that make *above-average* investments in developing human capability.

This is because the earnings of firms that invest in human capital are understated in the short-run because human capital "investments" are accounted for as "costs" that are buried in the category of selling, general, and administrative expenses (SG&A).

As a result, the market penalizes high "investment" firms in the short-run when their earnings are understated, but then rewards those firms in the long-run (after the benefits of training and other people-related investments appear – typically in about 12 to 18 months).

Human capital investments are the **only** investments for which this is true. [R&D, while accounted for as a cost, is separately reported. This buffers R&D investments from receiving the same harsh short-run treatment that the market metes out for investments in human capital.]

Precisely because of this, most publicly traded firms make sub-optimal investments in human capital (i.e., less than the amount at which the present discounted value of the marginal benefit equals the marginal cost, and profits are maximized).

Consequently, there is a "super-normal" return to human capital investments. In fact, the return on human capital investments typically exceeds the return on all other forms of investment.

Hence, the best predictor of a company's stock price is its spending on human capital.

Bottom line? Succumbing to the short-run pressures that the market creates to under-invest in human capital increases the likelihood that a firm will underperform in the market within a 12- to 18-month timeframe.

(For evidence and citations, see "The Impact of U.S. Firms' Investments in Human Capital on Stock Prices," June 2004. Available at www.mcbassi.com.)

For more information about McBassi & Company or its services, please feel free to contact us:

Call: 413.233.6558
Email: info@mcbassi.com
Web: www.mcbassi.com