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HUMAN CAPITAL MANAGEMENT PREDICTS STOCK PRICES

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Superior human capital management is an extremely powerful predictor of an organization's ability to outperform its competition. This white paper describes some key evidence that supports this claim, and briefly explores its implications.

The Evidence

In 2001 and 2003, under the auspices of our sister company (Bassi Investments, a registered investment advisory firm), we launched two different investment portfolios based on our research finding that, as a group, firms that invest a significant amount in training and developing their employees subsequently outperform the market.[1] In Table 1 (below), we refer to these portfolios as Portfolios A and B.[2]

In 2008, we launched four additional portfolios, based on broader concepts of human capital management, which we refer to as Portfolios C to F. We use a variety of selection criteria for these four newer portfolios, including other evidence of being a "good employer" and an unusual degree of commitment to talent management systems. (We manage three of these four portfolios for technology companies that operate in the talent management space and hence, are not at liberty to disclose the exact criteria used in selecting them).

The performance of these six portfolios, relative to the S&P 500, is summarized in Table 1. Overall, the average (weighted) performance of these portfolios relative to the S&P 500 is +4.7 percent per year.

Table 1
Performance of Human Capital Portfolios[3]
Relative to the S&P 500

Portfolio	Date of inception	Total return (through 5/25/10)	Overall performance relative to S&P 500 (in percentage points)	Annualized performance relative to S&P 500 (in percentage points)
A	12/1/01	+23.5%	+29.2	+3.1
B	1/1/03	+60.6%	+37.5	+4.4
C	3/25/08	+4.1%	+24.5	+10.6
D	3/25/08	-20.2%	+0.2	+0.1
E	10/14/08	+27.5%	+19.9	+11.9
F	12/23/08	+32.9%	+8.4	+5.8

[1] "How's Your Return on People?" Laurie Bassi and Daniel McMurrer, *Harvard Business Review*, March 2004.

[2] The primary difference between Portfolios A and B relates to industry weighting. Industry weights in portfolio A are tied directly to S&P 500 industry weights, while industry weights in Portfolio B are more flexible, and better represent the distribution across industries of those companies that meet the human capital standards for inclusion in the portfolio.

[3] Reported portfolio performances do not include fees or expenses and are based on tracking statistics provided by account custodian. S&P 500 does not include dividends. Contact Bassi Investments for additional information.

With the exception of Portfolio D (which is based on the most narrowly defined of the various concepts of human capital management that we use in creating our portfolios), each of these portfolios has substantially outperformed the market. It is important to note that with the exception of Portfolios A and B, the track record of these portfolios is relatively short. And, of course, past performance is never a guarantee of future returns.

Having said that, the cumulative performance of these portfolios (two of which are now over seven years old) certainly suggests that investment managers would be well-served to pay attention to broad measures of human capital management as a factor in portfolio selection.

We are often asked whether the performance of our portfolios simply measures "reverse causality" (i.e., those firms that are performing well are more able to invest in various forms of human capital management). The answer to this question is "no." Since each firm's past performance has already been accounted for (i.e., "controlled for") in its previous stock price, these results do not merely measure reverse causality. Rather, the human capital measures we use in our portfolio selection are independent *predictors* of organizational performance, as captured through stock performance.

Nonetheless, this evidence falls short of "proving" that superior human capital management causes firms to subsequently outperform their competition; outside of classically designed experiments, it is impossible to definitively prove the existence of causal relationships. Hence, the evidence summarized in Table 1 is likely to be as close as we can realistically get to answering the question of whether human capital management causes improved organizational performance.

Implications

Human capital management is fast emerging as an essential core competence (possibly *the* essential core competence) for organizations.[4] Although the firms that we hold in our portfolios are among the world's leaders in human capital management, our analysis indicates that even these companies, on average, are still relatively unskilled at measuring and optimizing their investments in human capital.

Why? For most of the human resource professionals in these (and other) firms, measurement remains a critical area of weakness. To allow their organizations to tap the full potential of human capital as a source of competitive advantage, their HR strategists need to engage the emerging field of human capital analytics. This would make it possible for organizations to develop and execute human capital strategies that are grounded in actionable business intelligence - rather than relying on the old standbys (intuition, one-size-fits all benchmarking, or accepted measurement myths within the HR profession).[5] Only then will organizations truly reap the benefits of unleashing their employees' full capabilities.

[4] "Maximizing Your Return on People," Laurie Bassi and Daniel McMurrer, *Harvard Business Review*, Volume 85, Number 3, 2007.

[5] See, for example, our article "Does Employee Engagement Really Drive Results?", *Talent Management*, March 2010.