Are Skills a Cost *or an* Asset?

By Laurie Bassi and Daniel McMurrer

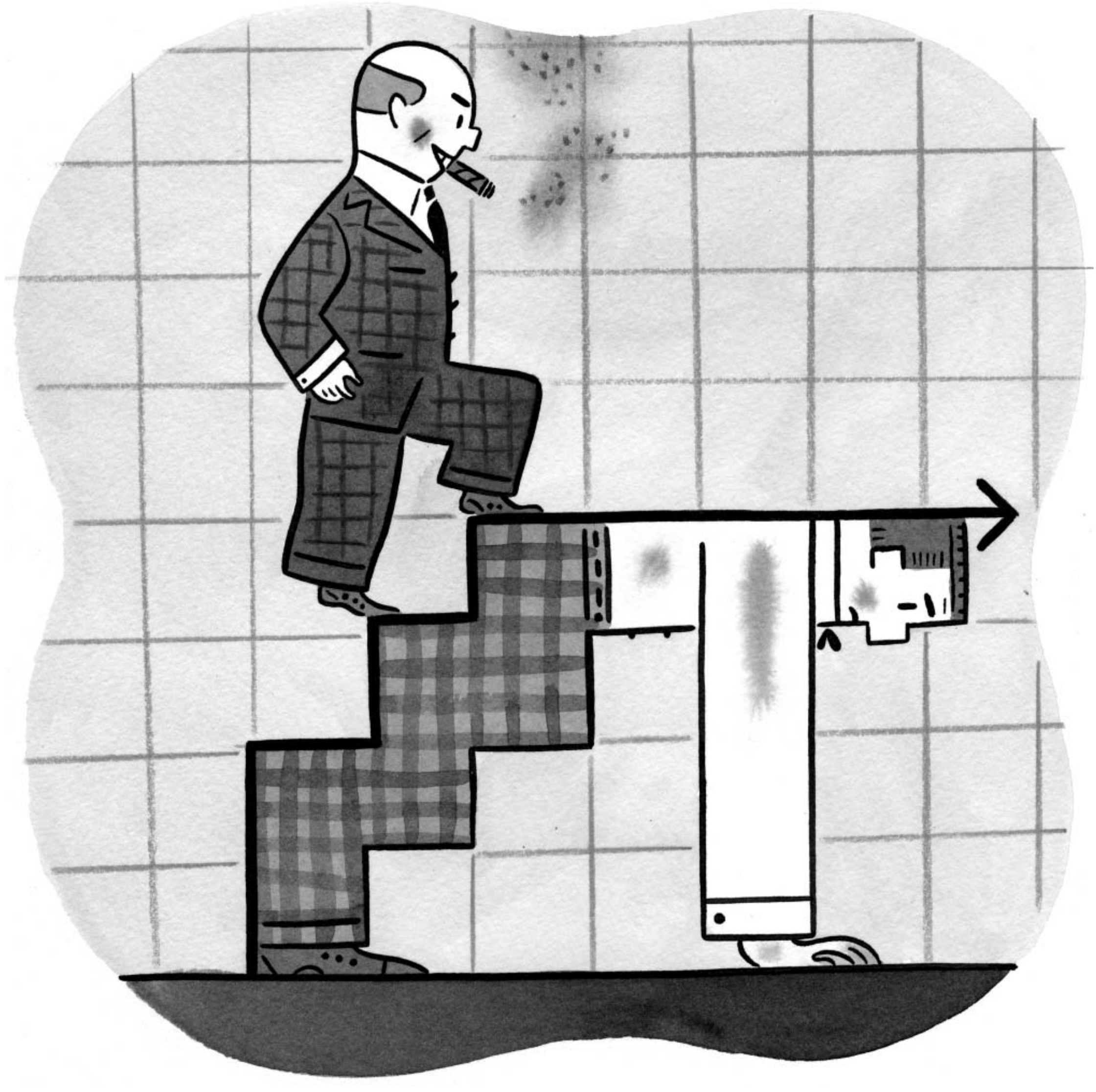
Though American corporations have been positioned at the hub of the global knowledge economy for some years, the reporting systems that track business progress are woefully out of date. No, we're not referring to the creative accounting that led to the flameout of Enron and kept Dennis Kozlowski well-supplied with shower curtains. The anachronisms of corporate accounting are most acute in the domain of human capital.

For in spite of CEOs' platitudes about people being their companies' most important assets, investments in employee productivity appear solely as costs of doing business in company-income statements – technically as "selling, general and administrative expenses." Skills acquisition and development thus fall into the same category as paper clips and electricity. By contrast, other major forms of spending designed to yield future value, like R&D, are assigned their own separate categories as depreciable investments. We believe this failure to give human capital its due has profound effects on the economy – not to mention on the ability of analysts to value equities properly.

For a variety of reasons – none good – Wall Street focuses disproportionate attention on the next quarter's earnings, which are directly affected by costs. In this environment, the outdated nature of accounting and reporting only exacerbates the chronic tendency among U.S.-based, publicly traded companies to invest too little in employee skills. Until accounting and reporting requirements are changed, efforts to create unsustainable increases in quarterly earnings will all too often take priority over investments that result in higher earnings in the long run.

Underinvestment in employees takes a variety of forms, notably as a failure to spend adequately on training. This underinvestment in intangibles yields very tangible harm to all stakeholders – employees, employers, shareholders and society as a whole.

Indeed, one need look no further than the economic and human toll that has resulted



from the recent accounting scandals in the United States to understand the importance of ensuring that accounting standards reflect current realities and require companies to distinguish among assets and liabilities, costs and investments – in ways that truly reflect their impact on firm productivity.

In the area of human capital, it almost goes without saying, this standard is not met. As a result, publicly traded firms only invest in the long-term productivity of their employees at the risk of Wall Street's disapproval. Most do not resist this pressure.

How do we know that they are under-investing? The evidence shows that the few firms that have resisted Wall Street's pressures to cut people costs have outperformed their peers, either on the stock market or in return on capital. We believe that simply requiring public corporations to report their investments in employee development would help to ameliorate the perverse consequences of

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the current system. Firms would have greater incentives (or, more accurately, fewer disincentives) to invest in their employees, which would ultimately not only improve the economic lot of workers, but also boost shareholder return.

WHAT'S DRIVING UNDER-INVESTMENT IN HUMAN CAPITAL?

It is an accepted tenet of economics that a necessary condition for maximizing profitability is for the firm to invest in each factor of production – labor, capital and natural resources – to the point at which the return on an additional dollar spent is the same for each. Over-investment in any particular factor will result in a lower return on that factor. Similarly, under-investment in a factor will result in a higher return on that factor.

To put it another way, a business that is allocating scarce resources efficiently would find that the return on people at the margin should be identical to the returns on other factors of production. Yet the numbers suggest that returns on human skills are consistently super-normal, implying that firms' investments in people are inadequate. From this we conclude that there is a general under-investment in employees – and that firms making unusually large investments in human capital will outperform the averages in the long run.

Why do firms ignore the obvious? Consider two organizations that are identical in all but one respect: Company A makes substantial investments in skills, while Company B does not. What will be evident to any analyst comparing the companies' income statements is that Company A has higher overhead for selling, general and administrative expenses, and correspondingly lower reported earnings, than Company B. What will not be evident, however, is that some of Company A's expenses are actually investments in future productivity. Consequently, Company A's stock price would be expected to be lower – at least in the short run – than Company B's. The decision of Company A to invest in employee skills thus occurs despite pressures from financial markets.

Do these pressures also apply to firms that have a long history of making significant investments in their employees? Unfortunately, the answer is yes. Even firms that have made significant human capital investments in the past face pressure to cut those investments in the short run to generate temporary increases in earnings.

IT'S THE NUMBERS, STUPID

So where's the hard evidence to support the relationship between profits, stock prices and investments in human capital? Such evidence has been hard to come by precisely because most firms don't release information on their skills investments.

We have been systematically filling this gap for almost a decade, gathering data on how much firms spend on employee education and training. We first began collecting numbers on investments in employee development in 1996, when we both worked in the research department at the American Society for Training and Development, an organization that represents managers of employee development.

At that time, very little was known about how much firms were spending on employee training. In fact, there wasn't even common agreement about what constituted employee

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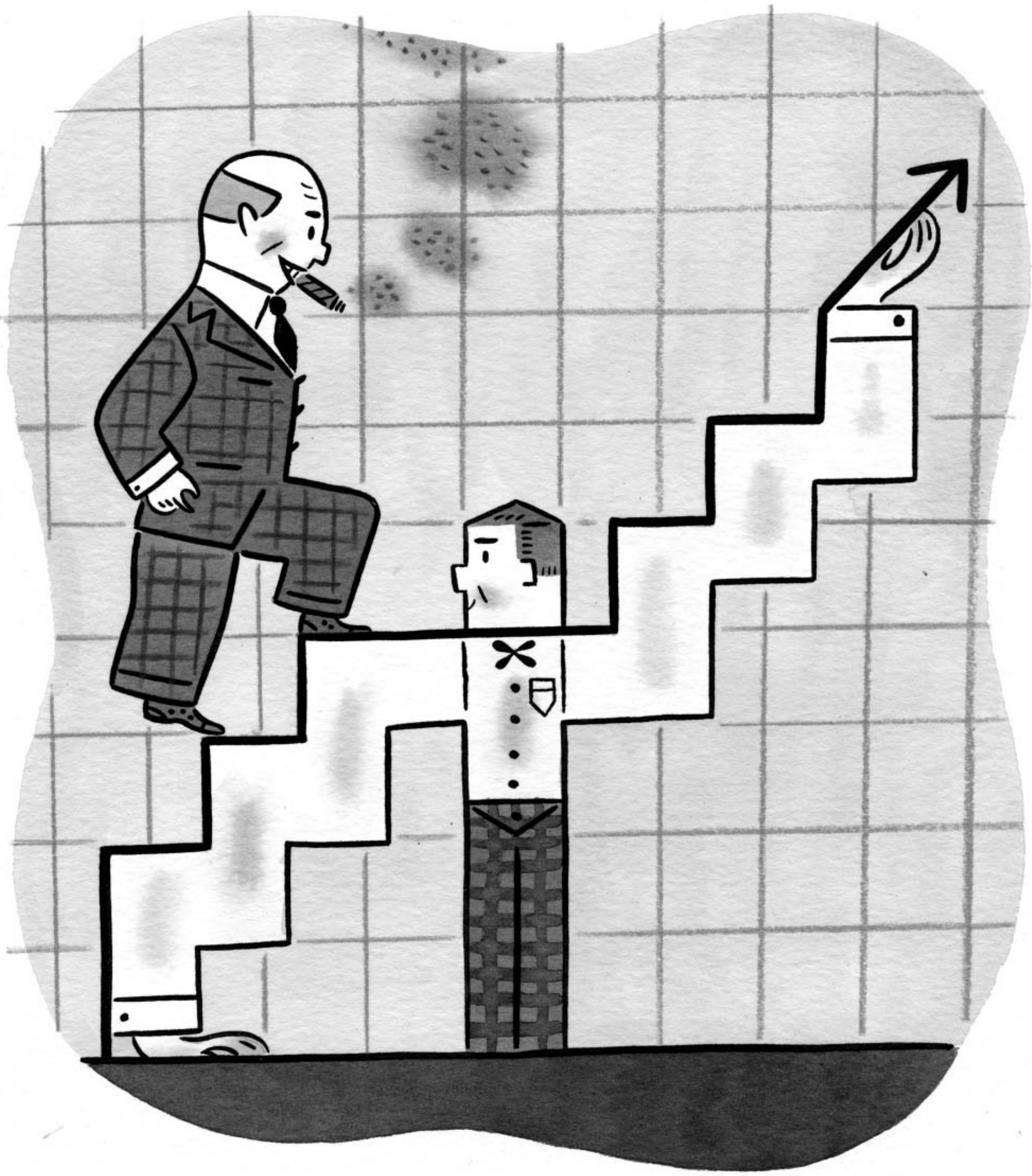

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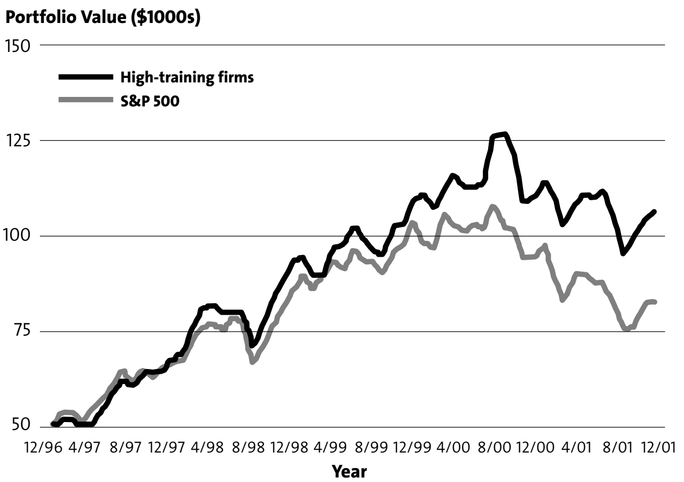
development. We worked with a consortium of large firms to clarify the ambiguities, and then established a benchmarking service to collect comparable data across a large number of organizations. To encourage participation, we offered each organization that reported data a free customized benchmarking report analyzing where it stood vis-à-vis comparable organizations.

The database grew to over 3,000 organizations, both inside and outside the United States, including for-profit firms, nonprofit organizations and government agencies. Of these 3,000 organizations, 575 were publicly traded firms based in the United States. As public corporations, each was required to report extensive financial information annually. Thus, when analyzed in combination with data on financial performance, the numbers on training expenditures provided the opportunity to examine whether employer investment in skills really did pay off.

The results were clear: firms that made large investments in employee development subsequently outperformed the stock market. Indeed, training and development expenditures per employee proved to be an important leading indicator of future stock prices. (For details, see Laurie Bassi, et al., *Human Capital Investments and Firm Performance,* June 2001, which is available in the Research section of www.bassi-investments.com).

GROWTH OF $50,000 INVESTED 1/1/97 THROUGH 12/31/01, HYPOTHETICAL PORTFOLIO OF FIRMS WITH HIGH TRAINING INVESTMENTS, VS. S&P 500
(NET PERFORMANCE AFTER DIVIDENDS AND DEDUCTION OF ALL FEES)



As part of the analysis, we created a series of hypothetical portfolios of firms that made the largest investments in employee development between 1997 and 2001. These firms subsequently outperformed the S&P 500 (including dividends) by a substantial margin in the five years following the investment (113 percent versus 66 percent).

This corresponds to an annualized return of 16.3 percent, which can be compared to an annualized return of 10.7 percent for the S&P 500 for the same period. Although these results held true in both bull and bear markets, and across sectors of the economy, they should still be interpreted with caution, for there are limitations inherent in hypothetical back-tested results. But, on balance, the data strongly suggested that firms' investment in employee development was a powerful predictor of future stock prices.

EXPLAINING THE EVIDENCE

Why would education and training investments be such a powerful predictor of stock performance?

In general, the stock market behaves quite efficiently in reflecting all available relevant information in current share prices. In light of this efficiency, two conditions must be met in order to find a leading indicator of future stock prices. First, an analyst must have access to information that is material to a firm's future performance. Second, this information must not be public – if it were, one would expect it would already have been incorporated into the share price.

Information about firms' investments in employee development meets both of these conditions. Indeed, not only is this information unknown to most market observers, it masquerades as something very different in the profit-and-loss numbers. As noted in the simulation experiment above, high-investment firms actually appear to analysts to be the high-cost firms, and are thus penalized in market capitalization.

PROOF IN THE PROVERBIAL PUDDING

Skeptical readers are no doubt asking, "If these guys are so smart, why haven't they gotten rich?" We're working on it. We have taken the research findings outlined above to launch an investment firm, Bassi Investments, that manages a series of portfolios (for full information on these portfolios, contact info@bassi-investments.com). The first was launched in December 2001, and the other two were launched in January 2003. The live track record of these portfolios is summarized below.

PERFORMANCE OF RECOMMENDED PORTFOLIOS

	RETURN SINCE 1/2/03*	RETURN SINCE 12/3/01*
Portfolio A (Created Dec. 2001)	34.4%	4.2%
Portfolio B (Created Jan. 2003)	38.9	n/a
Portfolio C (Created Jan. 2003)	34.9	n/a
S&P 500	27.7	-1.4

*Portfolio performances as of 3/17/04, includes fees and dividends.

We believe that these results offer striking evidence on the broader issue – that most firms systematically under-invest. (Caution is, of course, in order; the evidence is currently based on results from a relatively short period. And we would be remiss if we failed to point out that past performance is no guarantee of future results, and that it is always possible to lose money.)

EFFECTS OF UNDER-INVESTMENT IN HUMAN CAPITAL

Individually and collectively, we pay a high price for this under-investment. As a nation, we are excessively prone to layoffs and downsizing. Wayne F. Cascio of the University of Colorado's business school has extensively documented that downsizing not only hurts workers who are laid off, but also is counterproductive for the employer as well; layoffs typically destroy shareholder value in the long term. He finds that, all else being equal, downsizing never improved profits or stock market returns, and that the only firms that grow over time are those that increase their numbers of employees and assets.

Once people leave the formal education system, the workplace is the source of much of their ongoing learning – particularly learning that affects economic performance. So this tendency to under-invest harms both the short-run and long-run economic prospects of workers. And that, in turn, has a negative impact on both their families and their communities.

WHAT MUST BE DONE

The discussion above suggests a surprisingly easy fix – one that doesn't depend on much regulatory intervention. Reporting standards should be changed to require publicly traded firms to report annually on spending for employee education and training.

By making it possible for analysts to treat this outlay as an investment rather than a cost, this simple change would ease the market pressure to reduce training investments in order to reduce short-term "costs." This, we believe, would lead to gradual increases in worker training, to the benefit of firms, employees and shareholders alike. And unlike government programs to improve workers' skills, it wouldn't add a penny to the budget deficit. Indeed, it might increase tax revenues in the near term by forcing companies to depreciate outlays they now expense.

This is only a beginning, though. Congress should follow the lead of other industrialized nations and require the appropriate federal agencies to study how to transform our entire industrial-era accounting system into a knowledge-era accounting system that recognizes people as the assets they are.