HUMAN CAPITAL MANAGEMENT

Codifying best practice

Marketing material for professional investors and advisers only

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Schroders

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As we have conducted this research we have engaged with numerous consultants, former and current CPOs, CHROs, and HR practitioners. While the experts we have talked to each have nuanced views, they are almost all uniformly of the opinion that there is risk associated with focusing too much on an objective measure for human capital. In other words, **human capital analysis must combine quant and qualitative assessment.** A psychologist might argue that human behaviors become repetitive, or more predictable, when higher levels of trust are involved. Meanwhile, an HR practitioner would explain that systems to promote certain habits and rituals can successfully cultivate the desired outcomes over time. Both would be right to do so. However, when it comes to people, exogenous features must also not be ignored. In this way human capital analysis cannot provide definite answers, but can help channel our questions about **sustainable stakeholder value creation.**

Our proposed best practice guide is not entirely quantitative; far from it, in fact. It is also designed to be used as part of a broader investment and engagement process, very much as a supplement to the human capital sections in the Schroders Engagement Blueprint. Where companies are achieving different outcomes for similar levels of labor intensity, for example, we advocate using HCROI analysis in combination with this framework to begin to shed light on why. The approach described here is focused on the human systems that we believe are fundamental to effective human capital management. These are: operating model and workforce strategy, culture and inclusion, incentive and performance management, talent and learning, innovation. For each, we have set out the basic and best practice disclosures and activities, as we see them today, as well as the outcomes that are most relevant[1]. The logic is illustrated in Figure 1 below.

Figure 1: How it works

Companies that manage human capital effectively have visibility powered by good data, enabling them to manage different human systems optimally to deliver measurable impact for stakeholders. Our human capital management best practice framework seeks to highlight what investors can look for at each stage.

Source: Schroders.

It is important to reiterate: **human capital is not normative.** The capabilities of an organization's people are embedded in the knowledge, skills and relationships that are built up cumulatively as a company evolves. These are idiosyncratic. We are therefore not arguing that companies should develop a certain type of workforce, culture, or talent pool, as these must necessarily reflect a firm's own industry, its stage in the lifecycle and so on. However, we do argue that **there are effective and ineffective strategies for monitoring, influencing and delivering measurable human capital outcomes: human capital management.** And there are base level practices that can be applied across most sectors and organizations.

These are set out below. They should boost our understanding of the coherence and quality of a firm's human capital management and we believe this can **enable investors to have specific, measurable, achievable and time-bound conversations with companies on these topics.**

This can also help build comfort in terms of margin of safety. As cycles and industry dynamics evolve, our assessment of human capital management practices should help build confidence both in a company's ability to adapt to changing circumstance, and its ability to deliver sustainable stakeholder value.

1 Please note the framework we have included here is intended to be an evolving reflection of our work. Should stakeholders have views on what good or bad looks like, we welcome the opportunity to discuss. Along with work done by experts like Jac Fitz-Entz and Professor James Heskett, there is universal agreement among experts on the importance of addressing outcomes, as measured through a variety of KPIs. Notably, Heskett presents a balanced scorecard approach whose outcomes include: employee retention, customer engagement and retention, productivity, product/service quality, learning and innovation

INTRODUCTION (CONT'D)

The importance of company disclosure

Disclosure on these topics underpins our ability to evaluate the effectiveness of human capital management through outcomes. In certain cases, where there are not satisfactory outcomes, the quality of disclosures – and the degree to which the activities described are comprehensive – represent the primary components on which we can evaluate companies; added to which we can use data from sites such as Glassdoor, Payscale, Linkedin and our internal sustainability and financial models. We have thought hard about setting out a quantitative scoring framework here and have not done so because we do not believe it is fair (yet) to penalize companies for limited disclosure on a topic that is so nascent in terms of its integration into the financial and sustainability reporting discussion; relative to climate change, for example. However, we intend to update this framework over time, potentially introducing clearer scoring mechanisms than the 'basic' and 'best' practice guide rails that are included in this first.

Human capital reporting frameworks

As discussed in our first report – "Margin of Safety" – **companies can enable effective analysis of human capital management outcomes with four foundational line-item metrics** to compliment principles-based data. The Human Capital Management Coalition (HCMC) in the USA supports mandatory reporting of the following disclosures:

1. **how many workers** (including employees and independent contractors) the company uses to accomplish its strategy;
2. **total cost of the work force**, presented in a way that evidences a discernible through-line from the company's audited financial reports to issuer disclosures;
3. **turnover**, including management's actions to attract and retain workers and how changes in the ability to attract and retain workers affects the company's performance and strategy; and
4. **diversity data**, including diversity by seniority, sufficient to understand the company's efforts to access and develop new sources of human capital and any strengths or weaknesses in its ability to do so.

There are numerous other human capital management reporting frameworks such as the Workforce Disclosure Initiative (WDI), or the International Standards Organization (ISO 30414). Where relevant, we have integrated a parts of their approaches into our implied best practice, albeit we present here a more concise approach than these because of our focus on the five core human systems.

Going forward

Testing the materiality of HCROI has allowed us to identify both leaders and laggards across our range of non-financial sectors. We are further refining this list of companies to isolate specific instances where, for given levels of labor intensity and average wages, companies are generating meaningfully different levels of returns on human capital.

We have been conducting research-based engagement with a variety of these companies in follow up to this initial research. The aim is to interrogate what these firms are doing to manage their human capital, noting in particular the differences in human capital management between leaders and laggards. In this way we hope both to validate our view of best practice, such that it can be used as a representation of what good currently looks like, and to understand where there are opportunities for companies to improve their human capital management, for the benefit of all stakeholders. As our research on this evolves, we aim to focus more on the value that can be created by driving change in each of the individual human systems. In other words, to the extent that it is possible, we aim to unpack the degree to which improving a firm's strategic workforce planning carries a higher incremental return than say improving culture, or learning systems, for example.

As highlighted several times, the guide set out below represents our current view of best practice, applicable on a largely industry agnostic basis. We anticipate this will be subject to change as our research evolves and as we can identify and test the relevance of more outcomes-based metrics.

OPERATING MODEL AND WORKFORCE STRATEGY

How organizations plan and prepare their workforce to deliver on business strategy

The core premise of Strategic Workforce Planning (SWP) is that companies resource themselves adequately and sustainably to deliver on their ambitions. This necessitates proximity between the senior most individual responsible for human resources – CPO, CHRO or Global Head of HR, for example – and the board and executive committees. Simplistically, human capital demands, capabilities and potential shortfalls – skills gaps, for example – need to be identified and discussed as strategy is being formed. One would not be comfortable investing in an organization where CFO or financial controls were felt to be inadequate. Given the potential for people to create value as well as risk – as we have seen in our materiality work – it is imperative for companies and investors to build an equivalent human capital picture, for the benefit of capital allocation.

Topic	Rationale	Practice
Disclosure	– Size of workforce (both the number of employees and contractors) and total cost of workforce (salaries and benefits) – Senior most person (and board member) accountable for human capital strategy, explaining how HR fits into strategic planning – Discussion of major human capital risks (including health & safety) and opportunities and their relevance to company strategy – Description of company's approach to unions and collective bargaining (including data on coverage and any litigation)	**Basic**
Disclosure	– Detailed cost breakdown (region, fixed vs variable comp, % of workforce eligible for SBC, benefits by type, training, hiring costs) – Assessment of proportion of workforce cost that is equivalent to maintenance vs investment capex – Succession planning (including % of roles that have succession plans in place) – Workforce capabilities assessment, health & safety data, and workforce scenario plan for near, mid- and long term	**Best**
Action	Involve senior most individual responsible for human capital or HR in the strategic planning at executive committee level to ensure that the firm can develop adequate resources to deliver its goals in a 'vuca'[2] world. Single points of failure, blind spots, and dependencies can be identified ahead of time and the business can invest accordingly. Clear workforce data and reporting is a prerequisite to this.	**Basic**
Action	Assess workforce maintenance cost and workforce investment cost to create visibility on the incremental returns on capital invested. Succession planning and scenario based capability assessments should also be conducted in line with traditional strategic planning. Rotating senior management personnel from operational roles through the HR team benefits both commercial and HR teams.[3]	**Best**
Outcomes	Firms that do this well should aim to build resilience through the cycle, de-risk M&A, reduce key person risk, and become more efficient capital allocators driving higher human capital ROI (HCROI) and returns on people-adjusted capital employed (ROPACE).	**Desired**

Source: Human Capital Management Coalition (HCMC), WDI, ISO, OCAI, Thruue, Working Group on Human Capital Accounting Disclosure, Schroders.

Chanel, one of the world's largest luxury brands, recently made headlines when appointing its new CEO, Leena Nair, formerly the Unilever CHRO. While one of the co-owners retains the role of executive chair, the company statement was clear to recognize the importance of "the freedom of creation, cultivating human potential, and acting to have a positive impact in the world." In her tenure at Unilever, it adopted numerous leading practices in SWP, as recognized in this CIPD case study.

2 The acronym VUCA was first coined by the US military to characterize an increasingly unstable world. It stands for: volatility, uncertainty, complexity and ambiguity. Back to our point on margin of safety, human capital management, and in this case strategic workforce planning, should be focused on building the capability to manage these issues.

3 There is a handful of famous examples for rotating operational managers through the HR team. Systems-thinking in HR requires a clear view of the commercialsensitivities in a company.

CULTURE AND INCLUSION

The invisible hand that guides employee decisions and judgement in a way that the company would desire it to be

There are numerous culture models out there, and we do not to promote one or other. Rather we aim to highlight the potential that effective management of culture and inclusion can have on stakeholder outcomes, specifically employees and investors. Our materiality work highlighted the costs of toxic workers, as well as pointing toward the 'residual' driver of HCROI, part of which we believe is driven by culture / inclusion. Numerous academics have articulated the positive consequences of culture on stock returns, as identified through surveys. Most recently, Boustanifar and Kang updated and expanded on Edmans' work, finding the best companies to work for generate annual alpha of 2% to 2.7%. Culture is of course not the only reason people use to articulate why a particular company is good to work for, nor is it the single contributor to returns. Our work on, and testing of, human capital metrics aims to get closer to quantifying its importance, but qualitative assessment remains important.

Topic	Rationale	Practice
Disclosure	– Turnover (voluntary and involuntary across permanent and contract workers) and engagement (cut by region and gender) – Diversity data (at board, exco, senior management and workforce/function) and timebound targets (for exco and workforce)[4] – Senior most person at exco and board level accountable for culture (including how its management is overseen at board level) – Articulation of the company's corporate culture and values with an explanation of how these are applied throughout the firm	**Basic**
Disclosure	– Detail on structure, composition, and frequency of employee surveys and other listening devices such as exit interviews, including how the conclusions of these are monitored, and resultant changes assessed; unregretted vs regretted turnover – Data on nature and volume of use of grievance mechanisms/whistleblowing, and inclusion of employee voice in boardroom – Explanation of how intersectional and gender diversity is built into talent and succession planning (with inclusion pain points)	**Best**
Action	Tone is set at the top: culture needs to be clearly aligned to the company's purpose and strategy, monitored with robust data.	**Basic**
Action	Employee listening devices should capture global engagement and experience, focus on identifying pain points and address issues of intersectionality and psychological safety, ensuring no recourse is felt by whistle-blowers. Analysis of outcomes KPIs (eg regretted churn) should be followed by iterative approaches tweaking management of culture, focused on features in our third report.	**Best**
Outcomes	Firms that manage culture and inclusion effectively aim for higher retention, higher engagement, higher HCROI and stronger NPS.	**Desired**

Source: WDI, ISO, OCAI, Thruue, Cameron & Seppälä (2015), Housman & Minor (2015), Corporate Culture & Performance (Kotter & Heskett), The Trust Factor (Paul Zak), Porath & Pearson (2013), Edmans (2012), Boustanifar & Kang (2021), Schroders.

One of our conversations with a CPO put it bluntly: *"Be skeptical of generic values… If you don't show integrity, you will not keep your job. Strong culture is about establishing firm values through the identification of: how do we work together [in a way] that sets us apart from the competition".*

4 As noted in our previous reports, we plan to do more work specifically on Diversity & Inclusion in future with a view to understanding its importance to human capital returns. We include a variety of diversity data here because it is fundamental to building a clear picture of a firm's culture. Our thinking on this issue is as follows: taking the theories from the neuroscience of trust through to questions of D&I, inclusion is critical. To the extent that a given company's diversity promise would ring hollow if it were not backed up by sufficient policies and systems to promote inclusion, inclusion is the human capital 'system' – along with culture – that needs to be addressed discretely. Companies' strategic workforce planning, their talent development and training processes – all of their human capital systems in fact – should have diversity running through them; but given findings implied by those assessing the nature of challenges identified in employee reviews, inclusion is a core part of company culture.

INCENTIVE AND PERFORMANCE MANAGEMENT

Motivational and improvement programs (carrot and stick)

Most of the investment world considers executive committee incentive structures. From a human capital management perspective, we are focused on incentive and performance management systems, because both can have profound consequences on different stakeholders. There are various streams of literature that have been focused on worker performance. These can be cut three ways: pay-for-performance, the importance of employee ownership, and the relevance of creating meaningfulness, aka purpose[5]. There is significant complexity behind both remuneration structures and performance management. The Schroders Governance Team's principles on management compensation are summarized in the Schroders Engagement Blueprint. While remuneration structures should be specific to individual companies, promoting long term value creation as well as reflecting the desired corporate culture, our human capital research has found examples of over-zealous use of non- financial KPIs in compensation coupled with non-disclosure of the underlying criteria; neither of which are good. Here, we are largely focused on worker incentive and performance management, but note the importance of management comp structures they indicate the value placed by the board on different departments and disciplines[6].

Topic	Rationale	Practice
Disclosure	– Explain how executive remuneration policies promote the desired culture at all levels of the organization, publish clear and intelligible pay structures with metrics aligned to company strategy and long term value (TSR and sustainability performance) – Ensure and explain how all direct employees are paid a fair living wage and commit that all workers and contractors in indirect operations are too – Detail the performance appraisal system, frequency of reviews and split between outcomes and behavioral targets	**Basic**
Disclosure	– Provide detail on the composition, calculation and criteria used behind non financial items in management pay – Detail median adjusted and unadjusted gender and ethnicity pay gaps, as well as the CEO pay ratio (regional detail helpful) – Summarize workforce eligibility for, and take up of, full range of non-monetary benefits (including any gender or diversity bias) – Frame how performance management system fits into SWP/Talent process, and how the firm promotes performance culture	**Best**
Action	Ensure hurdles need to be achieved before management incentive plan is actioned and use underpins between financial and non-financial criteria. Assess financial wellness of employees against pay and benefits. Implement regular 360 degree performance reviews, with a view to coaching workers through reviews.	**Basic**
Action	Providing inclusive benefits packages is core to effective incentive management, as is eliminating wage disparity based on diversity. Build effective performance systems that address behaviours and outcomes to support high performance culture.	**Best**
Outcomes	Firms with strong incentive and performance management target higher trust, lower absenteeism and lower employee turnover.	**Desired**

Source: WDI, ISO, Schroders.

While the most popular employee benefit at one large hotel brand is supposedly discounted room rates, the firm in question has worked hard to address the cost of living crisis in recent years. Initiatives include one-off cost of living packages, six month allowances, free financial wellbeing and budgeting advice, support for carers and so on.

5 Empirical evidence has been found, for example, to document relationships between employee share schemes and absenteeism (Bryson, Freeman, 2014), while the Institute of Labour Economics has found that employees who perceive their work to be meaningful report fewer sick days (Nikolova, Cnossen, 2020).

6 One of the ways in which we hope to be able to identify where human capital leverage is delivered most valuably within an organization is by looking at the relative differentials between members of the executive committees. It is not uncommon that Heads of HR are among the lowest paid in excos. But if a company's human capital discipline is as well resourced as finance, should this be the case?

TALENT AND LEARNING

How firms attract, recruit, develop and retain diverse people to deliver strategic value

Talent and leaning systems relate to the organic and inorganic ways in which a company can build its human capital. One of the core tenets of our human capital thesis is that people can be appreciating assets. In other words, effective investment in a firm's human capital through training, hiring and other processes can grow its capabilities – and value – incrementally. Talent and learning systems are critical here at micro and macro level . We often acknowledge the importance of training in building future capabilities, but a recent conversation with the CPO of a multinational cloud services provider highlighted as many as 65% of exit interviews flagged lack of career development. There is a clear logic to this, in that the higher up an organization one goes, the narrower the funnel of roles. Again, this illustrates the importance of talent and learning systems in terms of identifying value creators and future skills requirements, developing them, offering people career growth and ultimately retaining them effectively.

Topic	Rationale	Practice
Disclosure	– General description of career development and training strategy (data such as average number of training hours per person) – Explanation of career development and learning (training) systems, as well as how they align to corporate strategy – Any outreach programmes that work on sourcing talent at grass routes level (partnerships with colleges or communities)	**Basic**
Disclosure	– Comprehensive description of how the company identifies skill requirements for future success, and assesses current strengths and gaps in work force; overview of how the impact of strategic talent initiatives and training are tracked with ROI analysis – Detail on how talent is identified, internal promotions, lateral moves, career planning time frames, buy vs build criteria – Data on participation in, and outcomes of, training for employees across all demographics and contract types, cut by gender and other protected characteristics; detail on how company is preparing reskilling initiatives to support strategy and flexibility	**Best**
Action	Allocate a fixed portion of HR budget to training on compliance, health & safety, continuous professional development	**Basic**
Action	Conduct effective top down and bottom up reviews to identify skills requirements in line with company strategy; deliver inclusive and high quality learning interventions and iterate on them based on feedback and ROI analysis; deploy talent dynamically across projects.	**Best**
Outcomes	Firms with strong talent and learning systems seek to deliver better retention, innovation and internal promotion rates.	**Desired**

Source: WDI, ISO, Schroders.

BBVA introduced an agile staffing model as part of the bank's strategy to deliver digital products and deploy technical and data skills to multidisciplinary teams. The firm's 'single development agenda' was the system designed to prioritize projects that were aligned to strategic goals, and was core to allocating talent – and skills – to different projects more effectively. This flexible talent pool approach has been effectively deployed in many other sectors – Nvidia is another such example.

7 Work published here by the OECD in 2010 argued the macro consequences of training: "*estimates for European countries show that a 1% increase in training days leads to a 3% increase in productivity, and that the share of overall productivity growth attributable to training is around 16%.*" At company level the OECD has also been clear on the importance of training in as the future of work evolves – see here.

8 This is where again, we must be careful not to consider talent functions as being normative. Different industries lend themselves to the Pareto principle – 80:20 rule – or Price's Law – square root of the number of people in a firm deliver majority of value. There are then different methodologies designed to adjust for these. We believe that the aim of a functioning talent system built on synergy is to ensure that optimal fulfilment of all roles with the right skills leaves the sum of the parts greater than its constituent components. Our conversations with talent managers imply that in an ideal world, at most 20% of exit interviews would identify career development as a reason for leaving. A recent study by Oxford Economics, here, noted that companies with above average revenue growth were *"more likely than their peers to provide employees with advanced training and development programs"*. This is not inferring causality, but it is a subject we plan to do more work on given its importance to employee outcomes.

INNOVATION

The flow of information among people across the enterprise for product and operating model evolution

Our thinking on innovation is heavily influenced by the work of Clayton Christensen[9]. Innovation does not have to involve a new invention. Instead it can often be driven by taking a mature technology or practice and applying it in a different or novel way adjacent to the incumbent vertical in which it was deployed. Through a human capital lens, we view innovation in terms of product and operating model, the latter applicable to all parts of strategy. This is not about forcing 'light bulb moments' as it were; but rather building the environment in which ideas and information flow effectively across an organization. Again, there are numerous models for how to do this well. We do not look for one or other innovation approach to be taken, but instead look for a company – in its human capital management – to be deliberate about how it seeks to give people the space, incentive and support to innovate wherever they are in the organization. This is heavily linked to the other human systems and margin of safety. It is particularly reliant on diversity and inclusion, as perhaps best explainedin the Values/Principles Model introduced recently in the MIT Sloan Management Review here.

Topic	Rationale	Practice
Disclosure	– The senior most individuals responsible for product and operating model innovation – Breakdown of R&D spend, disaggregating portion focused on product vs operating model – Articulation of how company purpose and vision, including how innovation is integrated into this, as well as fostered in talent, culture, incentive and performance systems	**Basic**
Disclosure	– Detail behind any innovation systems (including partnerships), how results are monitored and the value these create – Explanation of the process through which innovative ideas are adopted and brought all the way to fruition – Metrics used by the board and executive committee to hold themselves accountable for, and measure, innovation – Clarity on how the company defines change readiness, how it is monitored and how it informs resource allocation	**Best**
Action	Developing clarity on how innovation fits into the company at organizational level is key. This involves clarity of vision, accountability and visibility on spend, such that resources, processes and profit formula can be optimally aligned, and the practice repeated.	**Basic**
Action	Innovation culture requires more than saying 'we embrace failure'; companies are rarely starved of ideas, but instead tend to suffer from indigestion. Introducing deliberate metrics and monitoring to support accountability can remove the blockages.	**Best**
Outcomes	Organic and inorganic growth that delivers incrementally higher returns through higher HCROI.	**Desired**

Source: Harvard Business School Online, KPMG, McKinsey, Deloitte, BCG, Higson Consulting, Schroders

Godrej Group is a famous case study for effective innovation through understanding its customers' job-to-be-done. At the time, almost 80% of Indian people had no access to refrigeration. Having space to understand their specific use cases, challenges and nuance helped the company launch a wildly successful low end product. Elsewhere, numerous companies in innovation intensive industries seek to monitor their employees views on innovation: for example, Pfizer includes innovation in its engagement survey, specifically asking employees "to what extent does Pfizer remove barriers that stifle innovation".

9 See: The Innovator's Dilemma, Clayton Christensen. Or for more detail on the different theories involved, see more at Harvard Business School Online here. Among the theories most impactful to our thinking on human capital, we would flag: understanding customer jobs to be done and then innovating to meet that need precisely; aligning company resources, processes and profit formula to facilitate effective innovation; monitoring the performance deficit or surplus to help innovate towards the right strategy for the industry's current stage in the lifecycle; deliberate and emergent innovation strategies.

10 See BMW Cr8 system, Vodafone Launchpad, DassaultSystemes innovation challenge as examples.

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