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Measuring Corporate Smarts

BY MARTIN DELAHOUSSAYE, KRISTINE ELLIS AND MATT BOLCH

Faced with empirical evidence that significant investment in workforce development leads to increased shareholder value, what CEO would dare cut the training and development budget?

Throughout the industrial era, the organization of assets was considered the cornerstone of success in business. Not anymore. While obviously important, it is no longer enough to rely on having the right things, in the right place, at the right time. Frederick Taylor would no doubt raise an eyebrow or two, but the world is a much different place than the one in which he operated. The science of management, it seems, has evolved into the management of science. Actually, it's more nature than science when one thinks of the organization as a holistic organ capable of growth and decay.

Taking the concept one step further, we can begin to think of the modern organization as possessing intelligence. Not in the sense of IQ, which is thought by some to be a fixed entity, but in the sense that organizations are smart enough to continually adapt to their environment. And in true Darwinian fashion, some adapt better and faster than others.

It's this adaptive capability that underpins Senge's view of the learning organization: Faced with rapid or continuous change, only the flexible and adaptive will excel. For this to happen, argues Senge, organizations need to develop the capacity to learn at *all* levels.

How well organizations achieve this capacity has, in recent years, caught the attention of the financial community. What you know, and what you do with what you know, has real value. Compared to the buildings that house those who own the knowledge, it's an intangible asset, but valuable nonetheless.

Measuring this and other intangibles has occupied the minds of analysts for some time—spurred on, perhaps, by the fact that for the past two decades the value of intangible assets has increased from 40 percent of the total market value of U.S. corporations to more than 80 percent at the close of the century. And the gap continues to widen.

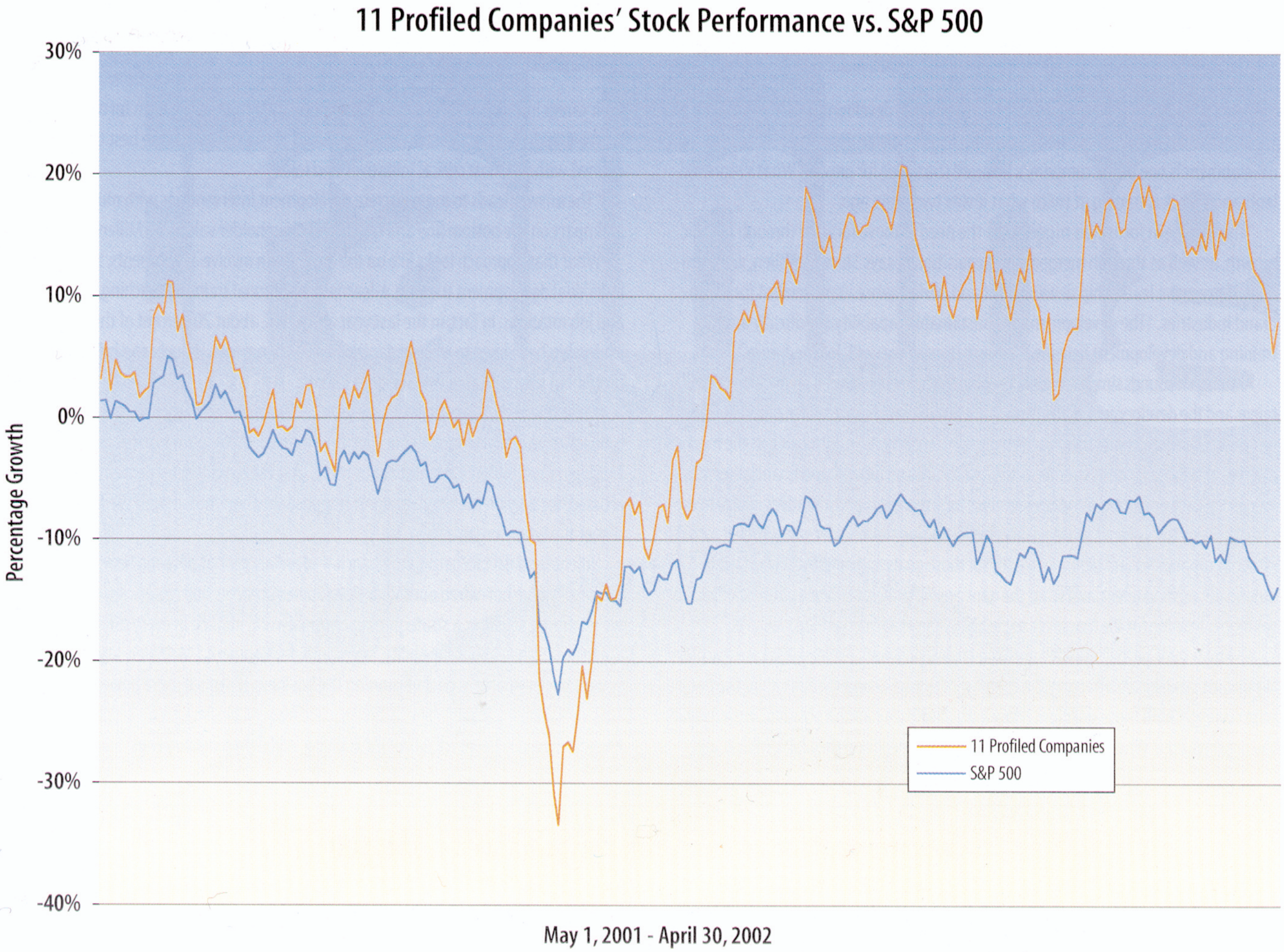
The Securities and Exchange Commission (SEC) continues to wrestle with the conundrum of measuring these intangibles and is attempting to define guidelines for how they should be valued. In the SEC and Financial Reporting Sub-Group's report, *Understanding Intangible Sources of Value*, the SEC commented on how to measure and report intangible asset values: "The Sub-Group concluded that new disclosures are necessary. These changes reflect the shift from a tangible, asset-based economy to one that emphasizes technology and services. Much of today's corporate value is associated with intangible factors. The recommendations call for immediate disclosures of managements' perspectives on drivers of aggregate corporate value, including intangibles."

Meanwhile, some investment analysts have created their own methods of measuring and valuing intangible assets. Some, like Laurie Bassi, founder of Knowledge Asset Management (KAM), Bethesda, Md., have focused on a specific type of asset: people, in Bassi's case, and how well they are trained and developed.

A one-time professor of economics at Georgetown University and former vice president of ASTD, Bassi has created a set of portfolio recommendations based on a simple premise: Invest in companies that invest in their people.

While working on the issues of workplace education and training at Georgetown, Bassi became concerned with the inability of most firms to "measure even the most basic things," she says. "They didn't know what they were spending; they didn't know what they were getting."

Bassi left Georgetown, "to go work on these issues" at ASTD, and eventually formed KAM to put her ideas into action—a financial model, based on years of research, that predicts stock market performance based on investment in training and development.



"Firms that make unusually large investments in training and education [a key cut-off point is about $1,000 per employee] typically have lower employee turnover," explains Bassi. "Lower employee turnover is associated with higher customer satisfaction. Customer satisfaction is a driver of profitability."

Another driver, says Bassi, is managerial proficiency. "Good management determines whether people stay or go, and managerial proficiency is certainly something that can be influenced by investments in employee education and training."

Like all investment analysts, Bassi includes a number of variables in her valuation model. "We looked at things like price-to-earnings ratios, price-to-book statistics, and measures of risk and volatility," Bassi explains. "And while it turns out that there are a few variables that matter and are worth tracking and controlling, it is the education and training variable that is the most significant predictor."

No guarantee, of course, but the combined stock performance of companies in KAM's five-year, back-tested research portfolio consistently outperformed the Standard & Poors 500 Index, against which the portfolio is tracked. Causation? Impossible to say, says Bassi, but a very strong correlation exists between training investment and economic value added (EVA), a performance measure most directly linked to the creation of shareholder wealth over time.

Training magazine interviewed 11 of the companies in the KAM investment portfolio (as of May 2002) for this feature. All make what Bassi calls a "significant" investment in their workforce, and all turned in better-than-S&P 500 performance over a 12-month period (see company stock performance charts). Individual company results will vary, acknowledges Bassi, but taken as a group, "there is undoubtedly something powerful going on here that says many of the firms that are performing the best are the ones making extraordinary investments in training," she says.

But if your company is not making the kind of investment in your workforce that produces better-than-average value for your stakeholders, what then? "I think this kind of analysis provides some high-level guidance," says Bassi, "particularly for those education and training professionals who can go to their CEOs and say, 'Look, by this criterion, we're not cutting it.'"

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Editor's Note: Nothing in this article should be interpreted to represent an investment recommendation. The investment returns referenced in this feature are not indicative of future investment results, and the research-based portfolio described was not managed by Knowledge Asset Management. There is no guarantee that the specific companies referenced in this article remain in the KAM recommended portfolio.

Hillenbrand Industries | *Batesville, Ind.* | *Employees: 10,000+*

Hillenbrand Industries' decision to focus on leadership development occurred just a few years ago, but once initiated, the momentum has been exponential. Today, leadership development is one of the company's five core strategies for growth. What's more, Hillenbrand's stock is trading at twice what it was two years ago.

"The change in focus was triggered by the need to move forward through organic growth, as well as through mergers and acquisitions," says Steve McMillen, vice president of executive leadership development and performance improvement for Hillenbrand Industries. "The development of a sustainable capability specifically around training and development became the touchstone, if you will, for the future."

Although it sounds simple enough, keeping the balance between an infusion of new talent and the development of the leaders already in place is an art form of sorts—and one that Hillenbrand Industries is achieving. The company starts by looking at the markets it serves and those it wants to enter in the healthcare and funeral, and financial services industries. Each operating company identifies business goals and initiatives critical to execute the company's overall strategy aimed at increasing shareholder value. Then it considers what capabilities and skills are needed for those goals and initiatives, what exists among the existing talent, and what the gaps are. "That helps create a path, whether the solution is training for the masses or some highly targeted intervention," he says.

A similar logic path is used for profiling critical positions—those that are the most significant positions in affecting the company's future—and then profiling the people who currently hold those positions. How long have they had the position? How long in the organization? What are their capabilities? What needs do they have? What are their career interests? What is their future potential? Then, going even further, Hillenbrand looks at its overall "talent portfolio" and asks: Do we have the best talent aligned with the most critical initiatives and roles?

"The answer leads to more discrete development interventions with much more of an impact on the bottom line and creation of shareholder value," McMillen says.

What that approach looks like on the ground can involve assessments, recruiting, individual development training, e-learning, traditional training, coaching, mentoring and job rotations. In fact, in the last year and a half, about 20 percent of the moves by leadership have been to cross-organizational assignments. Hillenbrand has also brought in substantial new leadership talent.

These talent decisions aren't made lightly. "We meet regularly with our executive colleagues and quarterly with our executive management team to focus on talent," McMillen says. "What's exciting about this is that the executive team members are focused not only on their own areas of responsibility now, but also on the future success of the whole organization."

Hillenbrand isn't forgetting the bench—development of potential leaders is also a priority. "We've hot-wired our talent development process and review, so whenever we're putting together a strategic plan or framework, implicit in every one of the steps are the questions about capability, talent and development," McMillen says. "When you make development part of running the business, it's much more powerful."

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Hillenbrand Industries Stock Performance vs. S&P 500