Measuring Corporate Smarts

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?
By Martin Delahoussaye, Kristine Ellis and Matt Bolch.

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.'"