Managing human capital for value creation

How purpose-driven employees help power profitable companies

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- A recent research study finds a link between purpose, corporate profitability and significant positive risk-adjusted stock returns, based on a private survey of about 500,000 employees in 429 firms.
- The link did not exist uniformly across all "high-purpose" companies — just among those where management conveyed expectations and empowered employees to succeed clearly. Further, the link was not driven by senior management but by midlevel managers.
- The study validates the importance of purpose as an aspect of corporate culture with measurable bottom-line impact. It also raises the possibility that if purpose could be observed by outside investors it could be a valuable input to stock valuation.

This paper draws from the results in Gartenberg, C.M., Prat, A. and Serafeim, G., 2018. "Corporate purpose and financial performance." Organization Science, forthcoming. One of the authors, George Serafeim, conducts joint research with Calvert aimed at enhancing public education and knowledge related to Responsible Investing and business practices; he receives compensation for this work.

Is there a link between a workforce that feels a sense of purpose and meaning at the workplace and a company's financial performance?

The common-sense supposition is that there should be. Indeed, in the 1990s, strategy scholars initially proposed that instilling a shared sense of purpose should be the primary role of top management rather than setting strategy.[1] They envisioned a shift in the corporate model away from the old doctrine of "strategy, structure and systems," to one based on "purpose, process and people."

The need for a new model focused on human capital became increasingly clear as the composition of corporate balance sheets was transformed from tangible assets to intangible ones. In 1985, assets like steel mills, factories and computer mainframes represented two-thirds of S&P 500 corporate assets, but now comprise just 16%.[2]

The intangible assets that have replaced them, such as software, social media and video streaming, are the products of companies with talented, engaged employees who find purpose and meaning in their work. The productivity, efficiency and innovation they achieve are hallmarks of successful firms, so there appears to be value in devising a measurement of corporate purpose and testing whether it correlates with strong financial performance.

The balance-sheet shift has coincided with the rise of Responsible Investing, which originated with Calvert and others in the 1970s with the goal of curbing the most deficient aspects of corporate environmental, social and governance (ESG) policies — what we call ESG 1.0.

However, Responsible Investing has also evolved in recent years to focus on the positive impact it can have both on society and financial performance (ESG 2.0). All companies must address a range of ESG factors that materially affect their industries. Past research shows that companies improving their performance on industry-specific material ESG issues outperform their competitors in the future both in terms of accounting and stock market performance.[3] Human capital, and in particular an engaged workforce with a strong sense of meaning and purpose at work, can be one of the most important material ESG factors for many industries.

Linking purpose and performance

In more than two decades since the fundamental importance of corporate purpose was proposed, there has been little progress in linking it with performance. One reason for this may be a lack of measurement methodologies to systematically evaluate purpose across firms and years.

To address the measurement challenge, the original study authored by Gartenberg, Prat and Serafeim had access to survey responses of about 500,000 employees in 429 firms over six years, across a broad range of industries, all domiciled and listed in the U.S. In this proprietary survey, compiled by the Great Places to Work Institute, employers were rated in terms of a wide variety of organizational characteristics, including workplace collegiality, management and the nature of the job itself.

Critically, this survey allows us to circumvent management's perception about the strength of purpose at the firm, which can be self-serving and biased. We consider companies with strong purpose to be those in which employees, in the aggregate, have a strong sense of the meaningfulness and collective impact of their work.[4] In an organization where people have a strong sense of purpose, employees feel:

- That their work has special meaning — it is not just a job.
- Good about the ways they contribute to the community.
- A sense of pride in what they accomplish.
- Proud to tell others where they work.

Of course, such positive attitudes don't necessarily lead to a positive bottom-line impact. For example, we adopted a working definition of purpose as "a concrete goal or objective for the firm that reaches beyond profit maximization." Critics have pointed out that such a focus on purpose could draw attention away from shareholder returns and ultimately lead to financial underperformance, especially if it doesn't enhance employee productivity. Similarly, in cases where companies define purpose in terms of goals such as universality, global responsibility or human values, these can divert attention from shareholder returns.

[1]Bartlett, Christopher A., and Ghoshal, Sumantra. "Changing the role of top management: Beyond strategy to purpose." Harvard Business Review 72, no. 6 (1994): 79-88.

[2]OceanTomo.com, "Intangible Asset Market Value Study," 2017.

[3]Khan, Mozaffar and Serafeim, George and Yoon, Aaron. "Corporate Sustainability: First Evidence on Materiality." The Accounting Review, Vol. 91, No. 6 (2016), pp. 1697-1724. Available at SSRN: https://ssrn.com/abstract=2575912.

[4]Our universe includes companies that may have low ESG scores on other factors. The goal of this paper is to isolate the impact corporate purpose may have on financial performance. It is not meant as a substitute for a broader ESG analysis.

This criticism bolsters the case for the kind of empirical research we have conducted, to provide evidence about the nature of the relationship between the strength of employee beliefs in a corporate purpose and performance.

Types of purpose

In our highest-level analysis, we aggregated employee responses like the four cited above into an overall measure of purposefulness. That measure was then associated with two common performance metrics — future return on assets (ROA) or Tobin's Q.[5] To avoid the concern that higher performance causes higher sense of purpose (i.e., reverse causality), we controlled for the level of current financial performance and estimate the effect of current sense of purpose on next year's financial performance. We also included controls for the industry in which a firm operates, firm size and other financial characteristics. This analysis found no association between strength of employee beliefs in a corporate purpose and performance.

However, using a statistical technique that allowed us to model the commonality in the survey responses and reduce the multidimensionality of the data, we identified two distinct categories within firms that qualified as "high purpose." The first type, high *Purpose/Camaraderie* organizations, includes companies that also score high on dimensions of workplace camaraderie (e.g., fun and family-like workplace environments).

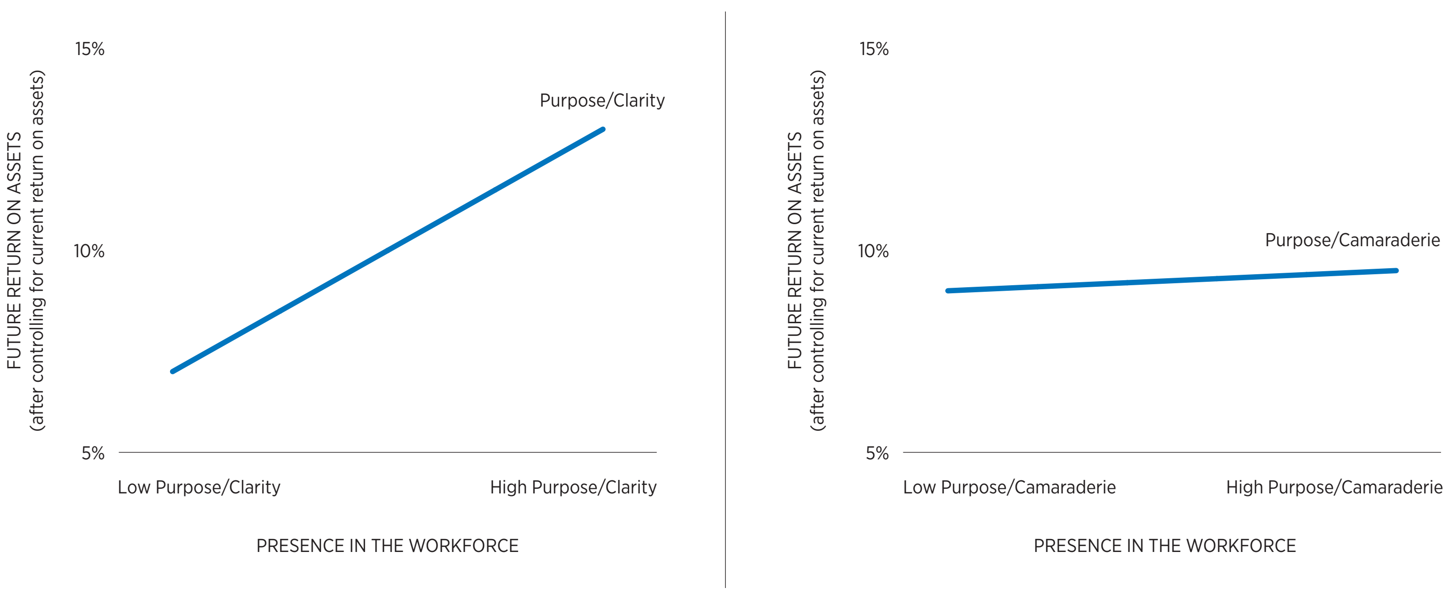
The second type, high *Purpose/Clarity* organizations, also scored high on dimensions of management clarity (e.g., workplaces where management makes expectations and resources to succeed clear).

When we replaced our aggregate measure of purpose with the factor measures capturing the two types of purpose organizations, we find that only the high *Purpose/Clarity* organizations exhibited superior financial performance (Exhibit A, left). *Purpose/Camaraderie* organizations did not have any particular association with higher financial performance (Exhibit A, right).

Exhibit A

Firms with strong purpose and clear direction from management outperformed.

Results for six years ended December 2011.



Source: Gartenberg, C.M., Prat, A. and Serafeim, G., 2018. "Corporate purpose and financial performance." Organization Science, forthcoming.

[5]Return on assets is EBIT over average total assets. Tobin's Q is total assets plus market value of equity minus book value of equity at calendar year-end over total assets.

The might of middle managers

Too much media attention is paid to legendary CEOs and how they drive organizational performance. The rest of the workforce is typically treated as a necessary cost of operations rather than as important organizational levers of value creation. Our analyses show that this perception is misguided.

To explore further the association between purpose and performance, we separated our firm-level measures of purpose into measures at each of five hierarchical levels of the organization (i.e., executives and senior managers, sales force, middle managers, salaried professionals and hourly workers).

This analysis revealed that only middle managers and salaried professionals drove the relation between high *Purpose/Clarity* organizations and financial performance. This finding does not imply that middle managers and salaried professionals were the only ones reporting purposeful work. To the contrary, we found systematic differences across levels of employees: The more senior the employee, the stronger is the perceived purpose of the organization.

As Exhibit B highlights, high *Purpose/Clarity* organizations earned significant positive risk-adjusted stock returns — i.e., alpha — of 6.9% annually (Exhibit B), over the six years studied, from January 2006 to December 2011. When we disaggregated the results for high *Purpose/Clarity* organizations, those driven primarily by middle managers had alpha of 7.6%. Professional/technical firms with high *Purpose/Clarity* had alpha of 5.9%.

The alpha was derived using a multifactor model based on the Fama-French market capitalization-weighted market index. The model also controlled for the small-cap factor, the value factor and the momentum factor (Fama and French 1993, Carhart 1997). Because stock valuations represent the market's assessment of future earnings potential, this reinforces the observation that reverse causality is not likely to be an issue here.

In our research, we hypothesized that the important role played by midlevel managers is justified by their location in the intersection between frontline workers and senior executives. Middle management is where the "rubber meets the road" — where high-level aspirational statements by senior executives are implemented, in terms of how the organization attracts, retains and develops talent, how it treats its customers, and how it interacts with its communities. Middle managers are uniquely positioned to play important roles in both strategy development and implementation. They have relationships both up and down the formal organization, which enables them to translate abstract strategic ideas into action.

Exhibit B

Middle managers were the strongest alpha drivers for high Purpose/Clarity organizations.

Results for six years ended December 2011.

	High Purpose-Clarity	**High Purpose-Clarity** Middle Managers	**High Purpose-Clarity** Professional/Tech Staff
Annualized Alpha	6.9%	7.6%	5.9%
Market Beta	0.88	0.84	0.83
Small-Cap Factor Beta	0.45	0.45	0.50
Value Factor Beta	0.17	0.14	0.18
Momentum Factor Beta	-0.33	-0.34	-0.31
Adjusted R-Squared	0.85	0.85	0.88

Source: Gartenberg, C.M., Prat, A. and Serafeim, G., 2018. "Corporate purpose and financial performance." Organization Science, forthcoming. Table shows estimates from calendar time portfolios of an investment strategy that buys the stocks of firms scored each year at the top quintile of Purpose-Clarity and holds the portfolio for one year at which point it is updated with the new ranking of firms. The portfolios are formed on each January 1. Each month the returns of each firm in the portfolio are equally weighted and aggregated, thereby constructing a portfolio return. The time-series of 72 monthly stock returns is then regressed on risk premiums for the market, as represented by the Fama-French market capitalization-weighted market index. The model also controls for the small size factor, the value factor and the momentum factor (Fama and French 1993, Carhart 1997).

Ruling out alternative explanations

There are several alternative explanations for the results we have presented — unobserved factors that might be supplanting or replacing high *Purpose/Clarity* in its correlation with performance. However, we found none of the alternative explanations to be persuasive, as they did not fit the results from the empirical analyses.

For example, reports of purposeful work might be tied to compensation levels. However, as we have noted, the most highly compensated group in the corporate hierarchy — senior executives — were not found to have any association with performance. Further, we examined the association between high *Purpose/Clarity* and average levels of variable compensation and salary and found no evidence of correlation.

Moreover, we examined whether the results stemmed from reverse causality — the possibility that strong current or anticipated performance might be driving a high sense of purpose among employees. If reverse causality explained the link, one would expect senior executives and the sales force to be the most logical drivers of the association because their compensation is typically tied to firm performance. Nevertheless, we established no association for the high clarity and purpose reported by senior executives or the sales force with firm performance.

An even less persuasive argument is that workers find purpose in a singular focus on profit maximization of the firm. While we cannot definitively rule out this possibility, we believe this interpretation is unlikely. It is inconsistent with the spirit of agency theory, where exactly the opposite is assumed for individual behavior. As a rule, incentives for the firm and employee need to be aligned because agents are not motivated on their own to make other people rich.

The potential for purpose in stock valuation

We view this paper as a first attempt to provide empirical evidence on the value of corporate purpose — one that leaves many unanswered questions, but opens the door for future research. Importantly, our study provides evidence of the importance of human capital and purpose as an ESG factor — an aspect of corporate culture with measurable bottom-line impact. It also raises the possibility that if purpose could be observed by outside investors — unlike the information gleaned from a private survey — it could be a significant input to stock valuation. In the section that follows, Calvert outlines recent research on methodologies for achieving that goal.

Calvert's mission to better measure human capital management

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Calvert mapped the current landscape of information widely available to investors to explore if and how key aspects of human capital management — purpose and clarity — can be accurately measured and translated into investment models.

Calvert employs a proprietary framework that generates quantitative key performance indicators (KPIs) derived from public information reported by companies and employees, concentrated on environmental, social and governance (ESG) factors. KPIs allow analysts to measure qualitative information, and rate and rank company performance relative to peers. Analysts are able to identify companies that are improving, leading or lagging compared to the industry standard.

The vast majority of Calvert's data-driven ESG models include information on workplace management strategies, trends and outcomes. Calvert's modeling system encompasses 200+ unique peer groups, which are based on exposure to similar ESG risks. Approximately 90% of the models include at least one KPI on workforce management.

Of the two concepts — purpose and clarity — the latter proved more amenable to initial efforts at quantification. We were able to assemble widely reported information and scalable KPIs on tangible concepts that pointed to clarity within an organization. The type of information that we examined included regular career development interviews, continuous employee feedback and investment in training. All of these may signal to investors that employees have the appropriate guidance and tools in place to do their jobs well.

In contrast, the idea of purpose, a more intangible metric, is difficult to measure. There is a growing amount of information available, for example, on companies' use and outcomes of engagement surveys, as well as employee-reported feedback aggregated through third-party websites. However, both investors and companies see limitations on using this data to generate reliable, repeatable indicators of a positive, "purposeful" atmosphere for employees that might result in superior firm performance.

Putting purpose to the test

Despite such shortcomings, we believed it would be valuable to see what, if anything, currently available tangible inputs of human resource management, as proxies for purpose and clarity, could tell us. We extracted and isolated human resource indicators broadly used in our investment models, and tested the specific data set against return on assets (ROA), return on invested capital (ROIC) and return on equity (ROE).

For two sectors — financials and information technology — our tests found a strong positive link between commonly reported, quantifiable KPIs on a company's management of people and fundamental financial performance. Companies in the top two quintiles of ROA, ROIC and ROE scored better than peers on human resource management KPIs. In remaining sectors, our tests did not find a significant positive or negative link.

Two companies in our info tech dataset offer examples of a commitment to purpose and clarity. A manufacturer of computer components reports that 96% of its employees believe that its products are making a positive impact on the world. Further, 90% of employees would recommend it as a great place to work, and the firm boasts 5.1% employee turnover — well below the industry average of approximately 9%. An energy company company implemented a "leader as a coach" program — a model to help managers facilitate team growth and development. The company is replacing annual performance reviews with regular check-ins, and sourcing employee feedback from a wider range of contributors.

Building on today's metrics

Information available to investors on human capital management continues to evolve, driven by advances in management strategy, better understanding of meaningful metrics and greater corporate disclosure. Investors like Calvert have an important role as advocates to encourage and guide that evolution.

Calvert's bottom-up approach is uniquely suited to identifying companies with innovative approaches to purpose and clarity. Our process combines traditional data with proprietary ESG research, which includes ongoing engagement with management to better understand corporate culture. Because generally available data on human capital management is inconsistent and deficient in many respects, Calvert views it as an attractive source of alpha that we can capitalize on with our expertise and commitment. This includes ongoing development and refinement of KPIs that help us better quantify aspects of workplace management that are relevant to financial performance.

We are in the early days of developing investment models that do justice to the impact of purpose and clarity, but believe that the potential benefits are significant for investors, companies and society as a whole.

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George Serafeim is Professor of Business Administration at Harvard Business School. He has presented his research in over 60 countries around the world and ranks among the top 20 most popular authors out of over 12,000 business authors on the Social Science Research Network.

Professor Serafeim's research focuses on measuring, driving and communicating corporate performance and social impact. His work is widely cited and has been published in the most prestigious academic and practitioner journals, such as The Accounting Review, Strategic Management Journal, Journal of Accounting and Economics, Journal of Finance, Organization Science, Journal of Accounting Research, Management Science, and Harvard Business Review. His research is regularly cited in the media, including The New York Times, Bloomberg, Financial Times, The Wall Street Journal, The Economist and The Washington Post.

Professor Serafeim has served in several not-for-profit organizations including the board of directors of the High Meadows Institute, the working group of the Coalition for Inclusive Capitalism and the Standards Council of the Sustainability Accounting Standards Board. He has expertise in professional services firms as the co-founder of KKS Advisors, focusing on integrating material sustainability issues in business strategy and investment decisions. He serves on the steering committee of the Athens Stock Exchange. He was appointed to the first-ever decarbonization advisory panel by the New York State Governor and Comptroller to protect the state's pension fund from climate change risks and identify sustainable opportunities. He has been recognized by Barron's as "one of the most influential people in ESG investing."

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