Environmental, Social and Governance (ESG)

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Measuring the value of human capital

Human capital refers to skills, knowledge and experience possessed by an individual or population, viewed in terms of their value or cost to an organisation or country. Within our Environmental, Social and Governance frameworks, human capital is identified as one of the largest drivers of value.

Key takeaways

- Human capital may be among the largest drivers of value creation, growth and competitiveness among companies – and one of the least transparent.
- We have identified five human capital indicators that we believe provide an effective way to measure and report on this area.
- There are three secular trends that underscore the growing materiality of human capital and make the need for measurement increasingly clear: persistent inequality, changing workplace preferences, and the need for innovation and new skills.

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The importance of human capital

In our analysis of companies, we see several clear areas where human capital can have a material effect on financial results:

- Attracting, developing and retaining the right people
- Supplying sufficient training for workers to take on new skills and technologies
- Building diverse, innovative, purpose-driven cultures
- Maintaining positive labour relations and preventing strikes and stoppages

Five essential indicators to measure human capital

We believe there are five indicators that enable companies to effectively measure and report on human capital management. We consider these to be the most valuable to investors and most reasonable to report across all industries and countries.

Indicator	Description
Total cost of the workforce	Salaries, wages, bonuses and pension benefits of all employees
Employee turnover	Voluntary/involuntary exiting and incoming employee data points
Demographic data	Gender, racial, ethnic and other measures of diverse representation across various levels within the firm
Skills and training	Total training days, type and costs
Culture and engagement	Surveys exploring employees' attitudes to work and their firms, e.g., purpose, well-being and empowerment

Quantitative data is critical to helping us differentiate companies, understand risk and opportunity and ask evidence-based questions to management. From that foundation, qualitative data, either disclosed in company reporting or shared through dialogue with management, can provide context.

High importance, low disclosure

Despite the importance of human capital, very little information is currently disclosed by companies. We measured the level and consistency of human capital disclosure within sectors and regions and found gaps that are largely driven by regulation. Last year, the U.S. SEC ruled on modernizing how companies report on business, legal and risk factors, including a specific new requirement to report information on human capital management, but did not include detailed guidance.[1] So there may be little change in what companies currently disclose. Poor, inconsistent disclosure could mean that human capital is undervalued by the market.

Without this disclosure, it is more difficult to understand elements like minimum wage, median wage and productivity, and to determine the impacts from

1. U.S. Securities and Exchange Commission, "SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K," news release. August 26, 2020.

upward wage pressure or increased competition for talent. Other major reporting gaps are around areas such as diversity, employee turnover and investment in skills and training.

Human capital indicators are sparsely, inconsistently reported among MSCI World constituents

Category	Quantitative indicator	Percentage companies reporting			
		MSCI World	U.S. & Canada	Europe	Japan
Total workforce composition	Number of full-time workers	94%	94%	98%	97%
Compensation	Total cost of the workforce (salaries, bonuses and pension benefits)	57%	17%	86%	91%
Collective bargaining	Percentage of workforce covered under collective bargaining agreements	42%	47%	40%	37%
Diversity, equity and inclusion	Gender diversity – full workforce	57%	46%	90%	24%
	Gender diversity – senior management	34%	23%	57%	4%
	Racial & ethnic diversity – full workforce	9%	18%	2%	0%
	Racial & ethnic diversity – senior management	4%	9%	2%	0%
Employee turnover	Employee turnover rate	28%	16%	57%	5%
Skills & training	Total cost of training per employee (or per hour)	9%	5%	21%	3%
	Total annual training hours received per employee	28%	19%	56%	3%

Source: Bloomberg and Capital Group. As of March 2021.

At a sector level, information technology, health care and consumer discretionary provide the lowest and most inconsistent human capital disclosures. These sectors also face material human capital risk. Within IT, for example, companies face intense competition for talent, and widespread attrition can negatively impact growth. Conversely, innovative cultures (supported by diverse teams) can build a competitive advantage. Health care companies rely on an engaged, productive workforce for higher patient satisfaction and better outcomes. Consumer discretionary sectors, with a high share of hourly wage workers, can face sudden cost increases due to regulatory change or industry pressure. Companies unable to pay a competitive living wage without significantly reducing profit margins are under pressure.

Three major trends underscore the investment implications

Three secular trends are making the need to accurately measure and value human capital increasingly clear:

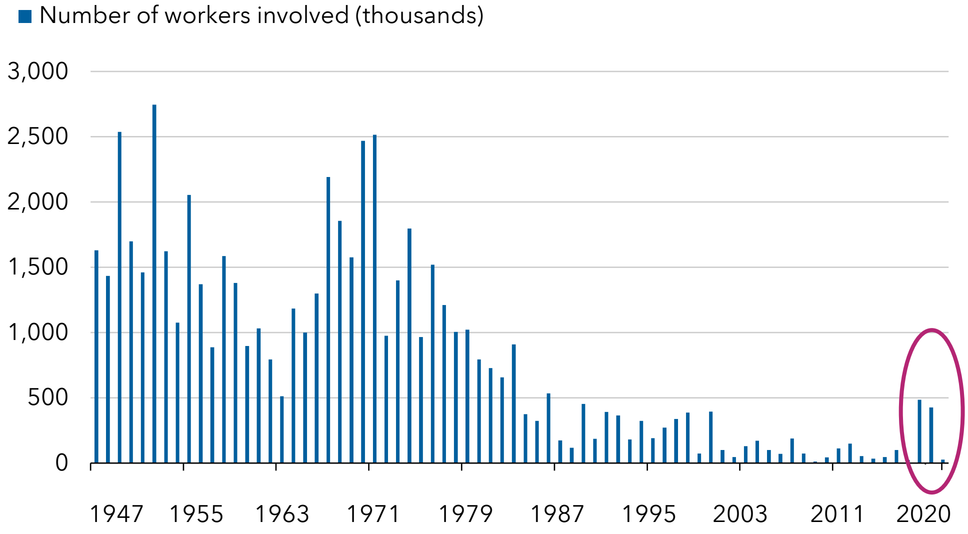
1. Persistent inequality could increase employee activism and work stoppages

Low wages, pay gaps and inequality are persistent across many industries and regions. In the U.S., workers' compensation is a declining share of GDP, hourly compensation isn't keeping pace with productivity, and significant gender and racial pay inequity remain (and has potentially widened throughout the pandemic).

Employees across almost all industries are coming together more frequently to push for change. Demands include anything from increasing wages and benefits to halting potentially unethical defence contracts to ending racial and gender discrimination. For example, in January 2021, more than 200 Google and Alphabet workers formed the Alphabet Workers Union. Members of the union contribute 1% of their yearly compensation toward union dues, which would be used to help compensate individuals for lost wages during a strike.

Sharp increase in workers participating in strikes in 2018 and 2019

Annual work stoppages involving 1,000+ workers 1947 – 2020



Source: U.S. Bureau of Labor Statistics

General Motors' six-week worker strike in 2019 resulted in $3.6B in lost production (44% of the company's earnings before interest and taxes in 2019). It's reasonable to predict that the number and length of work stoppages will continue to increase given the economic strain on low- and medium-wage workers compared to high-wage workers throughout the pandemic.

2. Changing workplace preferences

Before the coronavirus pandemic, U.S. unemployment was at record-low levels and employees had record-high confidence in finding new jobs. This led to an increased rate of changing jobs. As economies recover and reopen, many employers report difficulty finding hourly workers.

Employees have started looking for benefits beyond basic wages (after reaching a minimum level), including work-life balance, health benefits, financial planning benefits, training opportunities and a purpose-driven culture.

Employees and job seekers report valuing work environment, training and development higher than financial compensation

2021 Most wanted job characteristics:

Source: Mercer Global Talent Trends 2021

In 2021, while compensation is still the highest priority for employees, benefits related to health and financial well-being are increasingly important. Employees also report being more motivated by the opportunity to do purposeful work versus the opportunity to get promoted. In contrast, the same study released in 2017 reported that employees' most wanted job characteristics were: (1) fair and competitive compensation, (2) opportunity to get promoted and (3) leaders who set clear direction.[2]

Company culture may be intangible, but it is essential to attracting, retaining and motivating people. One notable academic study found a link between employee satisfaction and long-term value over a 25-year period. The research concluded that the "100 Best Companies to Work for in America" earned an annual four-factor alpha of 3.5% from 1984 to 2009, 2.1% above industry benchmarks.[3]

3. The need for innovation and new skills

As trends such as digitalization, automation and energy transition take hold, workforces will start to look dramatically different. There could be more competition for hiring and retaining employees with highly sought-after skills — such as those supporting cloud computing, big data and e-commerce.

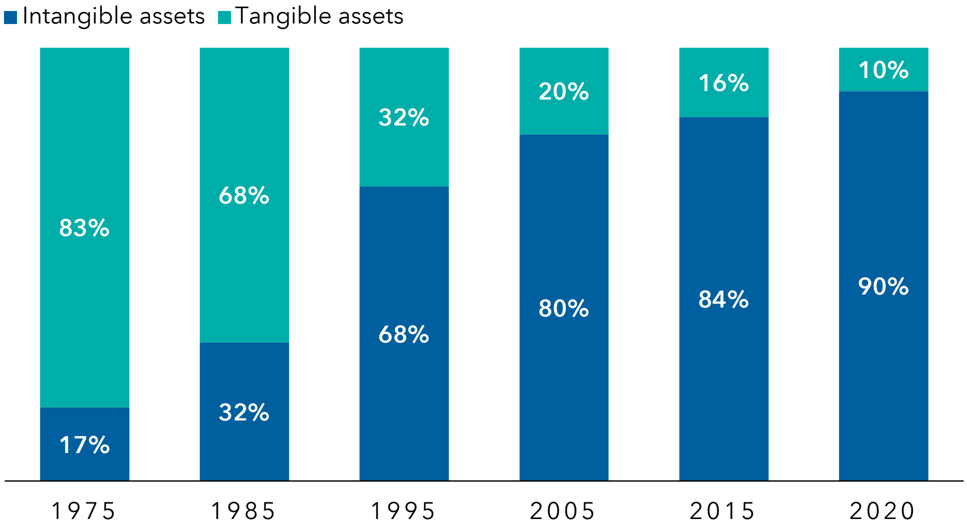
Several forward-looking companies have taken steps to retrain their current workers rather than hiring new ones. Amazon's $700 million investment[4] in worker training and PWC's $3 billion investment[5] in upskilling are two examples.

Corporate balance sheets have already transformed from tangible to intangible assets, including things like patents, software, brands and data, all of which are driven and sustained by human innovation. In 2020, approximately 90% of S&P 500 value was in intangible assets, which is in sharp contrast to 32% in 1985. This

2. Mercer, "Talent Trends: 2017 Global Study," (Mercer LLC, 2017). 9.
3. Alex Edmans, "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices." Journal of Financial Economics, September 2011.
4. Amazon, "Amazon Pledges to Upskill 100,000 U.S. Employees for In-Demand Jobs by 2025," press release, July 11, 2019.
5. PwC, "PwC network invests $3bn globally in digital training and technology to support clients and communities," press release, November 5, 2019.

shows the pace of digitalization within firms, which is often faster than workers can develop new skills.

Breakdown of tangible and intangible assets in the S&P 500
Components of S&P 500 market value



Source: Ocean Tomo Intangible Asset Value Market Study, 2020

A closer look at human capital within two sectors

Banks: Bank of America reimagines employee benefits, increasing satisfaction while managing costs.

Banks face intense competition for talent, which makes firm culture increasingly important in attracting and retaining the best people. Bank of America has made significant strides in improving employee engagement over the past five years without increasing personnel expenses. (The sector averaged a 7% increase in personnel costs over the same period.[6])

Bank of America's human capital management report is one of the most comprehensive in the banking sector. The company is often the first of its peers to adopt innovative benefits. For example, the company provides 16 weeks paid parental leave (equal amount of time for all eligible parents), child/adult care reimbursements and back-up care, and independent financial counsellors for all employees.[7] Bank of America has the highest minimum wage among peers, at $21 per hour and has pledged to reach $25 per hour by 2025.[8] The company also has demonstrated progress in its measurable commitment to DE&I. In 2020, 51% of new hires were women and 59% were people of colour.[9] Gender and racial pay equity was validated by a third party.

6. Source: Bloomberg and Capital Group. 2015–2020.
7. Bank of America, "2020 Human Capital Management Report." Bank of America Corporation, October 2020. 3.
8. Bank of America, "Bank of America Increases U.S. Minimum Hourly Wage to $21 as Next Step to $25 by 2025," press release. October 6, 2021.
9. Bank of America, "Annual Report 2020." Bank of America Corporation, 2021. 42.

Airlines: EasyJet sets the bar for employee satisfaction and has avoided strikes while keeping personnel expenses low.

Most stoppages and disruptions in the airline industry come from labour, which is also one of the largest expenses. EasyJet has set the standard for keeping employees productive and engaged and turnover low, all while maintaining costs among the lowest in the industry and avoiding major strikes.

The company employs workers on local contracts in Europe, offering competitive benefits that align with national regulations.[10] Other airlines choose to employ all workers in all locations on one contract in order to reduce costs. This can also lead to more stoppages. EasyJet monitors employee net promoter scores (eNPS) and regularly reviews results at the executive committee level.[11] The company met its target to reach 20% new female pilots by 2020[12] and is on track to exceed diversity levels, recruiting talent from demographics that are historically under-represented in the industry. (According to the International Society of Women Airline Pilots, currently around 6% of pilots in the industry are women.)

Summary

Most industries will be materially affected by ongoing human capital trends, if not experiencing the impacts already. Increased systematic human capital disclosures are an opportunity to understand how companies manage people, differentiate leaders and laggards, and identify those that are able to create a competitive advantage.

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10. EasyJet plc, "Annual Report and Accounts 2020." 53.
11. EasyJet plc, "Annual Report and Accounts 2019." 24.
12. EasyJet plc, "Annual Report and Accounts 2020." 50.

Risk factors you should consider before investing:

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