Purpose, Human Capital and Profits:

Five factors to drive enduring shareholder value.

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Regardless of a board's position on the purpose versus profits debate, human capital issues are an essential component of their discussions on how to drive shareholder value.

Why? There are well-documented advantages to shareholders of having healthy, engaged, hard-working, and productive leaders and employees. The result is good for performance, and leads to superior financial returns. As such, boards now are reviewing steps to ensure their organization engages in practices that lead to effective and sustainable human capital outcomes.

Determining appropriate levels of oversight — as well as identifying how to measure the efficacy of human capital outcomes — was a focal point of discussion among board members, institutional shareholders, proxy advisers, judicial and government leaders and corporate governance thought leaders at the November 2019 *Directors & Boards*' forum, "The Character of the Corporation."

Based on those discussions, and from our collective experience, significant empirical evidence points to five factors in driving long-term shareholder value through sustainable human capital practices.

Factor #1: Multiple Stakeholder Alignment

There is nothing new about recent focus on the need to manage the interests of multiple stakeholders while in the service of maximizing long-term shareholder return. Addressing the needs of buyers, sellers, and labor, and creating strong communities in which to operate, have been essential functions of commerce, if only on a pragmatic basis for centuries, as acknowledged in Adam Smith's *Wealth of Nations* in 1776 and Milton Friedman's 1970 essay "The Social Responsibility of Business is to Increase Profits." Countless contemporary research studies by academics and management experts from Michael Porter to Jim Collins, as well as our own organization, have validated this premise.

Corporations generate profits by creating and executing strategies that create benefits to society, such as saving lives by developing new drugs, distributing household goods, providing capital, creating vacation memories, allowing people to travel great distances, making other companies or markets more successful, providing nourishment and powering cities. While the role and causality of corporate and societal purpose should be debated philosophically and practically by boards, the fundamental benefit of multiple stakeholder alignment (including loyal buyers and productive, skilled employees) cannot be credibly disputed when it comes to driving growth and long-term shareholder value.

Factor #2: Culture, Leadership and Risk

Board members report that company culture has become a topic of greater direct focus in recent years. For example, many organizations view board responsibility and oversight to include:

- Setting the tone from the top.
- Defining company values and acceptable behaviors, as well as leadership trust and credibility.
- Addressing areas related to inclusion & diversity.
- Managing human capital risk.

Increasingly, however, boards also have been considering broader governance in areas such as employee wellbeing, engagement, purpose, dignity and sustainability. Data support connections between culture, reduced risk and positive business outcomes.

For example, innovation is six times higher at companies where men and women are treated equally, according to a Morgan Stanley report. Additionally, a Willis Towers Watson study finds that companies following a set of practices relating to employee engagement and the employee experience are 93% more likely to report significantly outperforming their industry peers financially (those with high levels of engagement achieve average one-year EBITDA growth of 16.9%, versus those with low engagement of 4.5%). Two-thirds of employees reporting an incidence of workplace abuse indicate their performance declined, and 25% admitted to taking frustrations out on customers, as reported by *Harvard Business Review*. Lastly, another Willis Towers Watson survey found that 94% of employers recognize workplace dignity as important to their success over the next three years.

Identifying appropriate measurement criteria relating to culture, leadership and risk remains an often-cited challenge in board discussions. Employee engagement data from employee surveys generally have been long-available for boards to review, as have diversity statistics. However, many board members say they now are looking to probe deeper into culture, with a growing list of potential metrics to review, including:

- Employee engagement: Engagement survey scores; Net Promoter Score, a employee-loyalty management tool; turnover by level, experience level, gender, and other demographics.
- Leadership trust: Third-party trust indices (measure employee trust).

• Employee wellbeing: Components of physical, emotional, financial and social wellbeing.

• Inclusion and diversity: Diversity by level, pipeline inclusion, selection inclusion and project inclusion.

• Workplace dignity: Employee completion rate of codes of conduct/harassment/compliance and ethics training, correlation between dignity and engagement, reported incidents, reported claims, adverse media mentions.

• Human capital risk: Claims as a percent of payroll, lost-time accident rate, productivity deterioration, third-party brand/trust indices (measure customer/brand trust).

Factor #3: Human Capital Programs (Compensation, Benefits, Careers, Wellbeing)

Beyond their traditional focus on executive compensation and pay equity, boards increasingly are considering a more encompassing view of analyses surrounding fairness of company "total rewards," (which generally includes pay, benefits, careers and wellbeing). There are several typical review areas.

Compensation

Aggregate reviews of compensation should include:

• Pay clarity: The factors that determine base pay (e.g., performance, potential, promotion, skills, gender, other demographics).

• Differentiation of incentives: The relative variation of short-term incentive (STI) and long-term incentive (LTI) awards in aggregate by role, unit and/or plan type based on performance.

• Incentive metrics: The extent to which incentive metrics for STI and LTI plans are aligned with strategic, corporate, and/or other market- and shareholder-focused goals (e.g., purpose; environmental, social, and governance issues; customer; operational; people; financial).

• Incentive cost and sharing ratios: Percentage of profit and value shared with executives and employees.

• Fairness: Pay fairness outcomes for various demographic groups.

Benefits

Aggregate reviews of company benefit programs, including several factors related to access, quality, value, inclusion and risk:

• Purpose-driven: The extent to which health, retirement, voluntary benefit and leave programs provide access, quality and value to participants (and support desired impact/employee experience).

• Flexibility and choice: The extent to which programs maximize participant value for company investment through personalization and customization.

• Fair and inclusive: Benefit programs that are equitable for various demographic groups.

• Fiduciary risk: The relative risk from company funding versus direct cost exposure for health, retirement, voluntary benefit and leave programs.

Career

Reviews of career and skill development/learning programs can ensure that companies will have the qualified workforces they need to execute their strategies and operations three, five and 10 years into the future.

The business press is replete with risk-oriented statistics, such as the World Economic Forum's finding that, by 2025, 52% of current tasks in the workplace will be performed by machines that require very different skills to operate, or the Institute for the Future's report that up to 85% of the jobs that today's college students will hold in 2030 have not been invented yet. These data occur in an environment in which a Willis Towers Watson survey reports that only 50% of employers believe they are doing a good job of developing people to their full potential.

In that context, board reviews of the following types of career and skilling data, as well as workforce planning in addition to more traditional succession planning information, enable fiduciary assessment of future workforce availability:

• Employment mode: The percent of the workforce as full-time, part-time, contractors and other categories today and in three, five and 10 years.

• Workforce availability: Percent of roles able to be filled with existing and/or known sources of hiring talent in three, five and 10 years.

• Hiring effectiveness: Average time to hire; offer acceptance ratio; percent of new hires who left the organization within the first 12 months.

• Succession planning: The availability of ready-now successors, versus ready in one, three or five years.

• Training and Learning: Training and development costs and hours; training and development costs as a percent of revenues.

• Retraining vs. Turnover/Hire costs: The long-term cost of retaining existing workers versus separating from them and hiring ones with new skills and/or using contractors.

• Reskilling: The percent of employees currently eligible for, and participating in, reskilling programs.

Wellbeing

Focus on employee wellbeing in light of data showing connections between employee wellbeing and productivity, as well as the hard- and soft-dollar costs and risks associated with ill-being.

The cost of ill-being in the United States alone is $2.2 trillion annually (or 12% of GDP), according to research from the Global Wellness Institute. A Willis Towers Watson study shows workers with financial worries and health issues have three times the absenteeism, three times the stress, and more than twice the level of disengagement as workers without such conditions. Companies with higher levels of wellbeing achieve better business outcomes, including 22% higher earnings per employee, and $1,000 per employee lower annual health-care costs.

Beyond their traditional focus on executive compensation and pay equity, boards increasingly are considering a more encompassing view of analyses surrounding fairness of company "Total Rewards," (which generally includes pay, benefits, careers, and wellbeing).

While boards historically have not delved deeply into employee wellbeing, the topic is central for organizations reviewing oversight of human capital. Typically, there are four primary components of wellbeing subject to review:

• Physical wellbeing: Percent of employees covered by health care, total cost of ill-being, absenteeism, presenteeism, wellbeing program participation, chronic care management, productivity, employee health and safety.

• Emotional wellbeing: Percent of employees covered by behavioral health care, employee assistance program (EAP) usage, behavioral health service access, paid time off usage, stress barometers, resilience training, emotional health indices.

• Financial wellbeing: Retirement readiness by age, financial literacy indices, retirement plan contribution levels, percent of employees living below the poverty level, percent of employees with second (or third) jobs.

• Social wellbeing: Inclusion and diversity measures, percent of remote working employees, employee engagement, leadership trust, workplace dignity measures (indicated above, under culture and leadership).

Factor #4: The Role of Environmental, Social and Governance Measures (ESG)

As shareholders increasingly factor ESG into their investment decisions, boards are also starting to factor ESG-related measures into their governance and decision processes. While human capital practices do not cover the entire gamut of the social factors in ESG, they represent a significant share.

ESG investing is estimated at $20 to $30 trillion of assets under management, according to various estimates. That equals more than a quarter of all professionally managed assets globally. MarketWatch places the number in the U.S. at approximately $12 trillion. In addition, 80% of world's largest corporations use Global Reporting Initiative standards.

A recent study by Willis Towers Watson's Global Executive Compensation Analysis Team indicates 61% of S&P 100 corporations incorporate ESG metrics into their incentive plans. Of those, companies employ the following measurement areas:

• People and HR issues (succession and talent development, employee engagement, culture): 39%

• Inclusion & Diversity: 29%
• Customer Service: 28%
• Environment and Sustainability: 18%
• Governance: 15%
• Employee Health & Safety: 13%

Board members increasingly have come to understand that, for many shareholders, ESG is an indicator of a company's responsiveness to market and consumer changes, and a proxy for innovation, agility and other contemporary drivers of growth and long-term shareholder value. As such, many investors have labeled 2020 "The year of the 'S.'"

Factor #5: Business Outcomes

Well-documented correlation exists between sustainable human capital practices and differentiated long-term shareholder value. Willis Towers Watson research indicates such companies are 93% more likely to report significantly outperforming their industry peers financially; academics such as George Serafeim, Bob Eccles and Ioannis Ionnou have shown increases in shareholder value between "high sustainability" versus "low sustainability" companies; and Morningstar found that two-thirds of ESG and responsible investing equity funds edged their way into the top half of fund performance for the 2018 calendar year.

The bottom line is that board members have come to understand the advantages to shareholders of having sustainable human capital practices and outcomes. As such, boards now are reviewing steps to ensure their organization engages in practices that lead to healthy, engaged, hard-working, and productive leaders and employees. They understand that, in today's competitive environment, shareholder interests depend on it. ■

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