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FILE: PERSONNEL/HUMAN RESOURCES

Managing Your Internal Labor Markets for Lasting Competitive Advantage

PLAY TO YOUR STRENGTHS

By Haig R. Nalbantian, Richard A. Guzzo, Dave Kieffer and Jay Doherty

CONTENTS

THE SUMMARY IN BRIEF

One of the largest assets of any company is its human capital combined with the system that manages it, but so many managers insist on treating employees as costs to be minimized rather than as investments that add value to the organization. The reason is that people and their skills — unlike more tangible assets — are hard to measure and predict. But increasingly human capital is becoming a company's unique competitive advantage, and it will need more active management and guidance. A new, fact-based science of human capital management has emerged that is based on systems thinking, determining the correct facts about the organization, and focusing on value. With this new way of managing human capital, executives can use their human capital to its full advantage by aligning the human capital strategy with the business strategy and finally allowing stakeholders to analyze and evaluate one of the most powerful assets of any company.

What You'll Learn In This Summary

✓ Why human capital is such a difficult asset to manage properly.

✓ How human capital and its management can be a source of enduring competitive advantage.

✓ The three principles of human capital: systems thinking, getting the right facts, and focusing on value.

✓ How to define and build a human capital strategy.

✓ How to conduct an Internal Labor Market Analysis of your organization to discover the current status of the work force.

✓ How to use Business Impact Modeling to determine the human capital drivers of business success.

✓ How to apply human capital management to areas of business, such as people, acquisitions and customers.

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— THE *COMPLETE* SUMMARY

What Is Human Capital?

American companies typically invest an average of 36 percent of their revenue in their work force each year, yet they know nothing of the return on that investment. Executives accept this lack of knowledge because of their inability to measure, assess or predict the outcomes of work force tactics as they can for other areas of the business. Since no company knows how to measure and manage human capital, no company has been able to use it as an advantage. But that is changing.

Past sources of tangible competitive advantage, such as access to capital, technology, and economies of scope and scale, are becoming less critical. The last unexploited sources of advantage are a company's intangible assets of human capital and its human capital strategy — the tactics, policies and practices used to manage it.

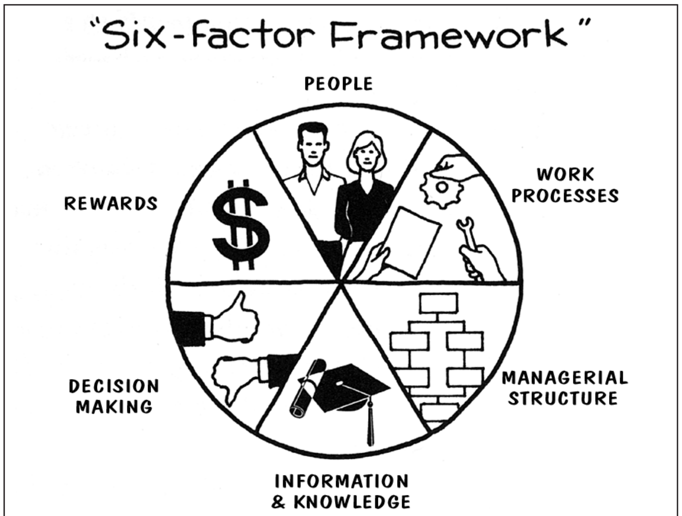
Six Essential Factors of Human Capital

People — The nature and quality of individuals influence the performance of an organization.

Processes — Dominant work processes have direct and indirect effects on organizational performance and differentiate companies in the same industry.

Managerial Structure — Management structure and practices directly affect the work of employees.

Information and Knowledge — The flow of information and knowledge drives productivity.



Decision Making — Important decisions affect strategy, operations, finance, marketing and sales.

Rewards — The organization's financial and nonfinancial reward structure reflects the motivational component of human capital strategy.

These six factors act together as a system, but they also function within the context of other systems. The human capital strategy must complement the company's marketplace, business model, and financial and physical asset management. Decisions made about one system without regard for others will always be suboptimal.

Your Human Capital

The combination of the human capital system with the company's market and business model creates two potent competitive advantages. Human capital practices remain relatively stable and endure longer than the effects of technology and financial capital. In addition, because of its unique context and goals, the human capital management system is difficult to copy. Other companies cannot co-opt "best practices" because they exist in their own system of interrelated practices and values.

In order to create the most value from the asset of human capital, ask the following questions:

- **What are we actually spending on human capital (cost), and what is it buying us (value)?**
- **Are we sure our human capital strategy is aligned with our business design?**

(continued on page 3)

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What Is Human Capital?

(continued from page 2)

● **What can we change in the way we manage people to generate greater returns by cutting, reallocating, or increasing investments?**

Typically these questions are answered — if they are asked in the first place — through historical storytelling, anecdotes, speculation or questionable "correlations." Because they are so rarely asked, CEOs, investors and managers tolerate more variance in human capital investments than they would in other assets.

There are four barriers to resolving this problem:

1. People are typically treated as an operating cost, not a source of value creation.

2. No one really owns the human capital issue, or is focused on making strategic decisions about it.

3. Practices and policies are made one at a time and not connected as though they are part of a system.

4. Because of a long-standing lack of good internal measures, **companies rely on benchmarking** of another — usually irrelevant — company's systems. ■

The Science of Human Capital Management

A fact-based science of human capital management — based on three core principles — has taken form to address the problems described in the previous article and allow companies to take full advantage of their work force.

Principle 1: Insist on Systems Thinking

The first principle of effective human capital management is systems thinking, or having an awareness of the connections that link organizational units, people, processes and behavior. Any major change in one area ripples through the larger system.

Systems are made up of interrelated parts, and the subsystems or elements of any system may operate with different degrees of interdependence. Changes in any subsystem are felt in other subsystems, so implementing changes in one part of the enterprise without making changes in other, related parts is a recipe for failure.

Every complex system is a web of causal connections and pathways, so the same end can usually be achieved through different means. Each system has an optimal route, and it may not be the same for different companies. Causal pathways also have feedback loops, which means that one practice has consequences for another, which in turn affects the first. Some of these strong pathways may be overlooked, usually because of overreliance on anecdotes or organizational folklore.

TechCo's Interrelated Systems

TechCo is a real company with a fictionalized name. It designs and produces computer chips that constantly change to meet customer needs. Most components are adapted from previous designs, and delay is deadly, so the company must operate without tolerance for errors.

In the mid-1990s, revenue growth and shareholder value flagged, and the rising turnover rate of design engineers was at fault. The engineers controlled the development of new parts from past designs. Experienced, high-performing engineers with knowledge of past designs were leaving. The CEO tried changing everything from variable pay to training to screening new hires, but nothing worked because TechCo hadn't identified the cause of the turnover.

After conducting statistical analysis of hard data, such as rates of movement through jobs, rates of promotion, employee financial gains, and outsiders hired into leadership, the following problems were discovered with the company's interrelated systems:

Barrier to Advancement — At a certain job level, promotion was highly improbable for the best-trained engineers, so they left.

Misaligned Incentives — Variable pay and stock options, incentives best suited for risk-taking cultures, were used. But TechCo's culture had a lot of direct supervision and intolerance for errors. Additionally, stock price was more affected by industry swings than company decisions.

Double Supervision — TechCo paid above-market wages to retain self-directed, goal-oriented people and then paid again for intense supervision and control practices.

Unintended consequences abound when there are so many interrelated parts and causal pathways. By understanding the dynamics of the organization's systems and the way a planned change will impact the whole organization, they can be minimized. Also, remember that a company is a subsystem in the larger market context.

The nature of systems allows for some programs and practices that are implemented in combination to produce different outcomes than they would if they were implemented separately. The goal is to create a situation where the result is better than even the sum of the combined changes.

It is impossible to solve problems in systems by treating the symptoms. It is necessary to identify and attack the root causes by gathering quantitative data.

(continued on page 4)

The Science of Human Capital Management

(continued from page 3)

Principle 2: Get the Right Facts

The second principle of human capital management concerns getting facts, specifically the right facts. Executives who refuse to spend a dollar on a new piece of equipment until they have studied all its costs and benefits will make multimillion-dollar decisions about people programs with little more than hunches or employee surveys.

Relevant and reliable facts are needed for good decisions. Facts from anecdotes are weak or unreliable. Facts drawn from benchmarking are generally stronger. Facts about cause-and-effect relationships have the greatest power, but they must have some analytical rigor behind them. There are several dimensions of facts that affect their power to inform.

The Say-Do Trap. Companies often rely on employee surveys, but what employees say is not always what drives their behavior. Just as marketers ask consumers what they would like and then measure actual buying behaviors, companies should also look at their employees' actions. Get the "right" facts by rigorously capturing perceptions and observing behavior. Consider the perceptions of both employees and the company itself.

Time Matters. Time is a key element of uncovering root causes of many human capital problems. Surveys provide a snapshot at a particular moment, but it's more important to see how fast or slowly issues important to employees are moving or changing.

Magnitude. To make good decisions about where to invest in human capital, know the magnitude of a program's effect and the improvement it will cause.

Inside-Outside Balance. Get facts from inside and outside your organization, but make sure that external facts are relevant. Often they can be misleading because other companies have their own say-do gap. Different terms can have different meanings to different people, so you may misinterpret data. In most cases, internal facts are the best guide on human capital issues because they should be based on your unique business model.

Principle 3: Focus on Value

In business terms, value is output minus the cost of producing it. Human capital is an investment with a stream of economic returns. When the benefits produced exceed the costs, the asset has produced real value. Every alteration in the asset has an effect on those returns, so actions — such as rotating people through positions; training; and reconfiguring pay and incentives — change the asset's potential to produce value. Even the personal choices of employees, which are affected by company policies, can influence value.

Unfortunately, most managers treat human capital as a

(continued on page 5)

First Tennessee Finds Value

First Tennessee National Corp. is a financial services company that used sophisticated market analysis to understand its customers. It identified customer service quality as the foundation of its competitive position. Since customer service depends on employee interactions with customers, the company wanted to understand its customers too, so it used employee and business performance data and statistical modeling. It discovered that locations with the longest-serving, customer-facing employees performed best in key customer and financial measures. The company decided to increase average years of service to increase revenue and reduce turnover costs.

But as the bank looked at its human capital practices, it realized it was hiring more generalists at higher salaries than long-time employees who had the valuable firm-specific knowledge. Incentive pay mostly went to executives and commission-based salespeople, not customer-facing employees. As a result, the experienced, lower-paid but most valuable employees were leaving. The bank took the following steps to fix the problems:

✓ It ensured high performers had a clear path to growth (and long-term service).

✓ It extended pay-for-performance to more customer-focused employees.

✓ It started training to broaden the capabilities of the existing work force.

Toyota and the Say-Do Trap

Toyota Motor Manufacturing North America believed pay and promotions were tied to performance. They also had training and career management programs to improve skills for promising individuals. They recently conducted an employee survey and found that collectively employees did not agree that pay and promotions were tied to performance, and they did not see payoff from the training.

However, analysis of those who received higher pay and promotions from HR data showed they did go to high performers. The data also showed that employees who accepted training were being promoted at much higher rates than those who didn't.

If Toyota had relied on what its employees said, it would have wasted time and money changing or eliminating human capital programs that worked well.

The Science of Human Capital Management

(continued from page 4)

cost to be minimized rather than a value-producing asset. However, cost reduction is something any company can do. It is not a creative business decision, and there is also a natural floor. There is no ceiling on the potential value of human capital to a company's unique competitive advantage.

Sources of value include human capital attributes such as tenure, experience, reward systems, and staffing practices. To look at these attributes as increases in costs is short-sighted. In order to determine which attributes and practices drive value in an organization it is necessary to get the right facts. ■

For Additional Information about noise in discerning facts, go to: http://my.summary.com

Human Capital Strategy Tools

Once executives understand the way to properly manage the principles of effective human capital management, they need to integrate those principles in the form of practical tools. Every executive must be able to use these tools to understand the organization's current work force and determine the type of human capital needed to support the business.

Defining Human Capital Strategy

The first step is to define the human capital strategy and make sure it is aligned with the company's business requirements. If a company changes its entire business strategy, it cannot assume HR will magically realign employees. It must consider what changes the new business strategy will require in human capital, whether the current work force has the right skills and experience to work in the new company, whether the company should change its hiring profile, and what training and rewards will effect the necessary changes.

Since human capital is an asset, human capital strategy is a form of asset management. It is a blueprint specifying all work force requirements and management practices needed to optimize business performance. Key work force characteristics have three dimensions:

Capabilities are the mix of knowledge, skills and competencies determining what the work force can do.

Behaviors are specific actions determining what the work force does.

Attitudes are the psychological propensities determining what the work force believes and values.

Together these characteristics define the work force and its productivity. Work force requirements reflect the uniqueness of business goals and therefore unique human capital strategy. The existence of HR policies and practices does not constitute a strategy. They must also be consistent and mutually reinforcing.

Human Capital Drivers

- ✓ How people are selected and developed.
- ✓ How their work is organized.
- ✓ How they are supervised or directed.
- ✓ How information is developed and shared.
- ✓ How critical decisions are made.
- ✓ How people are motivated and rewarded.

All organizations have a human capital strategy, whether explicitly defined or not, and HR is not the only group responsible for it. Line managers and top executives also impact the strategy.

Each of these factors, alone and in combination, affects the work force and its ability to deliver value. Your organization needs to have a coherent and explicit human capital strategy that produces the right work force for the business and manages it in a way to optimize economic productivity. To determine this, you must compare your current work force capabilities and performance with what they should be. This process requires the use of Internal Labor Market analysis (ILM) and Business Impact Modeling (BIM).

Internal Labor Market Analysis

The starting point of a human capital strategy is a clear understanding of the current work force and what it is becoming. At any moment in time, a work force is the outcome of three interrelated labor flows:

Attraction. Who comes to the organization and whether they achieve the goals of the organization.

Development. How people move through the organization and how successful the organization is at nurturing human capital to execute its business strategy.

Retention. Who stays, who leaves, and whether those who stay produce the highest value.

These dynamics govern the labor transactions inside the organization, the system known as the "internal labor market." Changes in any part of the system affect the other parts, so the work force is always in flux.

Rewards that include compensation, benefits and career-related opportunities play a critical role in internal labor market dynamics. Rewards affect who is in the work force and how employees make choices. They signal what an organization ultimately values. Over time, an organization becomes what it rewards, so measuring and modeling the internal labor market must include a careful evaluation of the drivers of rewards.

(continued on page 6)

Human Capital Strategy Tools

(continued from page 5)

In order to understand and manage the internal labor market, it must first be described. Using HR information, an organization can forecast what the future work force will look like in response to changes in external conditions or management practices. ILM brings together the three principles of human capital management — system, facts and value — for a holistic view of the way internal labor markets operate and apply to business objectives. ILM analysis provides a fact-based platform for making essential decisions about human capital.

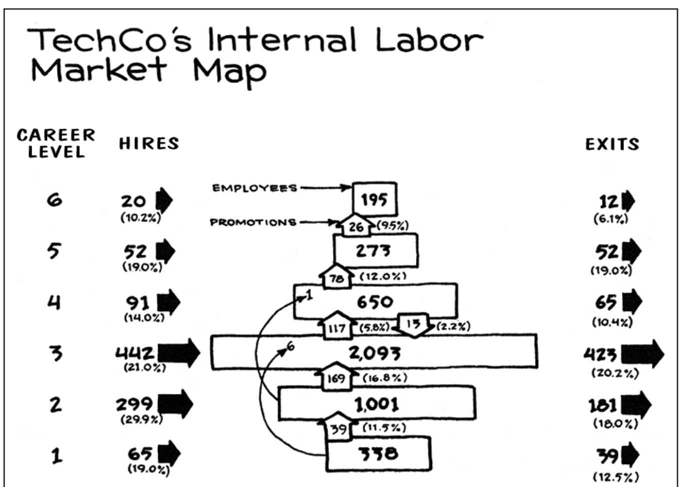
The first step is creating an internal labor market map — a graphic, quantitative picture that describes key dynamics related to the flow of people into, through and out of an organization over time. It displays where attributes of human capital such as experience and skill sets are concentrated. Every organization has a unique map, and it shows the number of employees at each career level and how they are moving.

TechCo's Labor Map

Insights from TechCo's labor market map (see below) include:

- A large population of engineers at Level 3, which is a career bottleneck or "choke point."
- Employees at Levels 1 and 2 have a high probability of promotion, while others do not.
- Level 3 employees are leaving in large numbers.
- Hiring practices are at odds with the need for firm-specific knowledge.

In addition to maps, statistical modeling of the dynamic process behind a map reveals how and why internal labor markets work. Statistical analysis can show drivers of turnover, promotion, lateral movement, compensation and individual performance. Statistical models rely on a common set of independent variables:



Employee attributes — Demographic and job-related characteristics measured at the individual level.

Organizational attributes and practices — The immediate environment in which employees work, and management practices that affect those measures.

External influences — Characteristics of the market environment in which the facility operates.

Modeling can determine how factors such as length of service in the firm and educational attainment affect the likelihood that an employee will leave in a particular year, all else being equal. It can also determine how changing labor market conditions influence pay levels of both incumbents and new hires. Knowledge of these interdependencies can prevent an organization from wasting resources on one-size-fits-all solutions and direct interventions where they are needed most.

Building Your Strategy

Human capital strategy is about the future and it depends on three questions:

- **Where are we now?**
- **Where do we want to go?**
- **What creates value?**

It determines where a company needs to be while closing the gaps between that goal and where it is now. Quantitative ILM analysis helps in determining the current state, but it should be supplemented with facts from focus groups, surveys and employee interviews.

Business Impact Modeling

ILM can also be used to define the future state of the desired strategy, but another way is Business Impact Modeling (BIM). It is a quantitative analysis of the running record of business performance to identify the work force characteristics and management practices that are the strongest drivers of the company's most desired and important business outcomes, such as productivity, profitability, quality and customer retention. It helps to discover the human capital drivers of value. BIM uses statistical analysis to focus on business outcomes where ILM focuses on work force outcomes. It is similar to ILM but it draws on a broader source of data. In addition to HR information and payroll systems, it draws on data kept by the finance, quality control, marketing and operations departments to provide measures of business performance.

BIM and ILM emphasize the importance of facts and their interrelationships through statistical models of work force and business outcomes. The statistical models are usually more accurate than an executive's opin-

(continued on page 7)

Human Capital Strategy Tools

(continued from page 6)

ions based on his or her experience, because they are consistent and objective where people are less so. Though experience is critical, it is insufficient to use without statistical analysis in the strategy-making process.

Building Human Capital Strategy

1. Know where you are. Use ILM analysis and qualitative data to ascertain facts about the current work force and work force management practices.

2. Project the future. Build a picture of where the organization should go and determine the human capital implications of strategy changes.

3. Find the value. Use BIM to identify human capital attributes and practices that create the greatest value.

4. Close the gaps. Identify the most important differences between "is now" and "should be," and protect the current sources of value.

5. Design the interventions. Using ILM to identify viable solutions and BIM to estimate investment returns, design specific features of changes to the work force and ways to manage them.

6. Implement with accountability. Use metrics to focus implementation efforts. ■

ProCo Changes Its Strategy

ProCo was a diversified consulting company with stable profitability and expertise in mature markets. The CEO wanted to grow the company by strengthening relationships with profitable clients and aggressively tapping synergies like cross-selling and developing new services for customers. The company knew it needed a human capital strategy to support the new business strategy.

First, ProCo conducted an ILM analysis to answer questions about the current work force:

- ✓ **What are our key skill sets?**
- ✓ **Can we develop and retain people with those skills?**
- ✓ **How do we attract the right people?**

Next, the company addressed the future state and realized they needed more people who could work across specialized functions. It also decided to build talent from within.

The company could see there were gaps between their current and desired work force:

- ✓ **Generalists were not promoted or rewarded.**
- ✓ **The company hired experienced mid-career professionals who often left.**
- ✓ **Younger people were leaving because they were not getting enough money.**

ProCo then used BIM to determine which human capital attributes and management practices were critical to the success of its business strategy and which staffing configurations drove revenue growth.

- ✓ **Teams of employees with mixed experience were most effective at driving revenue.**
- ✓ **Team member turnover detracted from revenue growth.**
- ✓ **Teams composed of employees from different services were more likely to expand client relationships than those focused on a single service.**

Applications of Human Capital Management

Once a new strategy has been determined, the job is not over. The history of business is full of failed strategies and implementations. Though these failures can be based on poor financial foundations, disturbances in the marketplace, or countermoves by competitors, they come more often from the people side of the business.

Though it is easy to blame people for not changing with the strategy, management must realize that people are part of a system. If the institutionalized practices and incentives have not changed with the strategy, the people will not change either. Even if a company uses recruiting and training to produce new skills, it could take years before the impacts are felt. These considerations should be built into the strategy design from the beginning. If the competitive environments shift, the organization should also go back and challenge strategy and human capital practices. Executives should also consider what blend of firm-specific and general skills is required.

Human Capital in Strategic Acquisitions

Though business leaders are always optimistic about strategic acquisitions, that optimism is not rooted in reality. Anywhere from 50 to 80 percent of acquisitions never deliver the anticipated benefits, and much of the cause is problems with human capital. Due diligence usually focuses on measurable characteristics, but rarely is due diligence done on the human capital of the acquired entity. Acquisitions cannot be made without considering what kind of integration will occur. Decision makers must do three things:

1. Know themselves, the target, and their differences.

2. Estimate the potential scope of integration.

3. Recognize the appropriate integration pace.

(continued on page 8)

Applications of Human Capital Management
(continued from page 7)

The factors of the acquisition's work force capabilities and management practices must fit with the company or an appropriate plan for that integration must be made. As decision-makers do this, they must consider the three principles of human capital strategy: Be conscious of the system impacts of the integration; base integration decisions on relevant facts beyond hunches; and select the course of action that will create the greatest value.

Linking to Customers

Companies almost always give a greater depth of analysis to their customers than their human capital. It has been felt for some time that employee satisfaction causes happy, spending customers. But evidence suggests this may not be true. It might be that employee satisfaction is actually a result of happy customers, and that the business practices that make happy employees may make happy customers. If satisfied customers make happy employees, then programs focused at employees are not creating the greatest value. Focusing on customers would be better. But it is still part of a system, so management should concentrate on getting the whole system in alignment.

Human capital practice must also be aligned with the broader business context and the external market, where business risk is a factor.

Companies often introduce variable pay programs as incentive mechanisms, but they are actually instruments of risk sharing, since employees don't benefit if the company is not doing well. Incentive programs are actually problematic because they usually only account for the price and allocation of labor services, not the price and allocation of the risks associated with performance fluctuations. Variable pay and stock options align the employee and the stockholder, even though performance volatility may be the result of random, external forces. Shareholders and employees are not equally positioned to deal with this risk. Variations in share price arise from systematic — market and industry — risk, or unsystematic, firm-specific risk. Investors can diversify across markets and portfolios and reduce both kinds of risks, but employees cannot. This makes it difficult to find a way to share risk effectively.

Performance Sensitive Analysis (PSA) is a proprietary statistical method that identifies and measures these different sources of volatility in a company's total shareholder return. It measures the correlation of a company's shareholder return with indexes of both industry and general market performance over a designated period. It can be used to develop better risk-adjusted measures of performance for incentive compensation programs that provide stronger performance incentives for employees at a lower cost to shareholders. ■

For Additional Information about the forces for and barriers against integration, go to: http://my.summary.com

For Additional Information on how investors and employees differ in their ability to diversify risk, go to: http://my.summary.com

Implications for Stakeholders

With their confidence shaken, investors are increasingly demanding that corporations disclose information about the performance of their largest annual investments. Human capital is a large part of the intangible assets that make up the difference between the book value and the market price of a company. The employees' knowledge and their management system together create an asset that is difficult to control and measure.

No single method has gained acceptance in the investment community, so until companies move forward with fuller disclosure, investors should look for three kinds of human capital information:

Knowledge-Based Information — What are the skills, experience and educational credentials of employees?

Workforce Investments — What investments are put into the work force and what is the return?

Use of Human Assets — How is a company applying supervision, talent development and rewards?

In order to provide improved business results through this new science of human capital, executives will have to expand their traditional roles in a company.

The **CEO** must optimize long-term value of human capital by treating employees as investments instead of expenses, constantly aligning people practices with business strategy, being aware of differences in human capital when making acquisitions, and making the story of a company's people a part of investor relations.

CFOs must learn to measure and monitor their largest investment like they do everything else, so they consider the value of human capital when making decisions.

HR must become part of the strategic circle rather than a cost center that only handles payroll and personnel records. HR can identify the true performance drivers, model interactions between programs and employees, forecast impacts of proposed programs, and identify how to make cuts without hurting performance.

Marketing can apply its tools for understanding customer behavior to understanding employees, because customer changes have implications for human capital.

Quality Assurance maintains excellent data on the causes of poor quality, which can often be traced to people and the way they are managed. ■