# Does The Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices

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## Introduction

The study "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices," suggests that certain social responsible investing (SRI) screens may actually improve investment performance, contrary to some views that SRI sacrifices returns or that it has no effect on financial performance.

This paper analyzes the relationship between employee satisfaction and long-run stock performance. It uses *Fortune* magazine's "100 Best Companies to Work For in America" from 1998-2005 to identify firms with superior employee satisfaction and calculates the returns to a portfolio of these firms.

Currently there is little existing evidence of the corporate performance benefits of employee-centric strategies. This void provides the motivation for this paper. To my knowledge, it constitutes the first study showing that employee satisfaction improves shareholder value, rather than representing inefficiently excessive non-pecuniary compensation.

## Summary of Findings

Between 1998-2005, a portfolio containing the firms in the latest *Fortune* list earned an annualized return of 14% per year, over double the market return, and a monthly four-factor alpha of 0.64%. Holding the initial 1998 list and not rebalancing each year for annual updates of the list also generates returns that are superior to the market. This outperformance was consistent, in both booms and recessions, and also held when extending the sample back to 1984. (The Best Companies list was first published in a book in 1984, but was not published by *Fortune* until 1998).

These findings hold when controlling for industry performance, a large list of firm characteristics, equal- or value-weighting, and outliers. The results therefore lead to the following implications and concluding message for investors.

## Implication #1: Employee Satisfaction and Shareholder Value

The first implication suggests that employee satisfaction is positively correlated with shareholder value. This is not as obvious as it may sound. Historically, employees were viewed as a cost to be minimized, much as one would minimize the cost of raw materials. Management strategies therefore sought to extract maximum effort from workers, while minimizing their compensation (in terms of both cash salary and working conditions). Money was viewed as the primary motivating factor for employees, as only physical needs were deemed necessary to be met. Intrinsic motivation was not considered, nor was retention in the

firm, as employees typically performed unskilled tasks and were easily replaceable. All of this was consistent with the main management theories of the time, which posited that what is given to employees, is taken from shareholders.

However, now the world is different. Human capital is increasingly important in the modern firm and workers are seen as key assets, rather than costs to be minimized. Firms are discovering that money is a motivating factor in the workplace, but only up to a point—once people have progressed past meeting their basic physical needs, they start to focus on factors such as self-esteem and camaraderie. Moreover, in the past payment was based entirely on tangible output, such as paying an employee fifty cents for every widget made. Today firms are shifting to the service sector, where creativity and initiative are especially desired. However, since they cannot be quantified, pay-for-output is less effective. Instead, motivation may be better achieved by providing intangible benefits such as a friendly work environment or flexible work schedule, ultimately leading to greater employee satisfaction.

Employee satisfaction may thus have multiple benefits for shareholders. It can increase workers' identification with the firm, which then generates intrinsic motivation. When employees feel valued and that they are contributing to the firm, they begin to develop emotional ties and good will, which then motivates them to do more than the minimum amount of work, even in the absence of pay-for-output. Employee satisfaction can also achieve better retention rates. This becomes a source of competitive advantage when looking at the benefits of skills and knowledge accrued over time and costs of hiring and training employees.

Implication #2: Market Valuation of Intangibles

The second implication looks at how the market responds, or does not respond, to intangibles. Even if managers understand the arguments for investing in human capital, they may still choose not to invest because the investment is not visible for long periods of time. As a result, in the short term stock prices may fall and the manager will be seen as doing a poor job. A leading cause of this so-called "managerial myopia" is the focus within the United States on quarterly earnings; by focusing on short term profits, investors do not see the benefits which accrue in the longer run.

These concerns of "managerial myopia" are based on the assumption that the benefits of investment are difficult to credibly communicate to the market. This is the reason for choosing to analyze the *Fortune* list, which represents independent verification of a firm's intangibles and *is* easily observable to investors. The author measures portfolio returns from the start of February, several weeks after the publication of the *Fortune* list. If the market did fully respond to intangibles, the *Fortune* list would have been incorporated into prices by the start of February and there should be no abnormal returns to the *Fortune* portfolios; however, this was not the case. By showing that intangibles are *not* incorporated into the market, even when certified by a study as respected as *Fortune*'s, this study suggests that intangibles in

general are not incorporated into the stock market. This provides support for managerial myopia theories.

Some Caveats

1. *Causality*. While this report documents a statistically and economically significant association between employee satisfaction and stock returns, it cannot make strong claims about causality. This is because I could not control for unobservable variables. It could be that a third variable (e.g. superior management practices) drives both employee satisfaction and stock returns. This would mean that firms should not expect to increase corporate performance by improving employee satisfaction (without changing management practices). However, everything stated above would still hold for investors.

2. *Generalizability with respect to employee satisfaction*. The *Fortune* survey only contains 100 companies per year, the right-tail of the employee satisfaction distribution. This small sample may not be fully representative of the effect of employee satisfaction *in general* on shareholder returns. For example, employee satisfaction might only matter at very high levels.

3. *Generalizability with respect to Socially Responsible Investing*. The results only document superior returns to an SRI strategy based on an employee satisfaction screen. We cannot draw conclusions about the profitability of SRI in general, particularly using alternative screens (e.g. environmental or societal factors).

Key Message for Individual & Institutional Investors

SRI is sometimes seen as an either/or decision: an investor can *either* maximize returns *or* invest responsibly and sacrifice returns by limiting his or her options. However, this study in fact suggests that by applying an SRI screen, at least a screen based on employee satisfaction, *the screen is actually picking the winners*. This makes the SRI Employee Satisfaction (at least as defined by the *Fortune* list) screen the ultimate in value investing, as it is able to incorporate intangibles, something the market is unable to do.