



## How Investing in Intangibles -- Like Employee Satisfaction -- Translates into Financial Returns

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Contrary to management theories developed in the industrial age, employee satisfaction is an important ingredient for financial success, according to a new research paper by Wharton finance professor [Alex Edmans](#). His findings also challenge the importance of short-term financial results and may have implications for investors interested in targeting socially responsible companies.

In a paper titled, "[Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices](#)," Edmans examines the stock returns of companies with high employee satisfaction and compares them to various benchmarks -- the broader market, peer firms in the same industry, and companies with similar characteristics. His research indicates that firms cited as good places to work earn returns that are more than double those of the overall market.

Companies on *Fortune* magazine's annual list of the "100 Best Companies to Work for in America" between 1998 and 2005 returned 14% per year, compared to 6% a year for the overall market, according to Edmans. The results also hold up using an earlier version of the survey that dates back to 1984. "One might think this is an obvious relationship -- that you don't need to do a study showing that if workers are happy, the company performs better. But actually, it's not that obvious," says Edmans. "Traditional management theory treats workers like any other input -- get as much out of them as possible and pay them as little as you can get away with."

Those ideas came to dominate management thinking during the industrial age when economic expansion was based largely on industrial machinery. In that environment, workers were required to perform relatively simple tasks and they were easily replaceable. Companies motivated workers mainly with money, paying by the piece in order to reward employees who churned out the most products.

In today's business world shaped by new technology, knowledge and creative thinking, the value of each employee is increasingly important, although hard to measure directly, Edmans says. "Nowadays companies are producing more high-quality products. They are focusing on innovation and looking for the value-added to come from workers rather than machines." Since key outputs, such as teamwork, building client relationships and idea generation, are difficult to measure, motivating workers by paying by the piece is less effective. This leads to the increasing importance of employee satisfaction as a motivational tool. Pleasant working conditions can lead to employees identifying with the firm, and thus exerting more effort than the minimum required by the employment contract. Moreover, it can be a powerful method of retaining key employees.

To test his theory that happy workers generate better returns, Edmans used the annual survey published by *Fortune* and conducted by the independent Great Place to Work Institute in San Francisco as a measure of employee satisfaction. Edmans says the survey is a valuable gauge of employee satisfaction because it is based on in-depth surveys of a firm's employees, rather than just an external observation of stated policies. *Fortune* began publishing the list in 1998, but Edmans also used earlier versions of the



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list published in book form in 1984 and 1993.

"This paper documents statistically and economically significant long-horizon returns to portfolios containing companies with high employee satisfaction," Edmans writes in his paper. "These findings imply that the market fails to incorporate intangible assets fully into stock valuations -- even if the existence of such assets is verified by a widely respected survey."

Edmans' paper controls for numerous variables, including industry returns, firm risk, and firm characteristics such as size and value. He notes, however, that the work rests on a relatively small sample since the survey is limited to 100 companies a year, of which only 65 to 70 are publicly traded at one time.

### **Not an 'Either-or' Choice**

Beyond exploring the link between employee satisfaction and financial performance, the paper may have other implications, Edmans suggests. First, the research could help inform socially responsible investing, which Edmans notes has become increasingly popular in the past 10 years. In this form of investing, ethical and social considerations are factored in along with expected financial returns when investors make decisions about taking stakes in companies.

"The traditional view of socially responsible investing is that it is an 'either-or' situation. For example, companies that endeavor to reduce their impact on climate change may offer lower shareholder returns, since such efforts often involve significant expenditures," says Edmans. However, if the firm's treatment of its own employees is one of the criteria investors use to determine whether a company is socially responsible, the study indicates that socially responsible investors may not need to sacrifice strong returns. This consideration could be especially important for fund managers investing on behalf of union pension plans or other employee benefit programs.

While the study has generated significant interest among socially responsible investing (SRI) practitioners, Edmans cautions that the research so far applies only to socially responsible investment that is focused on employees. The study does not address other screens investors may use to target socially responsible companies, such as environmental standards or religious philosophy.

Another, more subtle implication of the research, says Edmans, goes to the nature of short-term thinking among corporate managers. Even if managers believe employee satisfaction enhances long-term corporate performance, they may not act on their beliefs because investing in employees often reduces earnings in the short term. "This is a large concern people have had for a couple of decades now -- that the American corporate system is short-term or myopic," Edmans notes.

That concern, he adds, is driven by managers who argue it is not possible to credibly communicate to investors that profits might be lower in one period in order to invest in employee satisfaction that may pay off in the future. "This is why I take the most visible measure of employee satisfaction -- the *Fortune* list -- as independent verification of a company's employee satisfaction. What the paper shows is that even this highly visible measure is not incorporated into the stock market."

Edmans says the list is typically published in mid-January. He constructs his portfolios from the start of February, giving the market ample opportunity to react to the information in the list. If the market fully incorporated the contents of the list, he should not have found superior returns to his portfolio. "If this highly visible means of employee satisfaction is not responded to, then it suggests that intangibles in general -- the vast majority of which has nothing close to the *Fortune* list to verify them independently -- might be quite difficult to factor into the stock price," says Edmans.

Edmans cautions, however, that a correlation between employee satisfaction and stock returns need not imply causation. Although he controls for many observable variables, it is impossible to rule out the story that an unobservable variable, such as superior management practices, may cause both higher returns and satisfied employees. However, even under this interpretation, "it still remains that the market does not incorporate intangibles (whether they are satisfaction levels or good management) even when made publicly available, and that an investor could have earned significant risk-adjusted returns by trading on the *Fortune* list."

## More Skin in the Game

While the study shows there may be a reward in the market for investing in intangibles over time, Edmans points out that the research is not sufficient to encourage investors to shift away from the current short-term focus. "What's needed is not just for the manager to know employee satisfaction matters, but also to have the incentive to act on this," he says. If managers are compensated largely on short-term share price, their decisions about investing in employee satisfaction or other intangibles will not change. He suggested one way to correct this problem would be to compensate managers with stock or options that cannot be sold for a number of years.

Another response to the problem of management myopia might be for shareholders to take larger stakes in firms. Edmans explored this idea in an earlier paper titled, "Blockholders, Market Efficiency, and Managerial Myopia." "If you only own a very small percentage, there is no incentive to do your own research. You don't have enough skin in the game," he says. "If you have a larger stake, you have the incentive to research the company's fundamentals rather than just trade on short-term earnings."

According to Edmans, Warren Buffett is a good example of an investor who takes a large enough position in a firm to adopt a long-term perspective that pays off beyond a strategy focused on short-term returns. Similarly, Bill Miller, chairman and chief investment officer of Legg Mason -- who famously beat the S&P 500 for 15 years in a row -- deliberately holds a concentrated portfolio containing a small number of stocks, to allow him to understand each company deeply. "There is the Wall Street adage that, upon seeing a company announce low earnings, 'the market sells first and asks questions later,' which threatens to induce managers to over-emphasize short-term earnings," says Edmans. "However, shareholders with sizable stakes have the incentive to ask the questions first -- i.e., find out whether low earnings may in fact result from long-term investment."

One company that exemplifies many elements of Edmans's research is Google, which was number one on the most recent *Fortune* list. In addition to its reputation for caring about employees' welfare, it is known for emphasizing corporate social responsibility more generally. When Google went public, it wrote a letter to shareholders acknowledging Wall Street's "rules of the game," which are that public firms should make quarterly earnings forecasts and meet these short-term targets. Google explicitly stated that it would not play by these rules and instead would focus on long-run growth. So far, Google's performance has vindicated this approach.

Overall, Edmans's research is part of a broader shift among academics to develop new theories focused on the modern firm. "When I was at Morgan Stanley, we would value firms according to their tangible assets, cash flows and earnings -- which is common across most of Wall Street and much existing academic research," he says. "But nowadays, significant components of a firm's value cannot be captured by accounting numbers."

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