ROI INSTITUTE®

# What Drives Your Human Capital Investment?

by Jack J. Phillips, Ph.D., and Patti P. Phillips, Ph.D.

ROI Institute, Inc. | +1 205 678 8101 | www.roiinstitute.net | info@roiinstitute.net

# What Drives Your Human Capital Investment?

The concept of human capital investment has grown in the last two decades, underscoring the importance of human capital in the management of organizations. While the term human capital is commonplace in organizations, management's role in this important resource is often unclear. This lack of clarity lends to the mystery of human capital investment and now commands much executive time and attention – requiring a concerted pursuit for the optimal investment level.

While there is no consistent definition among human resource professionals and executives, a consistent theme is that human capital represents the relationship between what organizations invest in team members and the emerging success. The relationship to success is the mystery. Imagine this scenario. The CEO of a $5 billion revenue company proposes to its board of directors that the company make an investment of $1.8 billion for the coming year. When describing the investment, the CEO is optimistic that the returns will follow, although he does not know how much of a return will be realized and cannot estimate it reliably. However, he is confident that the investment is needed and that it will pay off for the company. The executive explains that this investment, which represents almost 40 percent of its revenues, is based on benchmarked data that shows other firms are making similar investments. When the investment is made, and the consequences develop, the CEO admits that the value of this investment may still be unknown; but, nevertheless, he asks for the money.

The investment in question is the investment in human capital. As extreme as it may seem, this scenario plays out in organizations each year as they invest in the workforce. Budget approvals are granted on faith, assuming that the requested investment will pay off.

There is far too much mystery about the connection between the investment in team members and the success that follows. This mystery causes some organizations to invest too much or too little – either of which can end in disaster. This brief assessment sheds new light on how to determine the optimum investment in human capital. Simply put, there are five strategies:

1. Let others do it.
2. Invest the minimum.
3. Invest with the rest.
4. Invest until it hurts.
5. Invest when there is a payoff.

These strategies explore the range of possibilities, enabling executives to examine all the options before deciding on a particular one.

## Strategy #1: Let Others Do It

Some executives prefer to take a passive role when investing in team members, attempting to minimize or avoid the investment altogether. While highly dysfunctional, this approach has proven effective for some organizations, depending on their strategic focus. This chapter explores the strategy of letting others do the investing, the forces behind it, and the consequences – both positive and negative – of implementing it.

The strategy is simple – let other organizations provide the investment for human capital. The motivating forces behind this strategy are grounded in cost management – the organization is either seeking to cut costs or to avoid costs related to team members. This focus on cost is often due to instability in the organization or industry or to an organization's need for expertise in an area; it is often indicative of a company with a short-term focus or one just trying to survive.

This strategy is usually implemented using two approaches. The first approach is to use contract and temporary team members in place of permanent team members. This arrangement allows the organization to add and remove team members with little or no commitment to them, thus reducing the expense connected to team member acquisition, training, benefits, and termination. The second approach is to use outsourcing to get the job done, often at a lower cost. Taken to the extreme, employers can outsource most of the functions that would be performed by regular team members in the organization.

## Strategy #2: Invest the Minimum

While the previous strategy focused on letting others do the investing in human capital, this strategy involves investing only the minimum in human capital. A few organizations adopt this strategy by choice, while others do it out of economic necessity. Either way, this is a viable option for some organizations. This strategy has several hidden landmines that can be detrimental to some organizations in the long term.

This strategy invests the very minimum in team members in every aspect of team member expenses: it sets salaries near the minimum wage level or very low in the industry, provides benefits at a level just beyond what is legally required, invests in training only at the job skills level with almost no development and preparation for future jobs, and offers little in the way of team member-support services. Organizations adopting this philosophy operate in a culture that is sometimes reflective of the industry and the competitive forces in the industry. These organizations experience high turnover and usually adjust processes and systems to take into account the constant churning of team members.

This strategy should not be confused with efficient resource allocation. Obviously, efficiency is gained by keeping costs at a minimum. The strategy presented here is a deliberate effort to dispense only the minimum investment in human capital. This strategy is about facing the inevitable in some situations or making a deliberate attempt to invest as little as possible in team members.

## Strategy #3: Invest with the Rest

Some organizations prefer to invest in human capital at the same level that others invest. Using benchmarking data, these organizations determine specific measures from organizations often perceived to be best in practice and try to duplicate many of the investment levels in their organization.

Investing with the rest involves collecting data from a variety of comparable organizations, often perceived as implementing best practices, to determine the extent to which those organizations invest in a variety of human capital functions, processes, and activities. Benchmarking data are used to drive improvement or changes, if necessary, to achieve or exceed the benchmark level. In essence, this strategy aligns the organization with the level of investment of the benchmarking organizations. Benchmarking does have two limitations, apart from locating the appropriate data. The participants in the study may not represent best practices. Also, your organization's needs may be different from the average of those in the study.

## Strategy #4: Invest Until It Hurts

While most organizations invest at the same level of other organizations, some operate under the assumption that more is better. They over-invest in human capital. The results can be both disappointing and disastrous. A few executives do this intentionally; others do it unknowingly. Either way, this is a strategy that deserves serious attention.

With this strategy, organizations invest in human capital beyond what is needed to meet the goals and mission of the organization or the demands of team members. Executives implement almost every program or project they see, provide every team member benefit available, and teach every new idea that comes over the horizon. For most over-investing organizations, this strategy is not a deliberate pursuit; rather, it occurs unintentionally through a desire to do everything possible to ensure that human capital is well funded. The consequence is that profits may be reduced, and talent wars are created as team members jump to the employer offering the best package.

Over-investing essentially is adding less value than it is costing and can hurt the financial performance. For example, there are many organizations that have excessive cost of retirement plans or healthcare because they have over-invested in these areas. Particular plans that are given to retirees, as retirees live much longer, are a tremendous cost for organizations to continue to absorb.

Organizations often take this approach because of several factors.

1. Union negotiations often lead to some excessive investments in compensation, pay, and benefits.
2. Talent retention is a driver as more companies offer perks to attract talent.
3. Some organizations chase the happy team member dilemma suggesting that happier team members will be more productive.
4. Finally, other organizations like to chase fads. As a new fad comes along, they like to invest in it whether it provides a benefit or not.

## Strategy #5: Invest as Long as There Is a Payoff

Some organizations prefer to invest in human capital when there is evidence that the investment is providing benefits. They often compare monetary benefits with the costs of human capital programs. This strategy is becoming more popular following the increased interest in accountability, particularly the use of return on investment (ROI) as a business evaluation tool. With this strategy, all HR programs are evaluated, and a few key programs are evaluated at the ROI level –the same way the ROI is calculated for an investment in buildings or equipment.

The ROI strategy focuses on implementing a comprehensive measurement and evaluation process for the human capital expenditures in an organization. This involves capturing up to seven types of data when a human capital program is implemented, as shown in this table.

Table 1. Types of data with the ROI strategy

Human Capital Program Measures

- **Reaction** to and satisfaction with the program
- Improved **knowledge and skills** necessary to make the program successful
- The **application and implementation** of the program
- Specific **business impact** measures directly linked to the program
- **Return on investment** data comparing the monetary benefits of the program to the costs
- Total **costs** of the human capital program
- **Intangible** data – not converted to monetary value (when the conversion is too expensive or lacks credibility)

Using this philosophy, only a small number of programs are taken to ROI, whereas every program is evaluated with reaction and satisfaction data. Also, when business impact and ROI are developed for an HR program, one or more techniques are used to isolate the impact of the program on the business data.

## What is Your Approach?

It is helpful to reflect on which of these strategies is your dominant approach to investing in human capital. We have taken surveys of chief human resource officers, and here are the results that we see reflecting how the changes in strategies are adjusting over time.

| Strategy | Survey Results 2005[1] | Survey Results 2020[2] |
|---|---|---|
| 1. Let Others Do It | 9% | 4% |
| 2. Invest the Minimum | 15% | 8% |
| 3. Invest with the Rest | 58% | 66% |
| 4. Invest Until it Hurts | 17% | 18% |
| 5. Invest as Long as There Is a Payoff | 11% | 28% |

[1.] N = 238

[2.] N = 309

The results show fewer organizations relying on the first two strategies to fund their human capital programs, and more are investing as long as there is a payoff. Some are using a combination of Strategy #3, Invest with the Best, using benchmarking data, and Investing as Long as There is a Payoff. This is a healthy combination. The key is to know where are you with your investment strategy and where you want to be? That’s the important issue.