PLAY TO YOUR STRENGTHS

MANAGING YOUR INTERNAL LABOR MARKETS FOR LASTING COMPETITIVE ADVANTAGE

HAIG R. NALBANTIAN, RICHARD A. GUZZO, DAVE KIEFFER, AND JAY DOHERTY

Compliments of Mercer Human Resource Consulting

Dear Reader,

The following preprint contains the preface and introduction of *Play to Your Strengths: Managing Your Internal Labor Markets for Lasting Competitive Advantage*.

Whether you call it human capital, the workforce, an intangible, or simply people – "it" represents the **single largest asset** that most business leaders know the least about. Now, more than ever before, executives are urgently seeking ways to manage this asset to drive performance and establish enduring competitive advantage. And as if the stakes weren't high enough, boards, and increasingly the investment community, are intensifying their demand for proof that this asset is performing.

Traditional approaches, such as benchmarking and copying the so-called best practices of other companies, have failed to deliver the required results. The key to success is uncovering the reality of the intended and unintended consequences of workforce practices that profoundly affect overall business performance.

The ideas in *Play to Your Strengths* give business leaders a new, yet proven approach to measure and manage the value of their workforce – achieved from within their own organization. We hope you'll find these ideas both useful and thought-provoking as your company works to secure a human capital strategy that delivers demonstrable returns on investment.

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Preface

THERE ARE TOO MANY MYTHS and too much conjecture about the management of people.

Considering the sophistication of the tools and metrics commonly used in major companies—inventory tracking, logistics, customer experience management, and financial measures—most tactics and measurements for workforce management seem almost primitive. Thus few, if any, companies know the return on investment (ROI) of their various investments in people practices. The same thing is true for the people tactics that most often drive overall business results.

Ten years ago we set out to bridge that gap, starting as a research and development group and gradually evolving into a consulting practice. Since that time we have worked with over a hundred global and national firms—some the best in the world, some average, some struggling. More to the point, we have had complete access to data—covering more than 2 million employees—that enabled us to measure and define actual people management practices, how those practices affect the workforce, and what their impact is on business performance.

Along the way we have learned a lot about the process of discovering organizational realities and turning that knowledge into strategies for business success:

- Some of the most profound learning in business comes from understanding your own organization.
- The opportunity exists to capitalize on what others cannot possibly know about your business.
- New methods for measuring and optimizing your workforce practices are now available.

In place of platitudes or meaningless generalities, this book explains the new science for making fact-based, firm-specific decisions. Unlike most business books, it does not urge you to adopt practices used successfully at other companies or in other industries. There's no reason to believe that those practices will work for you. Instead, this book gives you a framework for thinking strategically about the people side of your business and introduces you to new tools for managing your most valuable asset.

Whether you're a CEO approving a $175 million initiative, a CFO trying to judge the return on investments in people, or a human resources chief who needs to make a compelling case for change, this book will show you new ways to resolve those issues—and to make smarter decisions. For the first time you will see how to understand and measure the contributions of human capital to business success. Not only will you see things differently (and better), you will think and talk about your business differently.

Introduction

The Last Asset

THE CEO KNEW IT WAS A BOLD PLAY, but he was determined to get it past the board.

"Ladies and gentlemen," he said, "I propose to invest 36 percent of next year's sales—roughly $5 billion—in a venture I'm confident will produce great returns for the company."

He knew he had to take the high ground before they started asking questions.

"Let me say at the outset that I can't estimate a specific return on investment, but we will be able to benchmark our performance against other companies, so I am confident we can manage this venture effectively."

There was silence.

He was relieved.

They were stunned.

Strange as it may seem, an unspoken version of that dialogue takes place *every* year in every company from Germany to the United States to Japan. This is what it would sound like if CEOs had to ask their boards for permission to fund all the investments associated with the workforce—equivalent to an average of 36 percent of an American company's revenue each year.[1] The question for companies goes like this: Is the return you're getting on your various human capital investments exceptional, marginal, or negative? Unfortunately, that question seldom is asked and virtually never is answered. That's why for many companies human capital is the biggest investment about which they know the least.

The reason executives know so little about their human assets isn't lack of interest or concern. Indeed, CEOs and senior managers spend most of their time dealing with people problems. The problem has been their inability to measure, assess, and predict the outcomes of workforce tactics in the same way they do with other parts of the business. The tools simply have not been available. They didn't miss the boat. There wasn't any boat.

The only good news in this is that there has been parity among companies in their inability to manage human capital factors. The bad news is that this situation is changing dramatically. Measurement and management tools are now available. Companies that adopt them and learn to use them well will gain substantial advantages over organizations that are slow to catch on.

The Last Major Source of Competitive Advantage

Every company has tangible assets (financial and physical) and intangible assets (brands, customer relationships, and people). In the past, tangible assets were prime sources of competitive advantage, but their power to differentiate or confer special power has faded. For example, it was not long ago that executives struggled to obtain the capital they desired to run their companies. Nowadays capital flows relatively easily even during significant economic downturns. In early 2003, in a distinctly down economy, companies continued to get the money they wanted, ranging from the $2 billion Volkswagen was sinking into an existing plant in Puebla, Mexico[2] to $21 million in private financing for Chicken Out, a fledgling restaurant chain in Maryland.[3] Access to financial capital doesn't differentiate enterprises or give a business a competitive advantage over its rivals anymore.

Nor does technology set most companies apart for very long. Until recently, first movers with new technologies could establish competitive advantages they could ride for years, as FedEx did with its logistics/tracking system. Today, advantages rooted in new technology are short-lived. What one company has can often be acquired or replicated easily by others, making technology no longer special, just required.

At the same time the competitive landscape is tumultuous. Almost unthinkable things are happening: smaller companies taking on bigger ones, less-developed countries going toe-to-toe with larger ones. The Royal Bank of Scotland, like a latter-day Robert the Bruce, charged into England to buy Nat West, and it's now expanding overseas. Chile is crating off its counterseasonal produce to northern markets and hooking those markets on its year-round fishery. Lowe's is chiseling away at Home Depot's seemingly uncontested market dominance. Big pharmaceutical houses find the performance of upstarts such as Forest Labs depressing. China continues its Mao-defying revolution into a new economic dynasty. Nothing can be taken for granted anymore.

Thus, earlier sources of value creation and advantage—access to capital, technology, and economies of scope and scale—have become much less critical. What's left—the last unexploited source of advantage—is the largest part of most companies' intangible assets: human capital and the *system* each company uses to manage it.

Nobody has ever denied that people are important. Companies routinely profess that "people are our most important asset," although many behave otherwise. However, in a world where knowledge and connections to customers matter more and more, human capital—a company's stock of knowledge, technical skills, creativity, and experience—is becoming increasingly important.

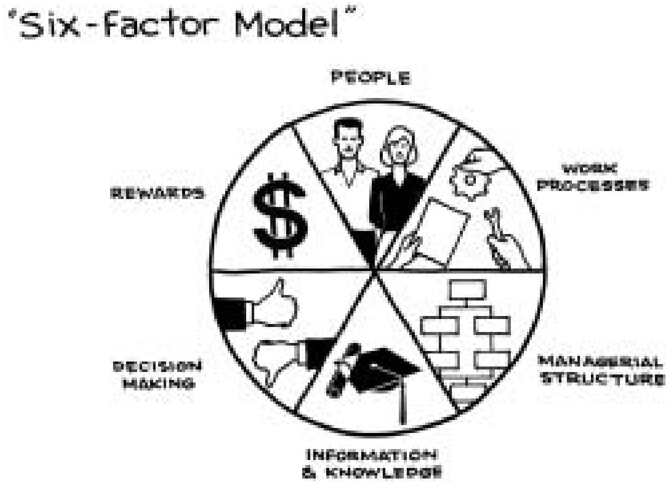
A great workforce alone is not, however, the source of advantage. If it were, today's best-endowed companies would simply outpay all others, staff themselves with the best people, and enjoy a permanent advantage. Obviously, this doesn't happen. The reason is that the real and competitive advantage comes not merely from the people but, more importantly, from the way firms *manage* them. We call that set of management tactics, policies, and practices an organization's *human capital strategy*. That strategy—that *system*—is the last asset with which companies can gain enduring advantages.

Human capital strategy is the sum of all actions—in both line and staff functions—used to manage people throughout an organization. It is the people analogue to a firm's business model or strategy.

Six Essential Factors

Human capital strategy consists of six factors that most affect business results *(Figure I-1)*. For details on the empirical basis of these factors, see Appendix A, "The Research Roots of the Six-Factor Framework."

Figure I-1



1. People

From the executive suite to the mail room, the nature and quality of individuals in the workforce obviously influence the performance of an organization. Specifically, this factor represents the human capital itself, the collective mix of attributes individuals bring into the company and then develop over time.

2. Processes

Dominant work processes have both direct and indirect effects on organizational performance. Two companies in the same industry may organize their work quite differently; for example, General Electric builds jet engines on an assembly line and Allison builds them in small work groups. Those differences often require different kinds of talent.

3. Managerial Structure

This factor characterizes how organizations direct the work of employees across dimensions of managerial direction (high control) versus individual discretion (low control).

4. Information and Knowledge

The flow of information and knowledge in an organization also drives productivity. This factor includes both internal dynamics (up, down, across) and external dynamics (to and from customers, suppliers, regulators, etc.).

5. Decision Making

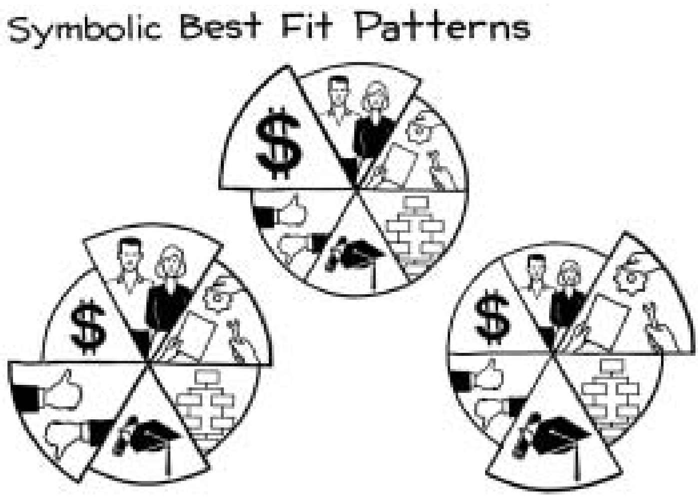
This factor focuses on important business decisions (not on day-to-day job-level decisions) that affect major areas of strategy, operations, finance, marketing, and sales.

6. Rewards

The motivational component of human capital strategy is reflected in an organization's reward structure: both the financial and the nonfinancial motivators that influence employees to work hard, innovate, and develop.

All organizations have a human capital strategy made up of these six elements, whether intended or not. The factors come together in unique combinations to fit the individual companies; thus different patterns work best for different enterprises *(Figure I-2)*.

Figure 1-2



Some drivers are critical for success, but all of them always are in play. At its best, a company's unique human capital strategy is a major barrier to competitors.

Context Is Everything

We emphasize that these six factors operate as a system in which they interact with, balance, and complement one another and their various parts. Of course, this human capital strategy system exists within the context of larger systems, just as one's family "system" resides in a social system, an ecosystem, and a political system. In the case of organizations the human capital system must fit and complement other systems—the company's marketplace, its business model, and its strategy for financial and physical asset management (including technology). Effective decision making must take into account those points of context.

We will talk more about this system's reality in Chapter 1, because ad hoc or silo-based decisions are too often devastatingly dysfunctional when they are made without regard to the overall system.

Together with the market and the business model context, the human capital system inherently shapes the unique character of a company. That creates two potent competitive advantages. First, the sum of a company's human capital practices is relatively stable and persistent, typically more enduring than the effects of technology and financial capital. Second, because it is unique to its context and goals, a successful company's system for managing human capital is very difficult to copy. Indeed, what works well for Company A is unlikely to work for Company B. A copycat may try to adopt two or three "best practices" from a top company, but that approach will not produce great competitive advantages. Why? Because the best practices of the highly successful company are part of its system of interrelated practices and values. It is the sum of a company's whole system that makes a company great. Thus, copying one or two discrete practices produces one of two outcomes: The first result is that the transplanted tactic works but generates no competitive advantage because, since it's easily adopted, it quickly becomes a new standard used by most companies. The second, more likely outcome is that it fails—sometimes quietly, sometimes stunningly—because the "borrowing" company can't copy all the other factors that support and interact with the adopted tactic at the great company. In other words, it doesn't fit into that company's unique system.

Our work shows that these two competitive advantages—longevity and inimitability—hold true even for close competitors in the same industry. Think about trying to copy a successful rival's entire system. Consider what would happen if BMW decided that the only way for it to be ultimately successful would be to transform itself into another Toyota and then beat Toyota at its own game. Or if Oracle aspired, as impossible as that might be, to copy Microsoft. Or Bertelsmann chose to model itself after Sony.

Each would struggle for years to emulate its competitor. It would have to change long-standing values, practices, and policies. It would have to match its workforce to the new strategy. It would have to train people in new ways of doing things. Key people would leave in disgust or have to be replaced because they weren't "wired" to lead or perform in the new system. There would be major turmoil before there were results. It would take years—if it were even possible. (Paradoxically, companies can change their business models more easily than they can change their human capital strategies.)

Thus, a company that gets its system of people management "right" has an extraordinary competitive advantage over its rivals. It will obtain better performance from what is often its largest asset, and won't have to worry about its rivals copying its key to its success. In doing this, a company is playing to its strengths.

Three Critical Questions

These realities—the sheer size of the human capital asset, its enduring character, and its competitive advantages—are driving people both inside and outside organizations to try to measure the value and drivers of workforce performance better. From the inside, organizations have long measured productivity in either broad financial terms (revenue per employee, etc.) or on an individual or operational basis (units produced per hour, etc.). Such measures are easily made, but they don't provide much insight into what tactics produce the outcomes. The real question is: What does it take for an organization to create more value, more effectively, and more predictably with human capital? To respond to that issue, companies must answer a whole set of questions that typically aren't asked in most organizations:

- What are we actually spending on human capital (cost), and what is it buying us (value)?
- Are we sure that our human capital strategy is aligned with our business design?
- What can we change in the way we manage people to generate greater returns by cutting, reallocating, or increasing investments?

The answer to these questions in virtually all companies is that no one really knows, but that fact gets clouded by historical storytelling, anecdotes, speculation, or questionable "correlations."

Look inside any company and the worst, least reliable performance metrics are those used for people tactics, practices, and policies. It is difficult to know what's working and what isn't because there is no science to it. This is not the case in a few critical areas of business. Financial economists in universities and on Wall Street over the years have provided CFOs with solid techniques for optimizing the use of financial capital and managing risk. On the operating side, the disciplines of statistical quality control and process engineering have improved product quality and cut cycle times. Thanks to advances like these, the physical and financial assets of today's organizations are in general much better measured and managed. Thus, most managers can answer these questions when they are focused on financial or physical assets. They know what to measure and have the tools and systems to measure it. They have developed disciplines for tracking and evaluating their activities. The same thing cannot be said for human capital, and this makes comparably good decision making on major outlays practically impossible.

Because basic questions on the human capital side seldom are asked, let alone answered, companies end up tolerating more variance in the performance of their human capital investments than in the performance of any other asset they manage.

In light of the history of business and protocols of most companies, the chances are great that these questions will remain unasked until perhaps CEOs or board members—maybe even institutional shareholders—start demanding answers. This is the case because there are strong biases against and even structural barriers to such inquiries.

Barriers to Change

There are four fundamental barriers to change. First, although companies may say somewhere in the first couple of pages of their employee handbook that people are their greatest asset, few really live by those words. The heart of the problem, which is virtually never acknowledged, is the pervasive sense that employees are merely an operating cost, not a source of value creation that can be changed and leveraged. Thus, expenditures on human capital are almost always considered costs to be minimized rather than investments to be optimized. And while from an accounting standpoint the workforce is deemed a fixed expense, in down cycles it is treated as anything but fixed.

A second, more complex phenomenon is that no one really "owns" the human capital issue. Organizations are not structured to create accountability for human capital. Think about it. In your company, someone is directly responsible for R&D, production, sales, customer service, finance, facilities, computers, trucks, and so on. Who is in charge of human capital? The HR department? Not really—not in the same way someone is in charge of accounts receivable or buildings. HR has important administrative duties: It helps with recruiting. It usually takes the lead in training and development. It has major responsibilities in advising senior management on rewards and other policies. The best HR managers act as consultants to business units, but they aren't responsible in an ultimate sense for the people throughout the enterprise. If anything, at least on their bad days, they tend to blame line managers for mishandling people and people issues.

So what about the line side? Obviously these managers look after people on a day-to-day basis, but their responsibility for people is more limited than most might think. They typically don't make many people policies or prescribe people practices; they are seldom allowed to "experiment" with people tactics; they are in no position to see or influence strategic decisions about human capital. Most line managers would say, therefore, that they don't own the people issues. On their bad days they tend to blame HR for their people difficulties.

Of course, no one will ever be fully in charge of people, but that begs the question. Who is going to think strategically about human capital? Who is going to ensure that the company's human capital strategy is aligned properly with its business model? Who is going to measure the impact of people on the firm's performance? Managing the purse strings is not sufficient. Swings of several percentage points in returns on labor costs are in play. For most large companies, even a 1 percent greater return on the labor bill would represent tens of millions of dollars falling straight to the bottom line.

The subject needs top-of-the-house attention and leadership, which we'll take up in detail in Chapter 12. In many companies, that will require CEOs to wade into this untidy mess with some of the tough questions we have just mentioned in order to launch a new era of creative and effective human capital management.

The third problem is that most practices and policies are made one at a time and are not connected to the others. Therefore, companies sometimes make decisions about leadership selection exclusive of the business model, decisions about benefits independent of pay decisions, decisions about pay in isolation from performance drivers, decisions about spans of control decisions decoupled from staffing models, and so on. Finally, all those individual decisions are exclusive of the larger organizational context. As we've said, organizations are systems, but most are managed like a set of discrete and unrelated events.

The fourth and most challenging factor that confounds the management of people is the long-standing lack of good internal measures. To fill the void, companies resort to all kinds of inputs. Decisions are based on instincts, anecdotes, and management myths—legends that have, in the absence of better science, taken on the mantle of "truth."

Myth Busting

Here are some management myths we'll blow up in this book:

- There is one best way.
- Strong cultures are winning cultures.
- The past doesn't matter.
- It's always good to "pay for performance."
- Employee turnover hurts the bottom line.
- Major people decisions are best informed by employee surveys.
- Acquisitions should be integrated as fast as possible.

In the absence of sophisticated measures, the most commonly used assessment is benchmarking. It is a "natural" process. It's baked into all people to want to know how they, not to mention their houses, dogs, and cars, compare with others. One can't get away from it, and it certainly has utility in business. But it also has limitations. Most benchmarking leads to the identification and use of best practices, which can make for terribly wrong decisions. Why, for example, would we expect the benchmarks or best practices at a GE appliance factory to be uniquely meaningful to SAP?

These barriers can be hurdled by measuring what up to now has been largely immeasurable: finding those things in your organization that uniquely contribute to your firm's performance (or erode it) and managing them aggressively. The requirement for doing that effectively is establishing "causal" evidence with which to make powerful business decisions. All that amounts to a new science for managing people, and that is what this book is all about.

The New Science of Human Capital Management

Unlike in the past, new and sophisticated means are available to get over those long-standing barriers. Thanks to many years of research in microeconomics, organizational psychology, and statistical analysis and to new developments in information systems, a fact-based “science” of human capital management has taken form. This science has its own theory, discipline, and metrics, not unlike the evolution of “modern” finance. Beginning in the late 1950s and running through the 1970s, there was a flurry of research (some of it Nobel Prize-winning) by economists and financial experts in academia that revolutionized thinking about financial markets and instruments. The practical significance of that research was seized by some farsighted financial institutions, such as Wells Fargo, Merrill Lynch, and Goldman Sachs. By the early 1980s core concepts and methods, sometimes called financial engineering, were being embraced and transformed into new products and even whole new markets. In the end, those concepts reshaped financial markets in fundamental ways that remain in place today.

We believe that we are on the edge of a similar revolution in the way human capital is seen and managed. This new science measures human capital drivers of business performance. More importantly, it gives decision makers the power to *predict* the impact of their choices involving human capital on future results with reasonable confidence.

This is quite revolutionary. Executives are going to have to change the way they think about these issues:

Today’s thinking…	**The new era…**
What does the employee survey *say* we should do?	What do our employees’ behaviors—that is, what they actually *do*—say we should do?
What works at GE and Microsoft?	What works here?
What does our function or group want?	How does this fit into the overall system?
What do the experts think?	What do the patterns over time in our company tell us?
How much does it cost?	What is the ROI?
What data do we have?	What data do we need?

This new path to better business performance and distinct competitive advantages relies on the discipline to enact three core principles.

The first is to "think systems." Business models and human capital strategies must match. Decisions about each are intertwined and are certain to fail if they are addressed independently. Furthermore, they must be in accord with the marketplace: the customer and the competitive and regulatory spheres in which your company lives.

The second is to "get the *right* facts." Go beyond external sources and internal perceptions and tap into the running record of your company—its performance trends and human capital patterns—to get firm-specific insights.

The third is to "focus on value." There's a floor to cost reduction but no ceiling to value creation. Find the points of leverage.

We're going to take up each of these three principles in Part I. Then, in Part II, we'll explain the core tools and statistical methods, with an emphasis on the concept of internal labor markets and how to measure their dimensions and implications. This is where the real science of our work shows up. It's not beach reading, but if you get your hands around this material you'll be positioned to transform the way you think about and manage your greatest asset.

In Part III we'll shift to common business challenges and applications ranging from implementing strategy shifts to managing risk. The last section, Part IV, looks to the future: what investors, CEOs, staff executives, and employees need to do to maximize the opportunities of this new science of human capital strategy.

Key Points

- For most organizations, human capital is their most important asset.
- Human capital is the last asset with which companies can create a sustained competitive advantage, since financial and physical assets, including technology, are typically no longer major points of differentiation.
- Companies tolerate more variance in the performance of human capital than in any other asset, because measures and analytics comparable to those used in other parts of the business have not been available.

- Most decisions about people, even in the best companies, are driven by hunches and what the competition is doing.
- One of the greatest risks on the people side of the business is missed opportunities—not knowing how to maximize the return on human capital.
- A new science for human capital management now makes it possible for executives to identify and understand the real human capital drivers of business performance.

[1] *Human Capital Management: The CFO's Perspective*. Boston: CFO Publishing Corporation, 2003, 11.

[2] Larry Dignan, "Investing It: Why German Auto Makers Are Humming." *New York Times*, August 24, 1997.

[3] "Chicken Out Rotisserie Announces $21.25 Million Equity Financing." *Business Wire*, October 14, 2002.

ADVANCE PRAISE FOR

PLAY TO YOUR STRENGTHS

"I encourage every executive who takes seriously the idea that people drive revenue, profit, growth, and customer satisfaction to consider the tactics discussed in this book."

David A. Daberko, Chairman and CEO, National City Corporation

"This book is a key read for all managers who want to invest astutely in their people to enable great performance for their companies."

Adrian J. Slywotzky, best-selling author of The Profit Zone *and* How To Grow When Markets Don't

"This is the new thinking in business. And it works. More than once I have applied the principles and tools presented here. The book simply provides an innovative way of getting the facts about how a company really is managing its people and how that affects its business results. With these insights you can do a lot, from setting long-range strategies to solving specific, pressing business problems."

Kurt Fischer, Vice President Human Resources and Diversity Officer, Corning Incorporated

"The authors have outlined a practicable, real-world framework for companies to analyze and implement change. Any organization that sees its people as an asset can benefit from this approach."

Daniel H. Mudd, Vice Chairman & COO, Fannie Mae, and former President and CEO of GE Capital, Japan