Interview with Bruce Pfau, author of *The Human Capital Edge*

Bruce Pfau is Practice Director, Organization Effectiveness, for a global human capital consulting firm at Watson Wyatt Worldwide. His book, The Human Capital Edge, co-authored with Ira Kay, reports on his research on human capital practices. It revealed that the shareholder value creation in companies with superior human resources practices is three times that of companies with inferior human resources management

David Creelman -
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David Creelman - What led to your study of the effectiveness of HR practices?

Bruce Pfau - We've been interested in this for a long time. The research began back in 1999 in response to the growing challenge facing our clients of justifying HR in dollars and cents terms. This issue really came to a head when Tom Stewart wrote his famous column in Fortune suggesting HR should be "blown up". He threw down the gauntlet to HR.

DC - How did you carry out your research?

Bruce Pfau - There was, of course, a lot of good existing work in this area; there was Schlesinger's work on the service-profit chain, Mark Huselid's work on high performing organizations, Jeffrey Pfeffer's work at Stanford and so forth.

However, no one had looked enough at the link between specific HR practices and the creation of shareholder value. We wanted to determine the size of the impact of HR on shareholder value, to determine if certain HR practices had more impact than others, and ultimately get at the lead-lag controversy.

The lead-lag controversy arises because there has been a lot of work showing that companies that perform well financially also have superior HR practices. However, the causality question is, do superior HR practices drive superior financial results?

Or is it that financially successful firms put in sophisticated HR practices, and that they were really a luxury that good financial performance allowed.

DC - What did you uncover?

Bruce Pfau - We've now done studies in the U.S., Europe and we're now rolling them out to Asia-Pacific. There are four or five main conclusions.

First, superior human capital practices are a lead indicator of good financial outcomes. And we have some rather compelling evidence of that.

DC - How did you determine that? It is easy to show correlation, but tough to prove causality.

Bruce Pfau - We used something called a cross-lag panel analysis that looked at results over time. It's a little difficult to show this over the phone, but essentially we looked at the correlation between a firm's human capital practices in 1999 and the financial outcomes in 2001; and we compared that to the correlation between the 1999 financial outcomes and the 2001 human capital practices.

If financial results drove human capital scores, meaning HR practices are a lag indicator, then the second correlation should be bigger than the first. If HR practices are a lead indicator, then the first correlation should be bigger.

In fact, we found the first correlation is twice as big as the second which is very statistically significant.

DC - This is important to our HR audience because they are going to need to defend this to critics from the finance department.

Bruce Pfau - Yes and it's a very important point. If good HR is a lag indicator, a luxury, then you cut back. If it's a lead indicator, then when times get tough maybe you spend even more on improving human capital.

DC - Let's get back to your other main findings.

Bruce Pfau - You can have something that is a good lead indicator, but isn't particularly potent. Our second finding was that there is a potent difference between those firms that have good human capital practices and those that don't. The shareholder value creation in companies with superior human capital practices is three times that of companies with inferior human capital practices.

What is particularly intriguing is those results came from our 2001 study. In our 1999 study, the difference was two times. When times are tough it appears that good human capital practices are even more important.

The third most important finding, and perhaps the most controversial finding, is that some HR practices generate more value than others and some actually are associated with downturns in economic value.

For example, multi-rater feedback is a questionable practice, and training aimed at helping employees advance to positions sometime in the future, rather than training aimed at more proximate needs, was also suspect.

Finally, with unfocused HR service technologies -- those whose goal is changing culture or freeing HR to do higher kinds of services -- the results were associated with decreasing shareholder value. In contrast, HR technologies with a clear focus, such as increasing customer service or decreasing cost, create a lot of value.

The fourth main finding is that although there are some differences between European economies and the U.S. economies, and between developed economies and developing economies, by and large the HR practices that work are the same worldwide.

DC - I've spent a lot of time in Asia and that finding certainly matches my own personal experience. Was there anything that really surprised you?

Bruce Pfau - At the time I really had no idea how the lead-lag research would turn out. I had hoped, as a believer in human resources, that it would turn out that HR was a leading indicator but, as a researcher, I know things don't always work out that way. So I was surprised by how definite the results were.

I was also surprised at how big the impact of superior human capital practices was. It might have been more realistic to think that good HR practices would give you a 10% or 20% edge rather than the finding that good HR practices generate triple the shareholder value.

I was also surprised to discover that multi-rater feedback showed up time and time again as having a negative outcome. My assumption, like everyone else's, was "how can it hurt".

When I present this information, I find people very accepting of the evidence that HR works, but some are very resistant to the suggestion that some of the things HR has done actually reduces shareholder value.

DC - What mechanisms might be involved that cause some training and multi-rater feedback to backfire?

Bruce Pfau - The reason I think training people for future jobs doesn't work, in general, is because companies never get the people to a position where they take these future jobs and hence, never get any payoff on their investment.

Multi-rater feedback fails for numerous reasons; it seems to be very prone to error. My conclusion is that it relies way too much on insight, and not enough on behavior change. People leave a multi-rater feedback experience saying "I got a lot of insight" but there is a whole raft of evidence that if you rely solely on insight you probably won't get any change in behavior.

And if multi-rater feedback doesn't change behavior, there will be no productivity or quality gains and if there are no productivity or quality gains, there will be no return on the investment.

DC - Do you have any closing comments for senior HR professionals?

Bruce Pfau - HR is extremely important. It is a lead indicator. It is a very potent indicator of superior financial performance. We ought to use the findings in The Human Capital Edge to re-allocate resources from those HR practices that have a small effect to those which have higher impact.