Q1 2021 EMPLOYEE SATISFACTION

Employees have always been understood as one basic element of what defines a corporation. However, perspectives on the role of the employee in corporate value creation have evolved significantly over time: from mere "inputs" in a production process or a "resource" to be managed, to an essential component critical for innovation and corporate success. As management and financial theory have continued to develop, the role of staff satisfaction as a driver and differentiator of corporate value creation is becoming clearer. New research and recent empirical work underline its materiality for investment outcomes, and not just for the employees themselves. This quarter's Research Spotlight reviews the evolution of thinking about this topic in the literature, some recent developments, and how ECO Advisors reflects this ESG theme in our investment portfolio.

The topic of staff satisfaction, labor relations, and employment practices as important components of ESG's "S pillar" is not new; in our Q1 2020 newsletter we discussed how companies that implement best practices in labour management (including, for example, flexible policies or paid leave) were better equipped to manage crises like the COVID-19 pandemic. The transmission mechanism comes from risk reduction, as such companies are less likely to need to rely on conditional loans or grants, or be regulated into bearing unexpected and unbudgeted staff-related costs. In this instance, the case for ESG materiality focuses on risk mitigation. However, the case for the value of "staff satisfaction" goes far beyond risk mitigation alone. Studies have found that employee satisfaction ratings and metrics were effective signals to help differentiate long term value creation, and that high levels of staff satisfaction can drive innovation, customer retention, and help to build and retain a company's critical intangible assets.[1]

Accounting for People: A Changing Perspective on Human Resources Traditional approaches to labour in economic models of the firm are based on the capital-intensive firm of the early 20th century, which focused on cost efficiency and modeled employees as an input cost.[2] Zingales discusses the type of firm modeled by these theories as the "traditional business corporation": typically an asset-intensive and highly vertically integrated firm, with a tight control over its employees.[3] Under these models, employees perform largely "unskilled tasks" and have no special status, and can be modeled like other inputs such as raw materials. Management's goal is to extract maximum output while minimizing their cost. "Satisfaction" arises if employees are overpaid or underworked, both of which are seen as sub-optimal and to reduce firm value. This way of thinking is grounded in what Alex Edmans refers to as a zero-sum, "pie splitting mentality", which can still be observed in the business pages of the 21st century, not just the 20th.[4]

Despite the historical conception of labor as simply an input cost to be minimised, mainstream views of corporate value creation have been evolving since Taylor's work in the early 20th century. Human relations theories developed to view employees as organizational assets, rather than expendable commodities,[5] [6] and more contemporary theories of the firm focus on employees as key assets, while some view human capital as the most crucial asset of all.[7] [8] Such notions are consistent with modern-day labor markets that no longer view labour as a replaceable commodity subject only to cost-minimisation.

From Risk Mitigation To Value Creation: Happiness, Employee Behaviour, and Innovation
Researchers theorised that employee satisfaction may improve employee retention, loyalty, motivation, and productivity, all of which should benefit the firm and should provide a competitive advantage. Research began to focus on what factors and conditions lead to more satisfied employees. In a well known study, Herzberg sought to determine what makes employees happy. He found that job characteristics have the capacity to gratify such needs as achievement, competency, status, personal worth, and self-realization, thus making one happy and satisfied. On the other hand, dissatisfaction resulted from unfavorable assessments of such job-related factors as company policies, supervision, salary, interpersonal relations on the job, and working conditions. Studies also began to link employee satisfaction and enthusiasm with value creation; one recent study found that "the more enthusiastic the workers are, the better operating results they achieve for the company." [9] [10]

One intuitive consequence of high employee satisfaction is reduced employee turnover. Companies on Fortune's list of 100 Best Companies to Work For tend to have significantly less employee turnover than average.[11] One survey suggests that unsatisfied employees are *eleven times* more likely to move to a new organisation in the following year.[12] Another highlights that employees that don't feel recognized for their work are much more likely to have interviewed for a job in the last three months, compared to those that do feel recognized.[13] As Herzberg noted, employees are more likely to show loyalty to their firm when they feel validated. For a company, the costs of headhunting, retraining, and lost productivity associated with a high turnover rate can have significant financial implications. A study by Employee

Benefits News on employee retention found that the average cost of losing an employee is 33% of their annual salary.[14]

Research also provides solid evidence for the intuitive idea that happy employees are also more productive and motivated employees. One recent study by De Neve, Ward, and Bellet (2019) found a clear causal effect of happiness on productivity. Happy employees not only worked faster, but also achieved 13% higher sales than their less-happy colleagues.[15] This result is consistent with prior behavioral economics results from Oswald, Proto and Sgroi (2015) that provide empirical evidence for a clear link between happiness and productivity.[16]

One reason Zingales cited human capital as one of a company's most important assets is that employee behaviour is an important determinant of innovation, as employees can create substantial value by inventing new products, or building client relationships.[17] Daniel Simon and Jed DeVaro also suggest that motivated employees design better products and are more positive in their customer interactions. This, in turn, leads to better customer satisfaction. Using data from both the American Customer Satisfaction Index and Fortune Magazine's lists of Best Companies, they examined the relationship between making the '100 Best' list and customer satisfaction and found strong evidence that firms on the list earn higher customer satisfaction ratings than firms not on the list.[18]

The theoretical and empirical literature provide support for linking employee satisfaction with firm value and competitive advantage. Can a focus on this factor help investors to choose the right companies that can outperform their peers over the cycle?

STAFF SATISFACTION & INVESTMENT PERFORMANCE

Modern research does support a relationship between employee satisfaction and shareholder value. In an important study focused on the link between employee satisfaction and financial performance, Edmans examined twenty-six years of data from Fortune Magazine's "100 Best Companies to Work For". He found that these companies' stock returns beat their peers by an average of 2.3% to 3.8% per year over a twenty-eight-year period. Initially he expected that employee satisfaction would be higher in sectors that are more dependent on highly skilled employees (who are particularly scarce). However, he found that the returns to being a "Best Company to Work For" were similar across manufacturing and service industries, high-tech and low-tech industries, as well as in sectors such as retail where the labour market is less tight.[19] The importance of employee satisfaction for investors is not limited to only "high skilled" industries. Similarly to human relations theorists, Edmans interprets measures of employee satisfaction as reflecting firms' intangible assets.

Other studies utilising different approaches have also established similar findings to Edmans' conclusion. The emerging realm of "alt data" has proven fruitful for researchers. Since 2008, there have been over two million employee reviews on Glassdoor.[20]

A recent study from Green et al. using Glassdoor data found that firms experiencing improvements in crowdsourced employer ratings significantly outperformed firms with declines, and documented an annualized alpha of 3.1%.

They conclude that employer rating changes are associated with growth in sales and profitability, and help forecast one-quarter-ahead earnings announcement surprises.[21,22] Studies like Green demonstrate a strong link between employee satisfaction and company performance — one that can be reflected in security prices.

One of the newest and most interesting pieces of research in this area is a 2020 study by Welch and Yoon examining the relationship between a firm's ESG profile, employee satisfaction, and shareholder value.[23] The study highlights that prior literature examining employee satisfaction indicates that satisfaction can help forecast stock returns, but how ESG efforts by a company may be related to employee satisfaction and firm value is still under-researched. For example, corporate commitments to ESG may themselves instil a sense of purpose in and motivate employees, which leads to productivity, and may enhance firm value.[24] Welch and Yoon's work finds that employee satisfaction *coupled* with ESG has a stronger impact on firm value than employee satisfaction alone, and that ESG leads to enhanced shareholder value when there are employees that are more satisfied and engaged in the efforts of the firm. Specifically, they find that firms with high ratings on both ESG and employee satisfaction outperform those with low ratings on both, as well as those with high employee satisfaction alone.

REFERENCE FOOTNOTES

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[2] Taylor, Frederick Winslow. *The Principles of Scientific Management*. Harper & Brothers, 1911.

[3] Zingales, Luigi. "In Search of New Foundations." *American Finance Association*, 2000, doi:10.3386/w7706.

[4] Edmans, Alex. Grow the Pie: How Great Companies Deliver Both Purpose and Profit. Cambridge University Press, 2020.

[5] Herzberg, Frederick, et al. *The Motivation to Work*. Wiley, 1959.

[6] McGregor, Douglas M. "THE HUMAN SIDE OF ENTERPRISE." *Readings and Exercises in Organizational Behavior*, 1985, pp. 28–35., doi:10.1016/b978-0-12-054752-4.50008-7.

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[9] Vorina, Anton, et al. "An Analysis of the Relationship Between Job Satisfaction and Employee Engagement." *Economic Themes*, vol. 55, no. 2, 2017, pp. 243–262., doi:10.1515/ethemes-2017-0014.

[10] The study measured "enthusiasm" for their jobs as being derived from the following metrics: satisfaction with the amount of salary, satisfaction with relations between employees, satisfaction with the leadership and communication of supervisor, satisfaction with working conditions, satisfaction with organisation and division of labour, satisfaction with the top management, satisfaction with the working time, and satisfaction with the chance of promotion.

[11] https://learn.greatplacetowork.com/rs/520-AOO-982/images/GPTW-Fortune-100Best-Report-2016.pdf

[12] https://www.forbes.com/sites/stevecooper/2012/07/30/make-more-money-by-making-your-employees-happy/?sh=5bccba35266e

[13] https://www.tinypulse.com/blog/17-surprising-statistics-about-employee-retention

[14] https://www.benefitnews.com/news/avoidable-turnover-costing-employers-big?brief=00000152-14a7-d1cc-a5fa-7cffccf00000&utm_content=socialflow&utm_campaign=ebnmagazine&utm_source=twitter&utm_medium=social

[15] Bellet, Clement, et al. "Does Employee Happiness Have an Impact on Productivity?" *SSRN Electronic Journal*, 2019, doi:10.2139/ssrn.3470734.

[16] https://wrap.warwick.ac.uk/63228/7/WRAP_Oswald_681096.pdf

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[20] Glassdoor reviews span across an overall rating of an employee's experience working at a company, plus subcategories such as work/life balance, culture, career opportunities, compensation, senior management, whether employee recommends, company outlook and CEO review.

[21] Green, T. Clifton, et al. "Crowdsourced Employer Reviews and Stock Returns." *Journal of Financial Economics*, vol. 134, no. 1, Oct. 2019.

[22] Green et al. found that when compared to industry-matched benchmarks, the alpha remained a statistically significant 2.1% during the study period. The results were also robust when controlling for firm characteristics, different weighting methodologies, and adjusting for outliers.

[23] Welch, Kyle, and Aaron Yoon. "Corporate Sustainability and Stock Returns: Evidence from Employee Satisfaction." *SSRN Electronic Journal,* 2020, doi:10.2139/ssrn.3616486.

[24] Bode, Christiane, et al. "Corporate Social Initiatives and Employee Retention." *Organization Science*, vol. 26, no. 6, 2015, pp. 1702–1720., doi:10.1287/orsc.2015.1006.