Understanding human capital risk.

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Without employee success, company success is extremely difficult to attain. A firm's ability to mitigate human capital risk plays a crucial role in the financial performance of an organization.

Human capital risk is unsystematic risk, meaning it is native to a particular company or industry. Unsystematic risks are not compensated within equity markets and should be diversified within a properly designed portfolio.

TYPES OF HUMAN CAPITAL RISK (HCR)

Complacency is an unwarranted sense of achievement related to a person's role and is often correlated with underachievement and reduced productivity within a workforce. A complacent workforce is dangerous to an organization because it creates an environment in which employees are not attentive to the deficiencies of their efforts, avoid accountability, and tend to make excuses.

Complacency often exists in tandem with other types of HCR including dissatisfaction and **attrition**. Attrition is the slow degradation of a company's productivity, internal controls, and culture. Attrition and dissatisfaction also lead to increased levels of **operational fraud and misappropriation**, everything from stealing office supplies to committing accounting fraud or funneling company assets.

Negligent hiring is the risk that the employer may be held liable for the actions of an employee if they should have known of the employee's potential risk to cause harm. For instance, an employee with a criminal record that the hiring manager did not properly investigate commits violence against a coworker. The employer would be liable for the damages as well.

Though negligent hiring has a specific meaning in legal processes, it more broadly refers to “hiring an employee without truly knowing their nature and history”. This risk stems from a lack of hiring diligence and can decrease a company's retention rate, increase complacency, and taint the company's culture. In the worst case scenario, it can endanger other employees, management, and the firm.

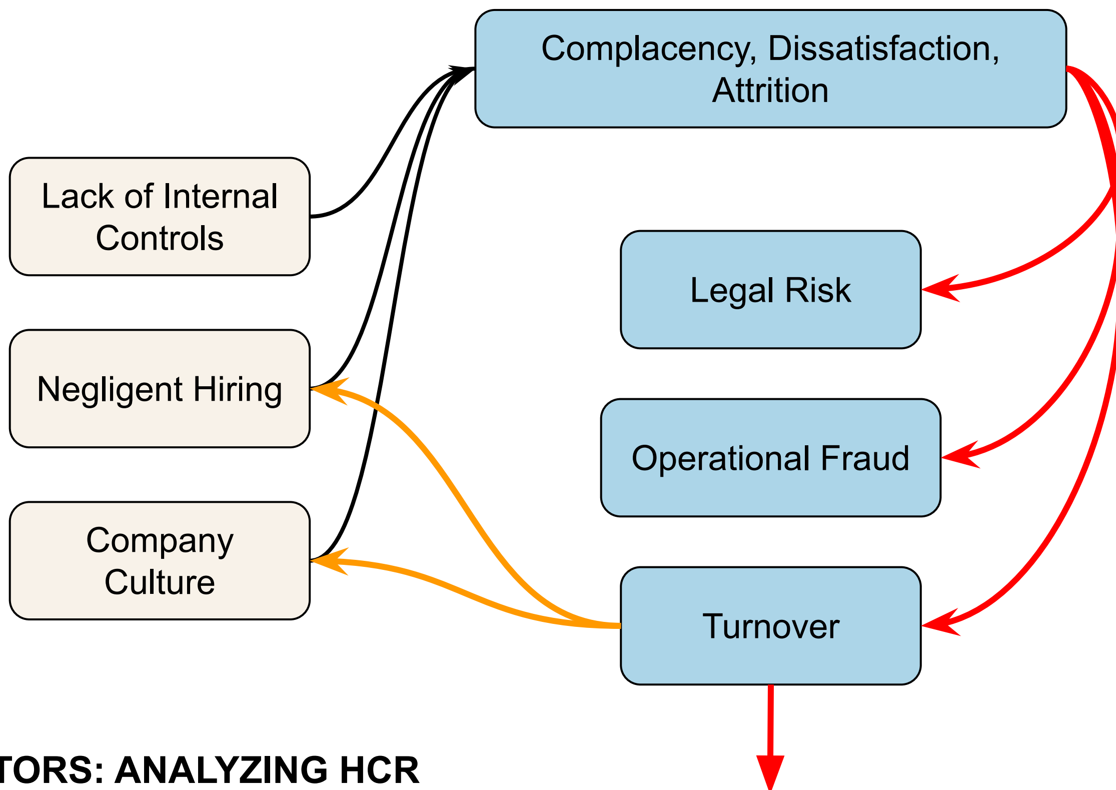
All of the above-mentioned factors lead to the primary human capital risk: **turnover**. Depending on the seniority level of an employee, it can cost between one and four times the salary of the position to replace them (Society of Human Resource Management). Operationally, turnover grinds down the productivity of the company as a whole and can lead to capacity challenges that force management to forgo expected revenue. Culturally, a revolving door and constant onboarding effects employee engagement, flattens overall morale, and increases the chances of all four previously mentioned factors.

ADDRESSING HUMAN CAPITAL RISKS

In order to mitigate HCR, an organization must adopt an enterprise risk management (ERM) framework. Enterprise risk management addresses risk from the perspective of the firm as a whole. Within this framework an organization is able to flexibly identify human capital risks and target their solutions. For example, rather than just analyzing a company's human capital performance as it relates to revenue and earnings growth, an ERM framework also utilizes four other principles when seeking to understand the inherent risk within an organization.

Governance & Culture	Strategy & Objective-Setting	Performance	Review & Revision	Information, Communication, Reporting
Board Oversight Operating Structures Define Culture Core Values Commitment HR Functions	Business Context Analysis Risk Appetite Alternative Strategies Business Objectives	Risk Identification Risk Severity Risk Priority Risk Response Portfolio Development	Change Assessment Risk & Performance Review ERM Improvement	Leveraging IT & Monitoring Risk Communication Risk Reporting

Within the aforementioned HCR factors, there is a cause-effect relationship. Negligent hiring, company culture, and lack of internal monitoring leads to complacency, dissatisfaction, and attrition. These factors in turn lead to legal risk, operational fraud, and turnover.



INVESTORS: ANALYZING HCR

Within an organization, it is crucial to address the three primary drivers of human capital risk: negligent hiring, company culture, and lack of internal controls. Like many business operations, addressing these issues is a highly qualitative process. Luckily, equity investors have several tools that allow them to analyze a company's ability to mitigate HCR.

TOOLS TO ANALYZE A FIRM'S HCR

The goal of this research primer is to address the role human capital risk plays in an investment portfolio. Because it is an uncompensated, unsystematic risk, HCR must be eliminated to diversified. When analyzing a prospective investment, HCR can be diversified by having a well-balanced industry exposure because some risks are native to a particular industry (ie banking and Anti-Money Laundering). Beyond blanket diversification, reducing HCR involves a thorough understanding of a firm's operations.

At Hoskin Capital, we consider four primary elements of a firm's human capital infrastructure. By combining qualitative and quantitative resources we are able to gain a holistic understanding of a company's culture and their exposure to human capital risk. We combine this analysis with third-party risk scores to inform our investment strategy. Below are several methods that may be used to inform your own security selection.

An analyst may consider a firm's turnover rate relative to their peers and their history. It may also be useful to compare a firm's voluntary vs involuntary turnover rates.

A firm's ability to address complacency and attrition is reflected in its employee utilization. An analyst can back out this utilization by considering a firm's net income per employee and cash flow per employee. These metrics can be contextualized against the firm's peers and history as well.

A company mitigates all types of human capital risks by implementing diligent hiring and monitoring processes. The effectiveness of these processes are apparent to outside investors in the form of training time, training expense, length of hire time, and use of background checks.

Arguably the most important component of a firm's enterprise risk management is its ability to cultivate a positive company culture. Unfortunately, this is also the most challenging aspect to quantify as an outside analyst. Qualitative data can be scraped from hiring interfaces like LinkedIn and Glassdoor and cross-referenced with press releases, accreditations, and legal documents (ie public employee suits). This is often an adequate way to gain a holistic understanding of the company's culture. An analyst may also use more quantitative measurements such as compensation relative to similar roles at peer firms, quality of benefits, percentage of women in the workforce, and whether the firm implements equality and inclusion training.

TAKEAWAY

Quality of human capital is a vital company component that is nearly impossible to measure accurately. At the end of the day, it may be most effective to get in touch with employees of the company, whether via LinkedIn, mutual connections, or some other means. They will be able to speak about the firm's culture, management style, and enterprise risk management practices better than any company filing or third-party article.

That said, it has been proven empirically that both gender and ethnic diversity improve the quality of a company's workforce and their performance (McKinsey) and these metrics (ie percent of women in workforce) can be used as a proxy for the quality of a company's approach to managing their employees. That said, this does not paint the entire picture and first-hand experience is still one of the most applicable methods for analyzing a firm's workforce.

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