Employee satisfaction and shareholder returns

Today Costco pays its employees over $20 an hour, compared with the federal minimum wage of under $10 an hour. One commonly held view is that a dollar paid to employees is not paid to shareholders. In 2003, an equity analyst was quoted in BusinessWeek as saying that "[Costco's] management is focused on … employees to the detriment of shareholders. To me, why would I want to buy a stock like that?" The equity analyst got it wrong. Since the date of the publication in 2003 Costco has delivered a total shareholder return of 17.8% per annum compared with the MSCI World Index of 8.4% per annum.

At Oldfield Partners we believe that looking after employees, and paying them well, can result in good returns for shareholders despite the short-term financial sacrifice. It follows that on the other hand employee dissatisfaction is unlikely to result in a sustainable outcome. There are several pieces of academic research outlining the impact that employee satisfaction has on long-term shareholder returns, although causality is open to debate. Costco along with notable other examples, we believe, show the benefits of looking after employees.

One of the more interesting pieces of research is by Alex Edmans, Professor of Finance at the London Business School. He puts forward the argument for looking at social factors, especially employee satisfaction when assessing a company. He studied 28 years of data (1984 -2012) and found that the total shareholder return of firms with high employee satisfaction outperformed their peers by around 3% per annum. This is particularly significant to us as Value investors when you consider that MSCI World Value outperformed MSCI World by 0.5% per annum during this same period. Edmans measured employee satisfaction using a list of the 100 Best Companies to Work For in America, an independent source which could not be manipulated in the same way that other sources such as Glassdoor, an employer review website, can be.

Glassdoor has compiled its own evidence on the best places to work. This group of companies have outperformed the S&P 500 index in nine of the last 11 years. Glassdoor based its study on 55m reviews, across 1m companies, amounting to the largest analysis of employee sentiment in history.

The counter argument is proposed in The Halo Effect, a book written by Phil Rosenzweig. The book explains problems with trying to disaggregate the direction of causality between employee satisfaction and company success. Rosenzweig highlights that when a business is going well, a "Halo effect" will surround all the other factors you may want to measure to assess the cause of the success; and when business performance begins to unravel, so will the factors. The Halo effect cannot be disproved but that does not mean it is always correct.

We believe that history provides the best evidence for employee support. There are several famous examples of companies offering employee support that have resulted in positive outcomes for shareholders. The most famous example was perhaps at Ford. In January 1914, Henry Ford started paying his workers $5 a day. This doubled the average wage, helped ensure a stable workforce and likely boosted sales as the workers could now afford to buy the cars they were making. Henry Ford was also famous for inventing the modern 'weekend' by making Saturday and Sunday days off for his staff by 1926; a move that was eventually copied around the world.

Turning to modern day examples, Herb Kelleher, founder of Southwest Airlines (a recent Oldfield Partners holding), is quoted as saying "If the employees come first then they're happy,

…a motivated employee treats the customers well. The customer is happy, so they keep coming back…it's just the way it works." From 1990 to today Southwest Airlines outperformed the MSCI World by 5.5% per annum despite the effects on the business over the last twelve months of the pandemic.

Another Oldfield Partners holding that has placed more emphasis on employees than competitors is the Swedish bank Svenska Handelsbanken. There are several points of differentiation in how Handelsbanken manages its employees including increased responsibility and increased recognition with a unique remuneration structure. At the heart of all of this is a decentralised model of branch-based lending that was initiated by Jan Wallander, CEO of the company from 1970-1978. This is the core of the company's ethos today. Since 1971 Handelsbanken has generated a return on equity in excess of its peers every year and over the last twenty years Handelsbanken has delivered a total shareholder return of 7.6% per annum compared with an index of global banks of 1.9% per annum.

Why is it that these organisations have succeeded for shareholders despite the expectation of poor performance from some analysts such as the one that covered Costco? We believe that looking after your employees results in reduced employee churn. This has major benefits, such as reduced costs of hiring and training along with other intangible benefits to productivity such as treating customers well. In addition, employees that expect to be in the job for a long time will focus on creating long term value rather than short-term profits and are therefore better aligned with long term shareholders.

John Kay wrote in 2012 about the principle of obliquity, where complex goals are best achieved indirectly. Bear Stearns was an example he gave of a company that focussed specifically on the goal of making money. It hung a sign on the trading floor asserting "we make nothing but money." Bear Stearns was bailed out by a combination of the Federal Reserve and JP Morgan. Kay's article gave many other examples of how the most successful businesses were not the most profit orientated.

Many of today's largest companies put customer experience ahead of profits at the outset and the value they create is based on their intangible assets. As a result, the focus on the people who create those positive customer experiences and hence intangible assets has never been more important. It is not to say that other factors are not relevant, but as the economy has shifted from manufacturing to services, the importance of employees has increased. Assessing companies for their employee well-being and satisfaction is a core part of our investment process and we are continually on the search for companies that care for their employees.

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The value of all investments and the income from them can go down as well as up; this may be due, in part, to exchange rate fluctuations. Past performance is not necessarily a guide to future performance.