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Lessons From Watson Wyatt's 2005 HCI

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Eight years of research into Watson Wyatt's Human Capital Index® (HCI) has consistently found a strong correlation between effective HR program design and financial performance. Indeed, the link goes beyond correlation: Effective HR programs are a leading indicator of financial performance.

The 2005 HCI investigated these increases in value. Analyzing an HR program's effects requires an understanding of how each program element affects the key drivers of financial performance. Although many factors drive organizational success — including industry, business cycle and technology — we focus on how HR policies and programs can drive business success by shaping employee attitudes and behavior.

The previous two *Insider* articles on the HCI (see *Watson Wyatt Insider*, September and October 2005) looked at both the short-term and the long-term costs of employee turnover. Recruiting new employees imposes short-term hard-dollar costs, as well as significant productivity losses from workforce vacancies and associated disruptions. Taking a longer view, however, the productivity effects of turnover — positive, negative or neutral — tend to dominate. Turnover quality ultimately determines whether long-term productivity rises or falls, which in turn drives financial performance.

This article begins to peel the process back further. We examine the effects of employee commitment and engagement on turnover and productivity. We discuss a methodology for assessing the effect of HR programs and policies on employees' commitment and engagement. We measure the link between employees' ratings of total rewards elements and their commitment and engagement. Watson Wyatt's HCI has found that organizations with a clearly defined total rewards strategy that substantially differentiates top performers from average performers significantly outperform other organizations. This article explores the mechanism we believe drives this result: the use of the total rewards strategy and program design to attract, retain and motivate key employees.

It is important to note that the research and findings in this article pertain to a generic workforce. For any specific company, achieving a sustainable competitive advantage begins with a human capital strategy designed to meet the company's specific business objectives and associated workforce needs.

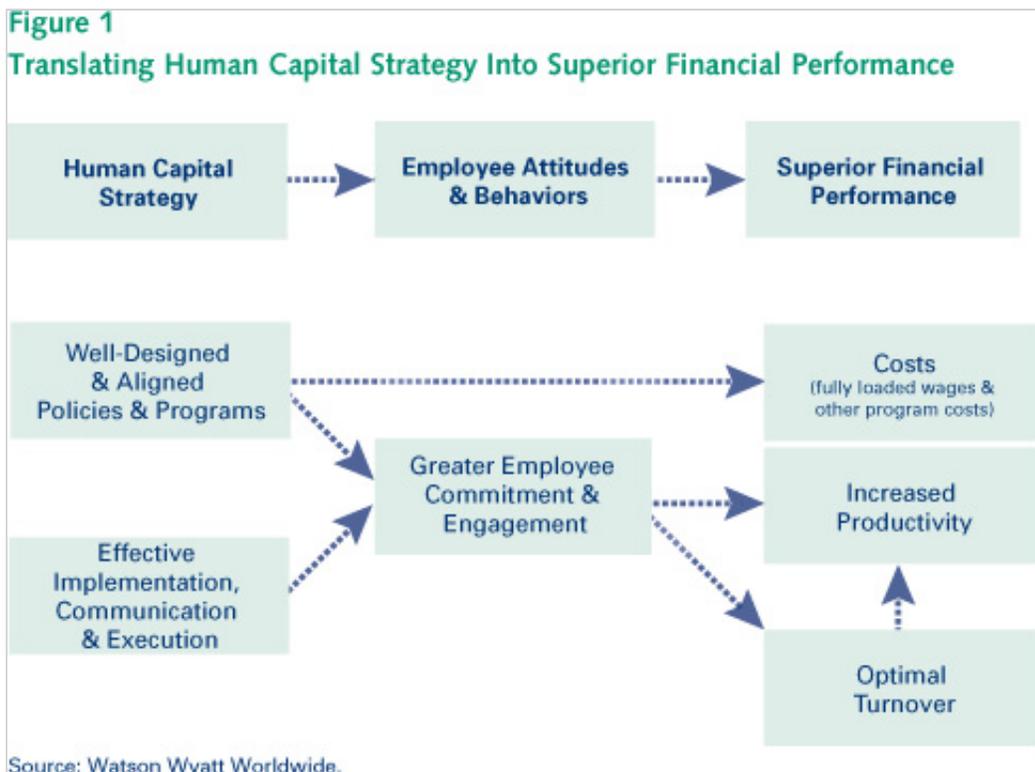


Figure 1 shows the model we use to link a human capital strategy to superior financial performance. As you can see, the strategy encompasses both the design and the delivery. A program is only as effective as its communication and implementation. A well-designed, effectively implemented and communicated human capital strategy will boost both employee commitment and employee engagement. These in turn will reduce turnover risk and enhance productivity. The program's design also largely determines its cost, including fully loaded wages and other costs such as training, communication and HR program administration. A firm can achieve superior performance only if the benefits — improved retention and productivity — exceed their costs.

THE KEY LINKAGES BETWEEN HUMAN CAPITAL PROGRAMS AND FINANCIAL PERFORMANCE

As shown in Figure 1, a company's human capital strategy affects the firm's financial performance in several areas. This article focuses on a few key linkages:

- The relationship between satisfaction with human capital programs and employee commitment and engagement
- The relationship between employee commitment and turnover (both risk and cost)
- The relationship between employee engagement and productivity

An unsurprising but important insight from research into employee opinions is that different employees evaluate programs differently. For example, long-tenure employees in their late 50s covered by a defined benefit plan are likely to value their retirement plan more highly than other workers. Entry-level employees may be more interested in training programs and other opportunities for career advancement.

Although some differences are predictable, others are driven by variations within demographic

groups. For example, some employees find incentive and pay-at-risk programs motivating, while others in the same demographic consider them too risky. At this point, we ignore such variations in preferences, instead focusing on how improving employee satisfaction with each element within total rewards boosts overall engagement and commitment. We do not project the return on investment (ROI) of specific changes to particular programs in this analysis — although in practice the model is set up to do it. It is important to note that by focusing on average effects on the overall workforce, we are underestimating the potential impact of changes targeted to specific employee populations. It is fair to say that this approach yields a conservative estimate of the possibilities for change.

There is a strong relationship between high employee engagement/commitment and satisfaction with key elements of the total rewards package (Table 1). Highly committed and engaged employees tend to be satisfied with their total rewards package. This is not surprising and does not in itself link satisfaction with total rewards with engagement or commitment.

Table 1
Highly Committed and Engaged Employees Rate the Elements of Their Total Rewards Packages* More Favorably

	Commitment		Engagement	
	High	Low	High	Low
Compensation & benefits	47%	6%	63%	10%
Training & development	52%	8%	79%	12%
Work environment	60%	12%	86%	16%

*Percentage of employees with high or low commitment and engagement who rated this element of the total rewards package favorably.

Source: *WorkUSA® 2004/2005: Effective Employees Drive Financial Results.*

We can achieve similar results by using regression analysis to control for factors such as employee demographics, industry and ratings in other areas. After doing so, these elements of total rewards still emerge as significant drivers of engagement and commitment — although communication, leadership, performance management and other factors also play significant roles. The regression analysis also projects how engagement or commitment rises as employees respond more favorably to one element, holding all other factors constant.

It is much easier to measure one element while holding all others constant in a statistical analysis than in real life — where effects vary depending on communication, execution, timing and external market conditions. For example, employees may be satisfied with much less when jobs are scarce than when they have plenty of employment choices. And the effects of multiple changes are difficult to measure individually — the total impact will be very different from the sum of its parts. Finally, changes to individual elements of the total rewards package are likely to change employee attitudes in a number of areas — creating “snowball” effects that magnify the results, either positively or negatively. We ignore those effects here, again increasing the likelihood that our estimates understate the possibilities.

Table 2 shows the rise in the probability of engagement and commitment achieved by improving compensation and benefits, training and development, and the work environment. We based these findings on data from *WorkUSA® 2004/2005: Effective Employees Drive Financial Results*, which is a nationally representative sample, and the estimates are averaged over the general population — individual effects would vary based on many factors, including employee

characteristics.

Table 2
Estimated Impact of Satisfaction With Elements of Total Rewards on Commitment and Engagement

Total Rewards Element	% Impact on High Commitment	% Impact on High Engagement
Compensation & benefits	15.7%	0.3%
Training & development	0.7%	0.5%
Work environment	1.8%	1.3%

Source: *WorkUSA® 2004/2005: Effective Employees Drive Financial Results.*

The next step is a three-way link: from engagement to productivity and commitment to turnover. In Table 3, we demonstrate how higher commitment affects turnover. Assuming that turnover risk from high-commitment employees is 10 percent, and turnover risk from low-commitment employees is 60 percent, the turnover risk differential is 50 percent. Our hypothetical company has 10,000 employees, turnover costs 60 percent of an employee's wage and the average wage is \$60,000. So for every employee who decides to stay, the company would save \$36,000. Under these assumptions, a 1 percentage point decrease in turnover risk would translate into 100 fewer turnovers — thus saving an estimated \$3.6 million.

Table 3
Change in Turnover Risk Associated With Changes in Satisfaction With Elements of Total Rewards

Total Rewards Element	% Impact on High Commitment	% Impact on Turnover Risk	Turnover Savings
Compensation & benefits	15.7%	8.8%	\$31.7 million
Training & development	0.7%	0.4%	\$1.4 million
Work environment	1.8%	0.9%	\$3.2 million

Source: *Watson Wyatt Worldwide.*

The other significant source of gains is increased productivity spurred by higher employee engagement. In *WorkUSA® 2004/2005: Effective Employees Drive Financial Results*, we demonstrated a strong relationship between employee engagement and firm financial performance. Employees who are highly engaged both have a clear line of sight (they know how to help their organization succeed) and are enabled to do it (they have the resources, training and tools to do their job well). They are more productive than employees who either lack the resources they need or are not sure how their job fits into the company's goals.

Measures of productivity usually vary widely both within organizations and across them. For example, within a company, productivity may mean very different things for the sales force and for the assembly line. A retail organization might measure productivity by sales per square foot, while a mining firm might measure it by pounds of processed ore per employee. However, one commonly used metric — sales revenue per employee — is available for thousands of publicly traded companies. It can be used to benchmark productivity across organizations, especially after controlling for industry and capital intensity. An even better metric is value added per employee, which refines sales-per-employee by deducting the cost of purchased materials to more accurately

measure value added and potential profitability.

The productivity differential between highly and nonhighly engaged employees also varies by employee characteristics, the job and organizational culture. For example, the productivity differential will be smaller at strictly hierarchical organizations that discourage initiative than at organizations that give employees more autonomy, either individually or through self-directed work teams. Some academic research has found productivity differentials of between 50 percent and 70 percent among employees in the same or similar positions within an organization.

If we assume that productivity per average employee is \$100,000, the estimated productivity differential would be between \$50,000 and \$70,000. In this case, a 1 percentage point increase in the probability of high engagement would add value to the tune of between \$5 million and \$7 million. Table 4 projects the jump in productivity associated with improvements in the three elements of total rewards.

Table 4
Estimated Impact of Satisfaction With Elements of Total Rewards on Engagement and Productivity

Total Rewards Element	% Impact on High Engagement	Impact on Productivity
Compensation & benefits	0.3%	\$1.5 – \$2.1 million
Training & development	0.5%	\$2.5 – \$3.5 million
Work environment	1.3%	\$6.5 – \$9.1 million

Source: Watson Wyatt Worldwide.

This analysis estimated the impact of higher employee ratings of three elements of the total rewards program. The next step would be to forecast ROI — the return on these improvements in light of their cost. To do so, we would need to analyze the program's design, the projected cost (and savings) and the projected effects on each segment of the employee population. Such a detailed analysis is clearly beyond the scope of this article. However, a complete analysis would yield results comparable to those shown in Table 5.

Table 5
Estimated Financial Impact of Satisfaction With Elements of Total Rewards

Total Rewards Element	Turnover Savings	Impact on Productivity	Program Cost*	Net ROI*
Compensation & benefits	\$31.7M	\$1.5 – \$2.1M	\$25 – \$30M	11% – 35%
Training & development	\$1.4M	\$2.5 – \$3.5M	\$3.0 – \$4.5M	-13% – 63%
Work environment	\$3.2M	\$6.5 – \$9.1M	\$5.0 – \$7.5M	29% – 146%

* Note: these numbers are purely for illustrative purposes and are not intended to be taken as a measure of the actual cost of or returns on these program changes.

Source: Watson Wyatt Worldwide.

CONCLUSION

The Watson Wyatt HCI has repeatedly demonstrated a significant, robust relationship between a firm's HR programs and its financial performance. To achieve these gains, however, organizations must implement programs that are appropriate for their workforce, their market and their business strategy. This analysis demonstrated the link between the value of employers' rewards programs to employees and employee commitment and engagement. By reducing turnover and increasing productivity, this relationship translates into stronger financial performance.

The numbers and analysis in this article outline the possibilities in very broad strokes. Real-life success would require a much deeper analysis to devise a customized plan. It would also require effective implementation and communication, with particular emphasis on those changes with the greatest range of potential outcomes, as well as an analysis of how proposed changes could spill over into other areas that drive employee engagement and commitment.

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