Morgan Stanley

INVESTMENT MANAGEMENT

Different People: Human Capital Management and Diversity

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An increasing proportion of millennials in the workforce, many of whom seek employers offering greater flexibility and who reflect their own values, means that companies need to evolve their strategies to attract the best young talent. Add to this the trends of an ageing global population, low unemployment and countries tightening immigration policies, then good Human Capital Management (HCM)—which falls primarily under the Social 'S' pillar of ESG—becomes clearer than ever for a company's competitiveness.

For the stereotypical 20th century business, big factories and heavy equipment may have been perceived as the keys to gaining competitive advantage. In reality, the latter part of the century saw significant changes in many businesses to the extent that today, many firms are focusing instead on cultivating smart labour forces that can adapt quickly to change. The advantages can be, in the words of the rock band *No Doubt*, "a spectacular surprise."

As many readers will be aware, the philosopher and economist Adam Smith had an opinion on most things including human capital, which he defined as "the acquired and useful abilities of all the inhabitants or members of the society."[1] More than 200 years later, this definition still provides an appropriate starting point for our latest monthly outlook.

Dominant trend: An ageing global population

With declines in fertility rates and increased life expectancy, the global labour force is ageing rapidly. The median age of the advanced economies is now around 40, but even China and

[1] *Adam Smith: An Inquiry Into the Nature and Causes of the Wealth of Nations Book 2 – Of the Nature, Accumulation, and Employment of Stock* (Published 1776).

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He and she, two different people
With two separate lives
Then you put the two together
And get a spectacular surprise

— Different People, by *No Doubt*

Korea are rapidly catching up.[2] In fact, Korea is projected to have the highest median age in the world by 2050.[2] The net effect of these trends has been a reduction in aggregate labour supply as older workers retire.

While this trend has been in place for developed countries for some time, the global dependency ratio—the ratio of nonworking-age to working-age population—has also been rising since 2011, following 45 years of improvement.[3] This has been partially offset in three ways: increased female labour force participation, delayed retirement and increased immigration. The question is whether this is enough.

More women working

Because the increase in female labour force participation has been pronounced in most developed nations for some time, this low-hanging fruit has likely been exhausted for those economies. However, Japan provides a good case study. Their workforce is among the world's oldest, with a historically low level of female participation—which Prime Minister Abe's "Womenomics" campaign explicitly aimed to increase. He was elected in 2011, and from 2012 Japan saw a big shift in female participation *(Display 1)*.

Retirement dates delayed

Delayed retirement keeps people working longer and eases pressures on pensions. It also ties in with other social forces like the breakup of the family. Whereas in the past the family unit generally took care of its senior members, now people tend to take care of themselves. And in places like the United States where divorce rates are high, even the nuclear family is no longer a reliable unit.

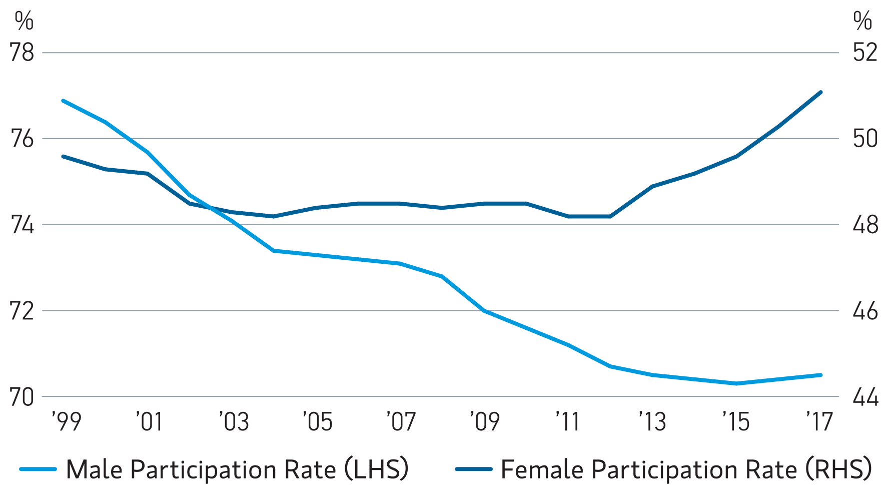
Migration could relieve labour shortages

Positive net migration has been the third way by which countries have been able to increase their labour supply. However, a recent shift towards more stringent migration policies makes it more challenging for companies to find the necessary skilled labour—a dynamic that is starting to hurt some economies.

Major economies including the U.S., U.K., Germany and Japan are either at or very close to full employment *(Display 2)*. They simply do not have enough people to fill jobs. For example, Germany—where a shortage in skilled labour is clashing with citizens' anxiety over immigration—is planning to introduce a new law to attract skilled migration from outside the European Union (EU) by the end of this year.

DISPLAY 1

In Japan, a sharp increase in women at work

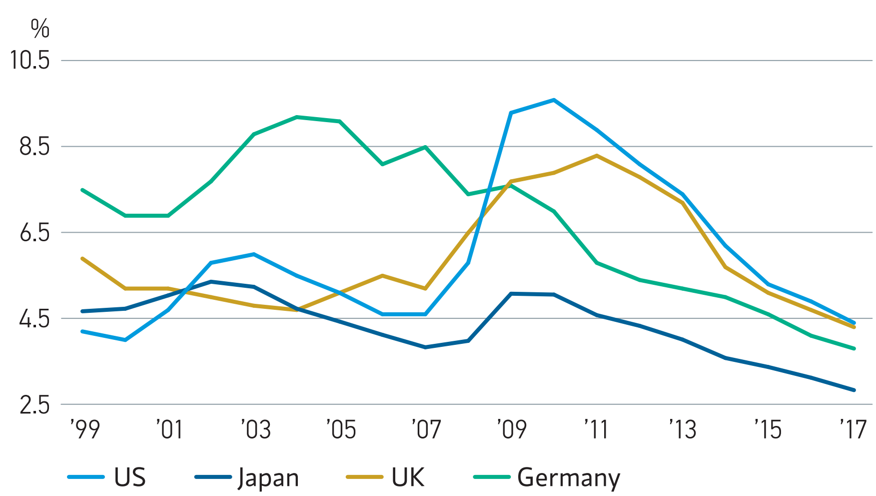


Source: Financial Times, Japan's Culture of Discrimination Saps 'Womenomics', 28 August 2018. https://www.ft.com/content/2d05e910-a45e-11e8-8ecf-a7ae1beff35b

DISPLAY 2

Low unemployment is causing shortage of skilled labour

Unemployment Rate



Source: OECD. https://data.oecd.org/unemp/unemployment-rate.htm

[2] Reserve Bank of Australia (RBA), Bulletin – December Quarter 2017. https://www.rba.gov.au/publications/bulletin/2017/dec/5.html

[3] United Nations World Population Prospects. Morgan Stanley Research. Projections refer to UN projections.

The new normal: Flexible work arrangements

Against this backdrop of labour shortages, companies are competing with one another to attract high-quality employees. The demands of the workforce—particularly new entrants—are evolving. Flexibility is one of the main job attributes they seek.

According to a Timewise-Ernst & Young study,[4] 87% of all U.K. full-time employees either work flexibly already or say they would like to. This number reaches 92% for young workers. Failing to offer flexibility could hurt share-price performance: Companies without flexible working schemes have underperformed the MSCI World Index over the last six years.[5]

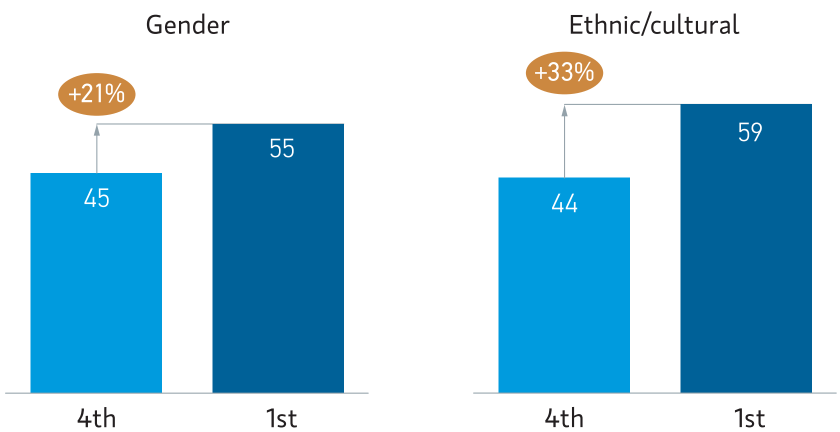
The desire for flexibility is often driven by family responsibilities such as the need to pick kids up from school. Morgan Stanley's Global Gender Diversity Composite looks into 14 indicators, including flexible working schemes and found that the percentage of companies in MSCI World reporting such programmes increased from 32% to 45% between 2008 and 2015. North America trails Asia-Pacific and Europe in terms of percentage of companies offering such schemes, at 32%, 56% and 51%, respectively.[5]

Where companies do not offer sufficient flexibility, people are increasingly moving to freelancing. According to the Freelancers Union, by 2027 freelancers could make up more than 50%[6] of the U.S. working population—including everyone from Uber drivers to lawyers and accountants. Between 2014 and 2017, the biggest increase in individuals working as freelancers was within the youngest cohort of 18 to 34.[7]

DISPLAY 3

Earning more with a mixed workforce

Likelihood of financial performance (earnings) above national industry median by diversity quartile (2017)



Source: McKinsey Diversity Matters Database.

Average EBIT margin, 2010-13 in Why Diversity Matters and 2011-15 in Delivering Through Diversity; Gender executive data: for 2014, N = 383; for 20173, N = 991; Ethnic/cultural executive data: for 2014, N = 364; for 2017, N = 5894

Let's examine the implications of these structural trends for businesses.

INVESTMENT IMPLICATION #1

Diversity has improved performance

There appears to be a linear relationship between a company's level of diversity and its financial performance. In 2017, companies that ranked in the top quartile for gender diversity in executive management were 21% more likely to experience above-average earnings than those in the bottom (4th) quartile (using a 'global data set' of 12 countries). Ethnic and cultural diversity also contributed to profitability: Top quartile companies were 33% more likely to outperform, compared to bottom quartile (less diverse) companies[8] *(Display 3)*.

These statistics are so striking that they warrant an explanation. Diversity expands the talent pool and strengthens customer orientation. A salesperson marketing products in Latin America is more likely to understand the customer if others on the sales team include someone from Latin America. According to research from the Center for Talent Innovation, when teams had one or more members representing the gender, ethnicity, culture, generation or sexual orientation of the team's target customer, the entire team was significantly more likely to say they understood that customer.[9]

[4] **Past performance is no guarantee of future results.** The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Timewise, Research produced in partnership with EY, Cite study, 19 September 2017. https://timewise.co.uk/wp-content/uploads/2017/09/Flexible_working_Talent_-Imperative.pdf.

[5] MS Sustainability Research. Lack of Flexible Working Can Impact Performance. Published 29 November 2017.

[6] Upwork and Freelancers Union Press Release. https://www.upwork.com/press/2017/10/17/freelancing-in-america-2017/. Published 17 October 2017. https://www.upwork.com/press/2017/10/17/freelancing-in-america-2017/.

[7] MS Sustainability Research. The Freelance Economy. Published 8 May 2018. Freelancers Union.

[8] Earnings cited are before interest and taxes; peer comparisons are made based on industry and geography. McKinsey & Company's Diversity Matters. Published January 2018.

[9] Diversity's Positive Impact on Innovation and Outcomes. Sylvia Ann Hewlett, Ripa Rashid and Laura Sherbin. Center for Talent Innovation and Hewlett Consulting Partners LLC.

These studies suggest that diversity also improves employee satisfaction by reducing conflicts between groups and increasing collaboration and loyalty. Instead of an "us versus them" mentality, diverse companies tend to have a more inclusive environment. Diversity tends to counteract groupthink-type situations, which can dampen innovation and lead to subpar decisions. Company reputations are also enhanced through diversity. Importantly, by casting a wider net in sourcing skilled workers, diversity-focused companies can win the war for talent and thus gain competitive advantages.

Along with the promise of improved performance, reputational consequences and legal requirements, employees and consumers are directly pushing companies to adapt their human capital practices, including those around diversity.

INVESTMENT IMPLICATION #2

Employee satisfaction also drives tangible results

Increasingly, employees are exerting pressure on companies to provide both flexible work arrangements and an engaging work environment. But building a happy, engaged workforce takes more than money: A recent study[10] found that 89% of respondents said they would consider making a lateral career move with no financial incentive in order to find greater personal satisfaction, pursue an entirely new career path or to take up a professional challenge.

Creating a work environment that is engaging and satisfying is proving to be good for companies' health: Those in the top quartile of employee engagement have had 22% higher profitability, 21% higher productivity and 10% higher customer satisfaction *(Display 4)*.

Companies with engaged workforces also recovered from the last recession at a faster rate (Gallup). Even companies' safety records seem to benefit from higher employee engagement, with more engaged work units having 49% fewer safety incidents (Gallup).

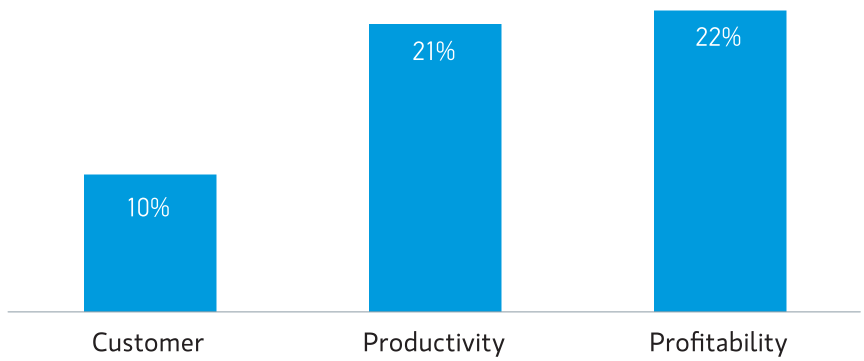
IMPLICATION #3

Customers: The other human resource

While engaged employees exert internal pressure on company behaviour, consumers—particularly younger ones—apply external pressure. For example, 51% of millennials said they would be more likely to buy products from a company where they agree with a CEO who actively speaks out on hotly debated current issues. Baby boomers, the least likely to factor the views of the CEO into their buying decisions, are diminishing in number. The future seems to favour companies whose customers agree with their outspoken views—a shift from the traditional approach of companies trying to stay out of current debates (Weber Shandwick).

DISPLAY 4

Key metrics are higher when employees are engaged

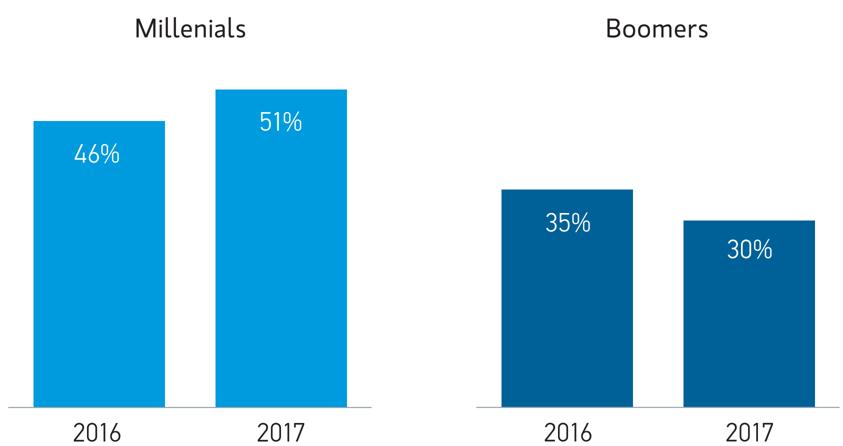


Source: Gallup; Workplace, 20 June 2013. *"How Employee Engagement Drives Growth"*. Susan Sorenson.

DISPLAY 5

Millennials influenced by outspoken CEOs

Portion of consumers more likely to buy when in agreement with the CEO who speaks out on hotly debated issues



Source: CEO Activism in 2017: High Noon in the C-Suite. Weber Shandwick. https://www.webershandwick.com/wp-content/uploads/2018/04/ceo-activism-in-2017-high-noon-in-the-c-suite-1.pdf

[10] Cornerstone. Career Trends Report. Study as of September 2015. https://www.cornerstoneondemand.com/careertrendsreport.

Human capital: Key to sustainability

An ageing workforce, more recently the trend of rising populism and countries adopting tighter immigration policies, has reduced the pool of employees available to companies in those countries. Like any scarce resource, human capital needs to be protected and nurtured.

To compete effectively, companies should consider engaging employees, offering flexible work arrangements, providing training and promoting diversity. All are crucial to maintaining and attracting talent, the lifeblood of innovation and productivity.

Over time, we believe companies that are good stewards of human capital will build sustainable competitive advantages that will translate into shareholder value. We therefore pay attention to companies' social scores—which encompass human capital issues—in building our portfolios. The social pillar includes working conditions, discrimination policy, diversity programmes and employee turnover rate.

Together, we believe that strong social behaviour can lead to significantly better financial results—a "spectacular surprise" in the words of the rock band *No Doubt*.

Risk Considerations

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