

When your people go the extra mile

Companies high in discretionary energy perform better on the stock market.

When employees expend more energy than what is required of them, companies see direct and positive business outcomes: Total shareholder return (TSR) outperformance of 9% on an annualized basis. On a risk-adjusted basis, the same market simulation conducted by the Korn Ferry Institute shows that companies with high discretionary energy do twice as well as companies low in discretionary energy. High discretionary energy companies also receive better credit ratings, indicating business sustainability.

Creating shareholder value is often used as a key metric to measure the performance of a firm. According to Jensen and Meckling's theory of the firm (1976), a company has a duty to maximize value for its shareholders. Vermaelen (2014) defines shareholder value as the present value of future expected cash flows over time. In many countries, corporate directors and managers, as representatives of the firm, have a fiduciary duty to pursue sustainable long-term value maximization for the shareholders.

Korn Ferry Institute's earlier research on organizational performance demonstrated that companies that have

the right combination of seven conditions—among them organization enablers, such as a compelling, purposeful vision, and people drivers, such as the right talent who are committed and aligned, and an inspiring leadership team—could elicit higher discretionary energy¹ from their employees. As a result, these companies also tend to enjoy better business performance, seeing up to 16.3% higher three-year earnings before interest, tax, depreciation, and amortization (EBITDA) margins and 8.1% higher three-year return on assets (ROA) margins (Huang, Chowdhury & Ho, 2017).

Figure 1

Discretionary energy is generated only when there is the right balance of leadership, people drivers, and organizational enablers.



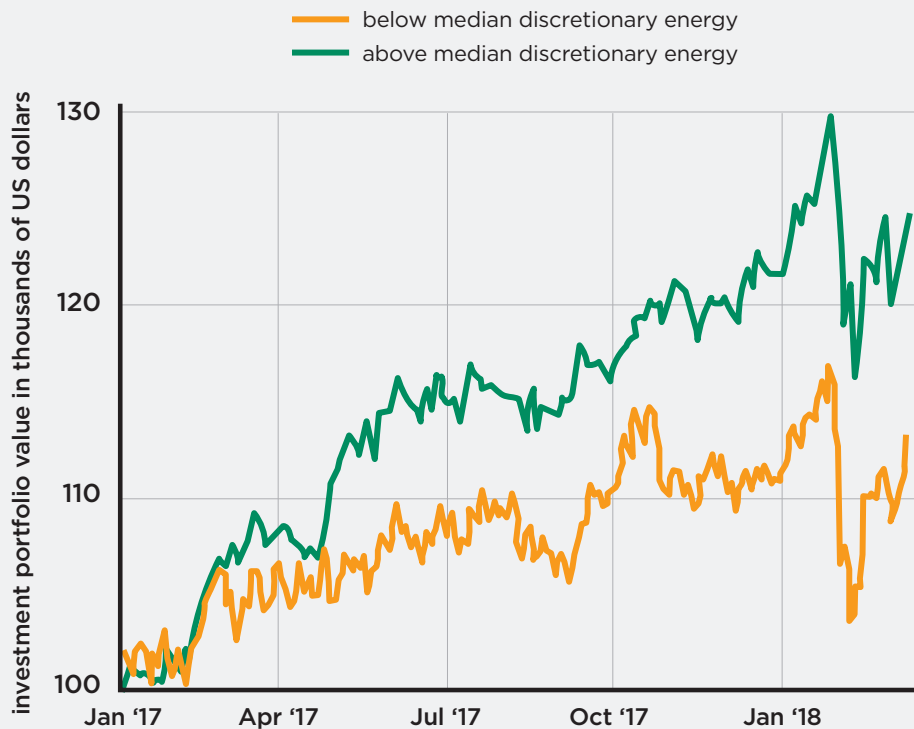
¹ To construct the discretionary energy index, a statistical approach based on factor analysis was used, for which each superior performance model (SPM) dimension (Figure 1) was weighted with respect to its proportion of variance derived from factor analysis in the data (OECD, 2005). Data was collected primarily through an online survey. In some cases, the SPM diagnostic was administered directly to clients' senior management teams, with the assistance of Korn Ferry Hay Group consultants. More than 1,000 employees participated in the study, of which 53% were senior management, 33% middle management, and 14% individual contributors.

A key question, however, remains: could these companies high in discretionary energy also generate higher value for their owners—that is, the shareholders?

Discretionary energy refers to employees' willingness and ability to go above and beyond what is expected in their current roles. The question, therefore, is: does it pay for companies to invest time, effort, and finances into creating an organizational infrastructure that takes into consideration the various conditions required for success? This question is based on the concept of creating value where management's decisions—be it in developing a vision, designing the organization, selecting the right people, or executing the strategy—will contribute to and generate a return on investment (ROI), which can increase the share price and pay larger dividends to its shareholders over the longer term (Vermaelen, 2014).

Figure 2

The Korn Ferry Institute studied how companies with high discretionary energy performed over the course of 12 months compared to those who have low discretionary energy. The starting value of each portfolio on January 3, 2017² was US\$100,000.



² The markets were not open on New Year's Day, January 1, 2017.

High discretionary energy companies significantly outperform low discretionary energy companies

Total shareholder return (TSR) is a common way to measure business performance and is often considered the single best indicator of a company's success (Favaro & Rotz, 2011). TSR represents the change in a company's stock price for a given period as a percentage of the beginning stock price plus its dividends. For instance, if a company had a stock price of US\$100 at the beginning of 2017 and a stock price of \$105 and dividends of \$2 at the end of 2017, its TSR for 2017 was 7%.

In this analysis, TSR was tracked for 43 companies representing three major industries: Technology/Telecommunications (43%), Healthcare/Life Sciences (23%), and Financial (11%). Other sectors made up the rest (45%), and were categorized as high discretionary energy or low discretionary energy. Two hypothetical portfolios starting at US\$100,000 on January 3, 2017, were constructed for the two groups of companies, and equal investments were made in each portfolio.

Over the course of 2017 to early 2018, companies with high discretionary energy clearly outperformed companies with low discretionary energy. At the end of the investment period, the high discretionary energy portfolio had a value of roughly US\$125,000, whereas the low discretionary energy portfolio had a value of roughly US\$113,000. On an annualized basis, this difference in return amounts to a TSR outperformance of 9%.

Figure 3

Company performance was also measured on a risk-adjusted basis using the Sharpe Ratio (Johnson & Soenen, 2003) and credit ratings. Similar to the results seen by TSR performance, high discretionary energy companies outperform their low discretionary energy counterparts with a Sharpe Ratio 2.3 times higher and with a credit rating two points lower (i.e., more positive).

	Low discretionary energy portfolio	High discretionary energy portfolio
Initial portfolio value	100,000	100,000
Ending portfolio value	113,216	124,882
Returns over the period	13%	25%
Annualized returns	11%	20%
Sharpe Ratio	0.80	1.83
Credit risk (lower is more positive)	8.7	6.7

³ The Sharpe Ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. This measure is often used by portfolio managers to analyze the performance discounted by the risk.

⁴ A better (lower) credit rating suggests that a firm is expected to sustain its business performance and, as a result, is deemed to be less likely to default on its debt obligations. Credit ratings were obtained from Moody's and S&P.

Harnessing discretionary energy of the workforce

Unleashing employees' discretionary energy can be achieved in part by giving them the right tools, conditions, and structure they need to do great work.

Based on the study of superior performing organizations, Korn Ferry found three empirical factors that contribute to the concept of the discretionary energy index (Figure 4), indicating that organizations need to work toward a clear and compelling direction and strategy; a capable, committed, and motivated workforce; and an infrastructure of systems and processes that is aligned with and clearly supports the business strategy (see sidebar).

For employees to go the extra mile and not count the cost, they are first aligned in terms of what the organization stands for—that is, their personal beliefs and values are in sync with that of the organization.

For this to happen, the company must not only have a clear direction and strategy, but these must be clearly articulated and understood by employees, requiring constant open, transparent, and two-way communication. Once employees are aligned on vision and purpose, they will look within the organization and themselves and ask: Does the infrastructure of the company confirm the vision and mission? Do we have the right people and skill sets to execute the mission? Are others in the company committed to the larger goal? If the answers to these questions are in the affirmative, then excitement within the employee is rising! The final icing on the cake is whether people are clear about what is expected of them as individuals and as a team, and are they rewarded equitably for the work they do. Do the organizational practices support a performance-driven environment, such as a reward system that is aligned with the business strategy and compensation integrated with other HR practices? These three empirical factors are captured in Figure 4, below.

Is your organization harnessing discretionary energy?

Factor I: Clear Direction & Strategy

- What does the organization stand for?
- What does the organization intend to achieve?
- How does the organization plan to achieve?

Factor II: Capable and Committed Workforce

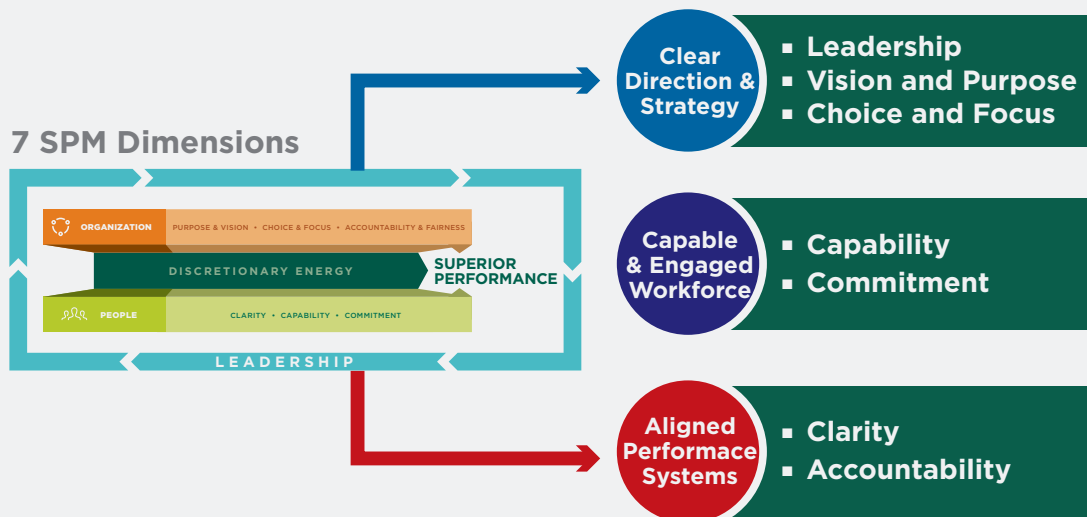
- Does the organization have the right people?
- Are people motivated to contribute?
- Does the organization use talent information systems to deploy best-fit talent into pivotal roles?

Factor III: Aligned Performance Systems

- Are people doing the right things?
- Does the organization reward the right behavior?
- Is the reward strategy aligned with the business strategy?

Figure 4

Three empirical factors, consisting of seven superior performance dimensions, contribute to the concept of discretionary energy.



Of the three factors, **Capable and Engaged Workforce**, referring to the supply, stock, and motivation of talent to meet current and future business needs, contributed the most to the discretionary energy index with 38%. This result adds to empirical evidence showing that people are the preeminent organizational resource and key to achieving outstanding performance (Pfeffer, 1994; Huselid, 1995).

The contribution of **Clear Direction and Strategy** to the discretionary energy index comes in a close second at 34%. This indicates that the leadership's ability to define and mobilize the organization around their strategies are quintessential in this increasingly Volatile, Uncertain, Complex, and Ambiguous (VUCA) world (Mack, Khare, Krämer & Burgartz, 2015).

The third factor, **Aligned Performance Systems**, representing the clarity, fairness, and connectedness of the organization's infrastructure, explained 28% of the discretionary energy variance. Clarity around job roles, duties, expectations, and how work contributes to success are known to bolster engagement, job satisfaction, and personal job performance. For employees to give their best, this must corroborate with a fair rewards structure; i.e., employees must understand how pay rates are determined, believe that it is related to performance, and know what is required to earn a raise (Lewis & Hezlett, 2016).

Conclusion

Companies must work toward the right mix of organizational enablers and people drivers to bring about the release of discretionary energy from their employees. Just being outstanding or most admired in one aspect of organizational success will not lead to sustainable business performance or controlled business risk. As organizations fight to remain competitive in an ever-changing, turbulent business environment, they will need to consider the following:

1. Determine a way to see if there is adequate focus and synergy among the superior performance factors in your organization. You will need to have the right measures in place to allow you to see the degree of discretionary energy that will likely be generated.
2. Establish a champion or team of champions to put a constant focus on discretionary energy. In the busyness of day-to-day business goals and objectives, it will help to have a champion or team to regularly maintain the conversation around the balance and synergy required for superior business performance (i.e., profitability, management efficiency, shareholder returns).
3. Track your discretionary energy regularly. Keep in mind that, like a health checkup, regular monitoring will enable you to detect problems before they start. They also can help you identify problems early, when your chances for treatment and cure are better. Thus, by getting regular discretionary energy screenings, you are taking steps that help the business to keep on track with its strategic goals and take immediate remedial action on red-flagged areas.

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The Korn Ferry Institute, our research and analytics arm, was established to share intelligence and expert points of view on talent and leadership. Through studies, books, and a quarterly magazine, *Briefings*, we aim to increase understanding of how strategic talent decisions contribute to competitive advantage, growth, and success. Visit kornferryinstitute.com for more information.