Bob Huebscher: Hi, it's Bob Huebscher. And this is the Gaining Perspective podcast where we bring you insightful conversations with some of the top thought leaders in the investment advisor profession and investment management industry. I am the founder of Advisor Perspectives and a vice chairman of VettaFi.

Today's episode, we'll focus on the human capital factor, or HCF. This factor applies workplace behavioral science, financial acumen, and deep data science to capture the powerful connection between human capital and stock performance. By understanding company culture and intrinsic employee motivation, my guests have transformed those insights into investment strategies for advisors looking for a way to generate additional alpha in client portfolios, understanding the HCF, and how these products fit in a portfolio can lead to better returns and greater client satisfaction.

And my guests today are David van Adelsberg. He is the founding partner of Irrational Capital. And Kristof Gleich. He is the President and Chief Investment Officer at Harbor Capital Advisors. So, I'm going to start off by having each of you tell me about your career paths, what led you to join your firms, your roles there. And then also explain the relationship between Harbor and Irrational, and how that came about. So, Kristof, I'll start with you.

Kristof Gleich: Sure. It's great to be here. So, quick bit of background about myself. I'm originally from the UK, born and raised. I graduated with an undergraduate degree in physics. And after studying physics, I then transitioned to work in the city. And I worked for Goldman Sachs for a number of years before joining J.P. Morgan. And then moved to the US about eight years ago. And have been at Harbor as the CIO and the president for the last five years, where I'm responsible for overseeing our investments platform.

Bob Huebscher: And David?

David van Adels...: Hi, I'm David van Adelsberg. My career spans three strands prior to the founding of Irrational Capital. The first is in tech and big tech. I worked for IBM. And I spent a decade in the HR consulting and training space before making a transition into financial services in the early 2000s. Irrational Capital sits at the middle of these three disciplines, technology, human capital, and financial services.

And I approached Dan Ariely, who you may know and your listeners may know, who's the very well known behavioral economist and social scientist. Dan had been studying human motivation in the workplace for his entire career. And both of us had had the experience where almost every manager that we'd encountered said something to the effect of, "People are our most important asset."

And if they were most important, we thought, "Well, let's see if we can measure it. And if they're an asset, let's see if we can provide investible access." And I know you asked a little bit about the relationship between Harbor and Irrational. And that's probably best for Kristof to mention because he found us as a result of the first of four research papers, research notes that were published by J.P. Morgan.

Bob Huebscher: So Kristof, tell me about that relationship.

Kristof Gleich: Alrighty. So, about three years ago I came across some research, spelled out the link or certainly hypothesized the link between human capital and stock market performance. Now that we're in the business of providing strong investment results for our clients, we're in the business of finding different money managers from across the world that have an edge. And in public markets, there's been a lot written about this, are generally pretty efficient.

And so, to find an edge, you need to look further for inefficiencies. And we came across this notion and this research that if you could somehow measure the value of human capital, and instead of as an expense on an income statement but you could treat it as an asset, you could find an investment strategy that could beat the market with a high degree of consistency. It's a very difficult thing to do.

It's a very difficult thing to measure. It is truly unique, with a word that is overused in our industry. And I was drawn in that we could partner with Irrational Capital and launch a distinctive suite of ETFs that we think can produce alpha and help advisors building portfolios the country over build stronger returns for their clients. And that's what kind of drew me in. And happy to jump into more details.

Bob Huebscher: Great. And just so we understand, Irrational is the sub-advisor to your funds, am I correct?

Kristof Gleich: Yeah. They're the index provider. But essentially, they're behind the stock selection, if you like, that feeds into the ETFs. And then Harbor tracks those indices that Irrational Capital put together.

Bob Huebscher: So David, tell me about your research in how you connected the dots between corporate culture and stock market performance.

David van Adels...: To make that connection, it really all starts and maybe it ends with data. Essentially, the perception of employees about their employer. And we have two types of data. The first is proprietary. So, when you think of this, think of employer sponsored 360 degree feedback or surveys. And that's company sponsored. And that goes from the frontline all the way up to the C-suite, and some cases, even into the boardroom.

That's the first type of data. The second is publicly available data. This is sort of the usual suspects where people opt in to provide feedback, employees opt in to provide feedback about their employer. We fuse these two data sets together. Our dataset is very large. It's stable. It's longstanding, longstanding in the sense that in some cases it goes back to 2006. And it provides extensive coverage.

So, just to give you a sense of that scope, we have 100% coverage of the S&P, over 95% of the Russell 1000, and excess of 80% of the Russell 2000. And it's from this very large, massive data set, which is refreshed on an annual basis, that we rate each company. We do that again annually. I'm happy to talk about that process if you like. And we essentially from that calculate using this behavioral data only a numeric rating for each company that we call a company's human capital factor rating.

Bob Huebscher: I am interested in that process. And I'm most interested in the specific variables that you are measuring to create that human capital factor. And just talk about that.

David van Adels...: Think of the collection of data, right? Employees providing the perception about their employer across an array of behavioral characteristics or factors, view of management, is the company going in the right direction? The perception around autonomy, levels of trust, effectiveness, efficiency, levels of motivation, how much bureaucracy, is this a fair place to work? Do I feel as though I'm valued?

All the way through to items around that are sort of the usual suspects, compensation, benefits, number of training hours, and so on. And when we looked at the data, what struck us and what was so fascinating, is that it bifurcates into what social scientists call intrinsic and extrinsic motivating characteristics. So, to make this simple, the intrinsic elements are things that are really deeply emotive, right? So, we feel them very personally.

And the extrinsic are things that are easier to count, right, levels of compensation. And what really is interesting is that the intrinsic characteristics, which we organize into six different dimensions of the human capital factor, have remarkably strong performance over time. So best, I'll just give you an example. So, the top one is organizational effectiveness.

Best versus worst over a 10-year period ending at the end of 2023, organizational effect have had an out performance of 5.9%. And you come all the way down, when you look at the extrinsic characteristics, so these are the things that are easier to count, it has a small signal. But nowhere near the level of the intrinsic characteristics. So, we blend all of these things together to create the human capital factor.

Bob Huebscher: So, when you say organizational effectiveness had a 5.9% difference, are you basically saying that the companies with the best organizational effectiveness outperform those with the worst by 5.9%?

David van Adels...: That's correct. Yep. Top quintile versus bottom quintile.

Bob Huebscher: Was there anything in the data that you found surprising or unexpected, particularly when it comes to motivating employees?

David van Adels...: The answer is yes. We're surprised often by the data. And we allow the data to really speak. So, let me just cite a couple of examples. One is compensation, right. It's a very usual suspect. The classical thinking is, "If we pay people more, they're going to feel better. And therefore, that's going to have some impact."

The truth of the matter is, what we found is that a sense of fairness around compensation. I feel as though I am fairly paid for the work that I do, that lights up the board. But the actual level of compensation over a certain threshold really doesn't. It's more of an extrinsic motivating characteristic.

The other thing is that timing makes a big difference. So, we saw some very interesting trends both coming into, during, and coming out of COVID. Coming into COVID, those companies that were well-positioned in terms of their human capital factor outperformed throughout the pandemic.

What was really interesting is in the early days and until the peak of COVID, what we saw was that those companies that created a sense of emotional security, a connection to the company, people felt embraced, those companies outperformed. And as we started to peak and come off, what was very interesting is that trust and flexibility, those firms that demonstrated trust and flexibility, really outperformed.

And I'll add one more, which is we've seen this throughout the entire data set and over a long period of time in terms of longevity. And that is that bureaucracy, those organizations which really have a high level of bureaucracy, stifle a lot of things. And those organizations that unleash their employees and trust them, outperform regardless of market conditions.

Kristof Gleich: Let me just jump in as well quickly from my perspective in terms of what surprised me and us through our extensive research work. So, look, the new investment factors do not come along very often. And it's our job when we're evaluating any investment on behalf of our clients to be cynical, and to kick the tires, and to do an awful amount of rigorous due diligence and investment research work.

And my original and our original hypothesis when we saw this research was perhaps it may be due to other common factors that are well known. So, factors are pretty established in investing. And by factors, I mean things like the value factor, or the quality factor, or the momentum factor. And what we sort of hypothesized is that maybe this was a way of capturing other well-known investment factors, but kind of repackaging them.

And so, we expected to see quality come through. We expected to see momentum come through, and explain a decent amount of the returns. However, what surprised us was actually how idiosyncratic, or if you like, unexplained that the returns were by other factors, which we then led to conclude were due to the human capital factor producing those returns. So, that really sort of surprised us in a positive way.

Bob Huebscher: Well, I can add to your dataset with one anecdotal point, which is my own experience, that paying people fairly, trusting them, giving them a flexible work environment, and charging them with responsibility is going to lead to a better outcome. I mean, as a manager who's built several businesses, that's the philosophy that I've always embraced. Kristof, how has this approach, the HCF and the strategies behind it, been received by advisors?

Kristof Gleich: Very positively. We now have three ETFs in the marketplace. And across the three ETFs, we have about 450 million of assets under management. So, they have gained early appeal and early traction. I think what resonates in much in the same example that you just shared Bob and your reaction, people have seen this.

It makes such intuitive sense to them that if you do right by the biggest asset, which is essentially people, giving them more respect, more freedom, more runway, more innovation, more creativity. And if you do those things and multiply those things millions or tens of millions of times across the entire market, that is going to result in stronger returns. And so, generally, people have leaned into the idea. But we're still in the early innings of establishing a new investment factor, the human capital factor, which is a really exciting time.

Bob Huebscher: What should advisors know about the ETFs that you've created, Kristof, that use the human capital factor? What is their risk management process? What are their expense ratios?

Kristof Gleich: They should know that all of these ETFs... So, let me just start with the tickers. So, there's HAPY, which is H-A-P-Y. HAPI, which is H-A-P-I. And HAPS, which is H-A-P-S. So, the commonality across all of these ETFs is that they are providing exposure to the human capital factor for different segments of the market at very attractive fees.

For example, from a total expense ratio, all appear in the cheapest quartile of their respective asset classes. Let me just sort of run through some of the differences between them. So, HAPY, which is the longest serving ETF, is the most concentrated ETF. And holds about 70 to 100 stocks on an equal weighted basis. And provides more all cap exposure.

And there's no kind of sector considerations to it. It just takes the best scoring stocks, puts them in an index on an equal weighted basis, and then constitutes that index every year. HAPI, and this was in response to client demand, does really something very similar, but does it in a slightly more diversified way.

And last, but by no means least, HAPS does everything I've just said, but it does it for small cap.

Bob Huebscher: Kristof, where have you seen advisors using these ETFs? How do they typically fit into client portfolios?

Kristof Gleich: Look, I'm sure a number of your listeners, probably all of your listeners, hold a fair degree of passive or index products or solutions in their overall client portfolios. So, what we found has resonated is especially on HAPI and HAPS, those are the sector neutral slightly more diversified versions, that they've been using them as a replacement to either a small cap index or a large cap index, depending on which part of the portfolio that they're looking at.

And then they are allocating to those as a source of alpha, of uncorrelated alpha, in their portfolios. HAPI at 35 basis points and HAPS at 64 basis points, we think are priced very, very competitively and provide real value for advisors portfolios.

Bob Huebscher: So, David, back to you. How can advisors take advantage of the HCF outside of committing allocations to the ETFs that you brought to market in partnership with Harbor?

David van Adels...: Sure. Well, first of all, we'd like them to take advantage of the ETFs. That's for sure. But if they're substantial in size, so for large asset managers, large institutional allocators, and broker, and advisor platforms, whether you're looking for a way in which to enhance a quantitative or a fundamental selection process, we offer access to the human capital factor or models in a variety of customized configurations. So, we can provide a human capital factor model or a portfolio covering a range of equity exposures and strategies. We can human capital factor an existing portfolio, or we can create something bespoke.

Bob Huebscher: If there's one key takeaway that each of you would like to leave with our audience of advisors about why the HCF and the related products are valuable to advisors and their clients, what would that be? Kristof, I'll start with you.

Kristof Gleich: Look, I think the market environment that we're now in, the 2020s, is a very different environment from the post-financial crisis era where essentially you could own any risk assets and generate decent, strong real returns for your clients. Returns are going to be harder to come by. And you have to look further afield to find sources of edge and alpha. And we think that the human capital factor really sort of crystallizes that and is a really cost-effective way of improving returns for your clients.

Bob Huebscher: And David?

David van Adels...: Most folks, maybe everybody knows that a or perhaps the key to sustained business success growth value creation is derived by a company's use and the level of motivation of their people. That's why almost all managers from the frontline to the boardroom say something to the effect of, "People are our most important asset."

And if you believe this, you can now invest based on this very simple idea. We often say it's sort of like wheels on a suitcase. I think we're all perhaps old enough to have carried suitcases over our shoulder through airports until somebody smart actually put wheels on the bottom of a two-suiter. And it was life-changing. This is that idea essentially to investing.

So, for allocators, advisors, and other investors, just have a look at the performance of H-A-P-I, for example, versus the S&P since inception. It's a strategy that we believe is simple. It makes sense. And it provides an opportunity for alpha from the most fundamental of fundamental investment criteria, and that being a company's people.

Bob Huebscher: Wonderful. Well, we'll include some links in the notes that accompany this podcast. You'll be able to learn more about David, Kristof, Irrational Capital, and Harbor Advisors. There'll be a link to the Irrational Capital homepage. And there'll be links to information about the three ETFs, H-A-P-Y, H-A-P-I, and H-A-P-S. You'll be able to see, among other things, the performance relative to benchmarks and the overall market. David and Kristof, is there anything else you'd like to add?

David van Adels...: Just thank you.

Kristof Gleich: Thank you for having us.

Bob Huebscher: Thanks for listening to the Gaining Perspective podcast with Bob Huebscher. And today, featuring David van Adelsberg of Irrational Capital and Kristof Gleich of Harbor Capital Advisors. To support our podcast, please share, subscribe, or leave a review to help make our podcast more findable for your friends and colleagues. You can subscribe to Gaining Perspective on your favorite podcasting service.