Corporate Governance and Performance

A brief review and assessment of the evidence for a link between corporate governance and performance

HERMES

Active promotion of good corporate governance in investee companies increases shareholder value in the long term.

Introduction

The objective of Hermes' corporate governance activities is the improvement of the performance of the companies in which it invests on behalf and for the benefit of its clients. Furthermore, we believe the **active promotion of good corporate governance in investee companies increases shareholder value in the long term**. In this paper we review the evidence for a link between corporate governance and performance and conclude that the research we have found supports the proposition that underlies our corporate governance work.

Defining 'corporate governance'

Research into the relationship between corporate governance and performance faces significant methodological and evidentiary difficulties. To begin with, there are many different interpretations of both 'corporate governance' and 'performance'. The term 'corporate governance' has come to mean many things. Traditionally and at a fundamental level, the concept refers to corporate decision-making and control, particularly the structure of the board and its working procedures. However, the term corporate governance is sometimes used very widely embracing a company's relations with a wide range of stakeholders or very narrowly referring to a company's compliance with the provisions of best practice codes. The problem that researchers face is not only to define what is meant by 'corporate governance' but also what amounts to 'good' or 'bad' corporate governance. Similarly, the term 'performance' may refer to rather different concepts, such as the development of the share price, profitability or the present valuation of a company. As such, the body of research into the link between corporate governance and performance contains studies that seek to correlate rather different concepts of corporate governance and measures of performance.

We note that if good corporate governance is defined simply as good management, involving productive relationships with shareholders and where appropriate stakeholders, the finding that it improves performance is not surprising.

Review of Research

In this paper we review the findings of research and other evidence broadly falling into three categories:[1]

1. **Opinion-based** research;
2. **Focus list** research and **performance of shareholder engagement funds**; and
3. **Governance-ranking research**.

After considering the leading research in these three categories, we set out our assessment of the findings and discuss their implications.

1. Opinion-based research

McKinsey's 'Global Investor Opinion Survey' (2000 (updated in 2002)) is the most widely quoted opinion-based research into the link between corporate governance and performance as measured by the valuation of the company. McKinsey **surveyed over 200 institutional investors and found that 80% of the respondents would pay a premium for well-governed companies**. The size of the premium varied by market, from 11% for Canadian companies to around 40% for companies operating in countries where the regulatory backdrop was less certain, such as Egypt, Morocco, and Russia. The UK and US scored 12% and 14% respectively. Although the study is opinion-based, we believe that the finding reflects a growing perception amongst market participants that **well-governed companies, which are perceived to be run in the interests of investors, may benefit from a lower cost of capital.**

There are a number of other studies that sought to link broad perceptions of the quality of companies to superior share price performance.[2] They generally support McKinsey's finding that investors favour companies, which they perceive to be well-governed. However, we note that opinion-based research relies on circumstantial and inevitably subjective data. The finding is therefore of limited evidentiary value.

2. Focus list research and the performance of shareholder engagement funds

Focus list research

Focus lists are issued by a number of investors and investor groups. In essence, they attempt to induce the management of the companies listed to address performance or governance related problems by publicising them. The inclusion of a company in a focus list generally also represents a statement of intent of the issuer of the list to engage with the companies listed to encourage

1. We do not to discuss 'event studies' most of which investigate the effect of shareholder resolutions. Such studies are generally dependent on the outcome of specific and often unique situations. We thus considered them less instructive regarding the performance effects of corporate governance related investment processes.
2. See, for example, Antunovich et al (2000) and BusinessWeek (2000).

improvements. The rationale for focus lists is that by publicising the problems of companies and announcing an intention to engage with them to address the failings, their performance may improve at some point after they are included in a list. In addition, the expectation that a company's problems will be addressed following its inclusion in a list can lead to an immediate positive market reaction.

The best-known focus list is issued by CalPERS. The so-called **'CalPERS effect'**, that is, the improvement of a company's performance following its inclusion in the CalPERS focus list, was first described in 1994. This research, which was updated in 1995, 1997 and 2001,[3] is generally regarded as the most compelling in this area. Until the most recent update of the research in 2004,[4] it showed that **companies included in the CalPERS focus list substantially outperformed in the five years after their listing (by 23% in the 1997 update and 14% in the 2001 update)**. Results from the 2004 update provide more limited support showing excess returns of just 8% over the five-year period after listing. Moreover, two thirds of the listed companies in the 2004 sample were under-performing at the end of the period.

Research into the effects of other focus lists also shows that after a company's inclusion in such a list its performance improved.[5] We note, however, that there is research broadly falling into the focus list research category which failed to demonstrate the CalPERS effect.[6] This may be explained by the fact that most focus list studies do not distinguish between companies that have the potential to respond to investor oversight and pressure and those that do not.[7] Moreover, focus list research does not capture the extent to which a worsening of performance or governance problems is prevented.

We also note that companies with adequate or good corporate governance, which under-perform as a result of problems relating to their strategy or financial structure, may be included in a focus list. Thus, even though performance and governance related problems often go together, the evidentiary value of focus list research in respect of a link between corporate governance and performance is not entirely straightforward. **However, on balance, the focus list studies support the view that the process of publicising problems of companies and, when appropriate, actively engaging with such companies to address the failings identified can improve their performance.** We consider that this finding in itself provides a sound justification for investors to act as active owners.

Performance of shareholder engagement funds

Further evidence supporting the proposition that active ownership improves performance is provided by the success of shareholder engagement funds. **Such funds invest in under-performing companies with potential for improvement. As such, their performance provides a real life test involving a significant financial commitment of the proposition.** By engaging with such companies and, if necessary, by using their ownership rights, active investors seek to encourage improvements that they consider will ultimately lead to an increase in the value of their investment. Hermes' Focus Funds take this approach.[8] They invest in companies that are fundamentally sound but under-performing as a result of weaknesses in their strategy, governance or financial structure. The Focus Fund team then engages with the companies' executive and non-executive directors and liaises with other shareholders and stakeholders as appropriate. Significantly, the Focus Funds team works constructively and co-operatively with the boards of investee companies and does not seek to micro-manage them. Indeed, the shareholder engagement programmes are intended to assist boards in taking tough decisions (rather than to take such decisions for the boards) and to support them in implementing decisions once taken. Thus, over a period of time, the Focus Fund team uses its influence as owner to help resolve the problems causing under-performance.

Hermes' original UK Focus Fund has out-performed the FTSE All Share Total Return Index by 3.9% on an annualised basis (net of fees) since its inception in 1998.[9] Similarly, since its inception in 2002, **the European Focus Fund has outperformed its benchmark by 3.5% on an annualised basis (net of fees)**.[10] In the US, **Relational Investors LLC, out-performed its benchmark by 7.8% on an annualised basis (net of fees) since inception.**[11] We believe that the out-performance of shareholder engagement funds in difficult market conditions using active ownership as an investment technique provides strong evidence in support of the view that there is a link between corporate governance and performance.

Hermes' original UK Focus Fund has out-performed the FTSE All Share Total Return Index by 3.9% on an annualised basis (net of fees) since its inception in 1998.

3. See generally Nesbitt (2001) and Anson et al (2003).
4. Hewsenian and Noh (2004).
5. Opler and Sokobin (1998).
6. See, for example, Carleton et al (1998). This research was different from pure focus list research in that it analysed the effects of engagement through private negotiations.
7. Caton et al (2001).
8. Further information on Hermes' Focus Funds is available on our webpage: www.hermes.co.uk.
9. 01/10/1998-30/09/2005.
10. 25/02/2002-30/09/2005.
11. 01/07/1997-30/09/2005.

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We would note that our engagements cover a variety of matters relating to corporate governance, including strategic weaknesses and difficulties with financial structure. Nevertheless, the strong performance of the Focus Funds supports our fundamental belief that **companies with active, interested and involved shareholders are more likely to achieve superior long-term returns than those without.**

3. Governance-ranking research

Governance-ranking research seeks to establish a link between one or more factors or standards[12] that objectively measure a company's governance quality and its performance. The focus on certain standards by reference to which the quality of corporate governance can to some extent be objectively measured has obvious attractions. However, it also causes problems and distortions in the findings of the research. To begin with, any single governance standard may for a number of reasons be unrelated to the performance of companies in a particular market during a given period of time. **Research that focuses on a single standard, such as the composition of boards, in isolation, may thus lead to incorrect conclusions.** Moreover, such research does not effectively capture the general benefits that may result from active ownership involving engagement regarding a larger set of standards. More complex research considers a range of governance standards against which the corporate governance qualities of the companies investigated are assessed. The selection of a set of governance standards introduces a subjective element into governance-ranking research. In addition researchers may attach different weight to them for the purposes of the ranking that underlies the studies, introducing further subjectivity.

Many of the studies that suggest that there is no link between corporate governance and performance focus on a single governance standard.[13] For the reasons explained above, such a result is perhaps unsurprising. Similarly, research involving a ranking based on compliance with too many potentially insignificant governance standards may distort the finding of a link between certain 'core' standards and performance. We therefore believe that the most valuable research focuses on a relatively small set of governance standards and seeks to identify which standards are directly related to performance.

The most celebrated governance-ranking study, which supports the proposition that there is a link between the quality of corporate governance, measured in terms of shareholder rights, and performance was carried out by **Gompers et al (2004)**. Based on an assessment of the governance of 1,500 US companies using 24 governance 'provisions' analysed by the Institutional Investors Research Center (IRRC) during the 1990s,[14] **the study found that if a fund had taken long positions in companies scoring in the top decile of their governance ranking and short positions in companies in the bottom decile, it would have outperformed the market by 8.5% per year throughout the 1990s.** The research also supported the proposition that companies with a good governance ranking were higher valued and had higher profits than those with a bad ranking. Prior to Gompers et al, **Millstein and MacAvoy (1998) had found that over five years, well-governed companies (identified on the basis of CalPERS ratings) outperformed by 7%**. Support for a link between good governance practice and shareholder returns was also found in research conducted by **Governance Metrics International**.[15]

Following on from the research by Gompers et al, **Bebchuk et al (2004) investigated which of the 24 governance provisions tracked by the IRRC are correlated with company value and shareholder returns. They identified six such provisions:** four concerning the extent to which a majority of shareholders can impose its will on the management and two relating to mechanisms that facilitate the defence of a hostile take-over. **Based on their assessment of the six provisions, they then constructed an 'entrenchment index'** and investigated the empirical relationship between this index and performance. They found that increases in the level of this index are consistently associated with economically significant reductions in the valuation of companies measured by Tobin's Q and that **companies with higher index levels were associated with significant abnormal returns during the 1990-2003 period.** Most significantly, Bebchuk et al found that **the six provisions on which their entrenchment index was based fully explained the correlation identified by Gompers et al between the 24 IRRC provisions and reduced company value and lower share returns during the 1990s.**[16]

In contrast to the research by Gompers et al and Bebchuk et al, the research into the link between

12. In the following we will use the expression 'standards' to refer to a broad range of criteria on the basis of which the quality of governance may be assessed. The rankings are generally based on an assessment of the presence of certain factors (for example, a 'poison pill' provision) or compliance with certain standards (for example, a requirement that half of the board members are independent non-executive directors).
13. See, for example, Bhagat and Black (1999) and (2002), Dalton et al (1998) and Demsetz and Villalonga (2001), Dulewicz and Herbert (2003).
14. The IRRC tracks 22 company level rules and coverage under six state take-over laws. Duplication between company level provisions and state laws means that taken together there are 24 provisions divided into five broad groups: Measures for delaying hostile bidders, voting rights, director protection, other take-over defences and state laws.
15. Drobetz et al (2004) replicated the finding of Gompers et al in respect of the German market. The research by Bauer et al (2004), based on an analysis of corporate governance data on a sample of European companies included in the FTSE Eurotop 300, provided somewhat mixed support. They found a positive relationship between the corporate governance standards investigated and share price and company value but not operating performance.
16. The findings of the research by Bebchuk et al will be put into practice once the so-called 'Shareholder Rights Index', an investable product based solely on corporate governance criteria, which has been developed by Glass Lewis & Co in collaboration with Bebchuk, is launched. This index is a custom-designed corporate governance version of the S&P 500 in which each company's relative weight will be adjusted, using an algorithm designed by Bebchuk, to over-weight companies with good governance and under-weight companies with poor governance.

corporate governance and performance carried out in recent years by Deutsche Bank covers several of the main markets.[17] **Deutsche Bank's recently updated UK research**[18] is based on an assessment of the governance of the FTSE 350 companies at the end of 2000, 2003 and June 2005 using 50 differently weighted corporate governance standards. **It found a clear link between the corporate governance and share price performance of the companies considered. During the four and a half year period investigated, the top 20% of the companies in terms of governance structure and behaviour outperformed those in the bottom 20% by 32%**. Deutsche Bank also carried out a momentum analysis in which companies were ranked on the basis of how their governance practices evolved over the period investigated. Here the outperformance of the companies which were consistently in the top 20%, as compared to the companies consistently in the bottom 20%, was 59%. Furthermore, the study found that companies, which improved from the lowest quintile, outperformed those companies that remained in the lowest quintile by 7%. **Deutsche Bank's research also showed that there was a positive relationship between the historic governance assessment of the companies and their profitability (ROE)**. For example, the top 20% companies (average 2005 ROE estimate of 20.9%) were significantly more profitable than the bottom 20% (average 2005 ROE estimate of 10.9%). Similarly, the research found that the profitability of the top companies was significantly better than that of the bottom companies using ROA and EBITDA margin. However, the research did not find a clear relationship between the quality of governance and investors' current valuations, measured by P/E, P/CF and P/BV, as opposed to the historic share price performance.

Finally, in a recent study of Bauer et al (2005)[19] the importance of corporate governance for Japanese companies is investigated. Using a unique data set provided by Governance Metrics International, which rates firms on six different corporate governance categories, it analyses whether companies with a high governance ranking perform better than companies with a low governance ranking. In the study corporate performance is measured by (1) share price, (2) company value and (3) operating performance. Using an overall index, the authors find that corporate governance positively affects share price and company value but negatively affects operating performance. A number of explanations for the finding regarding operating performance are discussed, for example, the possibility that companies with good governance tend to apply more prudent accounting policies leading to more conservative financial reporting. Moreover, using the individual corporate governance categories, the study finds that they differently affect the variables investigated. For example, whereas provisions towards financial disclosure, shareholder rights and remuneration matter in terms of share price and company value, provisions falling into the market for control category reduce company value. The authors explain this by the fact that takeovers in Japan are rare and hence any provisions in this area are futile.

4. Assessment of the research findings

Most of the governance-ranking research provides support for the proposition that good corporate governance improves performance.[20] We note that the governance-ranking studies are based on the assessment of certain governance standards in the past and thus on historic data. The standards investigated (and often the weight attached to them) vary between the studies. Moreover, as the standards assessed depend on the regulation applicable in a particular market and may vary over time, it is difficult to draw general conclusions. Some of the more sophisticated research partly addresses these issues by considering international standards and using momentum analysis. However, particularly the finding by Bebchuk et al, which suggests that corporate governance activities may need to be focussed on certain 'core' standards effectively to improve performance, needs to be treated with care.[21] Before any general conclusions are drawn, research replicating the finding by Bebchuk et al in respect of markets other than the US is required to identify those specific corporate governance standards that are directly linked to performance. In spite of these qualifications, the **governance-ranking research on the whole supports the proposition that good corporate governance enhances performance. The opinion-based research reviewed in this paper also supports the proposition that there is a link between a company's corporate governance and its performance.** However, as discussed above, a significant difficulty with opinion-based research is its reliance on circumstantial and subjective evidence.

Governance-ranking research on the whole supports the proposition that good corporate governance enhances performance.

17. See Deutsche Bank (2005a), (2005b), (2004a), (2004b), (2003).
18. Deutsche Bank (2005b), (2004a).
19 Bauer et al (2005).
20. We note that there is some research falling into this category that raises doubts on the existence of a link between corporate governance and performance. See, for example, Larcker et al (2004).
21. The governance provisions investigated by the IRRC are principally concerned with mechanisms enabling management to prevent or to delay take-overs. As the regulation of take-overs differs significantly between the main world markets, the six provisions identified by Bebchuk et al in respect of the US may not be of similar relevance elsewhere.

We also believe that engaging with companies regarding a larger set of governance standards as part of an active ownership approach will 'in itself' improve the performance of investee companies.

Focus list research and the performance of shareholder engagement funds provide convincing evidence for a link between active ownership (rather than the quality of corporate governance 'in itself') and improved performance of companies. Unlike the evidence for a link between corporate governance and performance established by governance-ranking and opinion-based research, this evidence is relevant regarding markets with different regulation. Indeed, the focus list research and the performance of shareholder engagement funds suggest that compliance with certain standards is less important than the extent to which ownership oversight and, if necessary, pressure is exercised. The evidence in this category thus supports the proposition that **it is not the absolute quality of governance, but rather the process of active ownership and oversight of management that is important.** This process is important not only in respect of companies where performance or governance related problems have been identified and possibly addressed but as an ongoing and general approach to the management of investments with the objective of preventing the occurrence of such problems.

Governance-ranking and opinion-based research, which focuses at least in principle on corporate governance issues, provides clearer evidence than focus list research and the performance of shareholder engagement funds in respect of a link between corporate governance and performance. However, in our experience, weaknesses in strategy and financial structure and governance-related problems often go together. Moreover, there may be a relationship between a company's compliance with standards and active ownership. This leads us to the main qualification of the existing body of research, namely, the question of causation.

It is notoriously difficult to prove causation, even where research establishes a correlation between corporate governance and performance. The issue of causation arises not only with regard to the significance of certain standards, but also regarding the extent to which active ownership influences the running of investee companies. We note that the authors of many of the studies we reviewed acknowledge that **there is a need for further empirical work addressing the issue of causation. We recognise the problems with the available body of research. Nevertheless, we consider there to be sufficient evidence in support of our view that good corporate governance improves the long-term performance of companies.**

Conclusion

Hermes' corporate governance work is based on the belief that both ensuring compliance with certain governance standards and active ownership based on a larger set of standards 'in itself' will improve the performance of investee companies. A body of research, which is beginning to evolve principally in the US, seeking to establish which governance standards are directly related to the performance of companies supports this view. We are monitoring the developments and, once further evidence confirming existing findings particularly with regard to markets other than the US becomes available, we may refine our governance activities so as to promote those governance standards that are most directly linked to performance.

However, we also believe that engaging with companies regarding a larger set of governance standards as part of an active ownership approach will 'in itself' improve the performance of investee companies. That is, other things being equal, companies with active, interested and involved shareholders will tend to outperform those with passive shareholders. **Moreover, active ownership may help to prevent major corporate disasters. This active approach to share-ownership underlies Hermes' engagement programmes both in relation to its index-tracking core investments and its Focus Funds.** The focus list studies described in this paper, alongside the success of our Focus Funds, provide firm support to this approach, suggesting that **it is not simply the absolute quality of governance that is important, but to a significant extent the process of active ownership and oversight of company management.**

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