Smith Group
ASSET MANAGEMENT

Measuring Management:
Using corporate governance data to improve portfolios

Introduction

In a perfect world, a company's managers would run things so as to maximize the value of the shareholders' investment. In reality, management and shareholder goals often conflict. Management, from the CEO down, may become focused on their own power and enrichment, to the detriment of the corporation's long-run health. Such misalignment of interests can have disastrous effects on shareholder wealth, as seen in the corporate history of firms like Enron and WorldCom.

The Basics...

- Corporations vary in their governance styles. Some are more shareholder-friendly, while others are more management friendly
- Past research has shown a link between shareholder-friendly governance policies, strong firm performance and favorable stock returns
- The Smith Group has developed a model which analyzes key corporate governance variables and assigns a governance score to every stock in our universe

Corporate governance data provide a way to determine which firms have a management stance that is oriented toward shareholders, rather than management. For money managers, such data raise the possibility of creating better portfolios and increasing returns. Investment professionals on the leading edge of this issue are designing computer models that use corporate governance data to evaluate stocks.

The Smith Group has developed a model which builds upon prior work in this field. The model allows us to create a corporate governance ranking of every stock in our universe, and utilize that ranking when creating and managing equity portfolios.

This paper will summarize past research investigating the link between corporate governance variables and stock performance, and outline the construction, validation and application work we have done with the Smith Group Corporate Governance Model.

Background

Will corporations with shareholder-oriented governance structures really outperform other companies? What exactly are "shareholder-oriented governance structures"? These are the kinds of questions researchers in the governance field have asked. The increasing availability of corporate governance data has allowed researchers to develop some compelling answers.

In the article *Corporate Governance and Equity Prices* (2003), Paul Gompers, Joy Ishii and Andrew Metrick draw an analogy between corporations and governments. In the analogy, firms with policies oriented to shareholders are democracies, while those with policies oriented toward management are dictatorships. Gompers and his colleagues combined twenty-four governance factors into one index which served to indicate where an individual firm stood on the democracy-dictatorship spectrum. Their data was from the Investor Responsibility Research Center, and covered factors such as:

- Takeover defenses
- Voting rights
- Director/officer protection

Strong defenses against takeovers, limits on shareholder voting rights and protection for directors and officers (from legal liability or termination) are dictatorship policies. The authors constructed their governance index by adding one point to the index for each dictatorship policy which a company had. Since there were twenty-four factors under consideration, the maximum score for an individual firm was 24. Such a firm would

Some of the governance factors found by prior studies to be most strongly linked to good firm performance are:

- Board is controlled by more than 50% independent outside directors
- Board has outside advisors
- Performance of the board is reviewed regularly
- Nominating committee comprised entirely of independent outside directors

be a pure dictatorship, while a firm with a score of 0 would be a pure democracy.

Fifteen hundred large firms were scored. Those in the top 10% were considered dictatorships, while those in bottom 10% were considered democracies. The returns to these two groups of stocks were analyzed for the period September 1990 to December 1999. It was found that a long-short strategy which bought the democracies and sold the dictatorships generated favorable returns of 8.5% per year. It was also found that democracies were more profitable and had faster sales growth than dictatorships.

In a subsequent paper, *Corporate Governance and Firm Performance* (2004), Lawrence D. Brown and Marcus L. Caylor constructed a measure of corporate governance which they call Gov-Score. Using governance data from Institutional Shareholder Services (ISS), they employed fifty-one separate factors, adding one point for each factor which was share-holder-oriented. Thus more democratic firms scored higher, with a maximum theoretical score of 51.

They applied this scoring algorithm to 2,327 firms, finding that higher scoring (more shareholder-oriented) firms had higher operating performance (based on factors such as return on equity, net profit margin and sales growth), higher valuations and higher dividend payouts than lower scoring firms.

Brown and Caylor also evaluated which governance variables in their model were most strongly related to firm performance (see box on previous page). Interestingly, this led them to find that some of the individual factors (7 out of 51) which were thought to represent good governance actually were associated with poor firm performance. Examples of such factors were:

- Consulting fees paid to auditors less than audit fees
- Simple majority (rather than supermajority) required to approve a merger
- Any 'poison pill' is shareholder approved

The upshot of the research by Gompers/Ishii/Metrick and Brown/Caylor is that shareholder-oriented governance policies have been associated with strong firm performance and strong stock market performance. The caveat has also been raised that not all governance factors are equal. Some may even have an unexpected relationship to firm performance. These findings served as a starting point for the Smith Group's research into corporate governance.

Creating a corporate governance ranking

The Smith Group's proprietary governance model began with over 200 governance variables gathered from company filings. Rigorous statistical and "common sense" testing was applied to narrow these down to the factors which we found most significant in predicting future stock performance. These are incorporated into the actual model.

Smith Group governance factors fall into the following categories:

- **Board of Directors** - Independence, composition, structure, size, and separation of the CEO and Chairman roles are important factors
- **Takeover Defenses** - Unequal voting rights, golden parachutes, poison pills, and blank check policies reflect poor corporate governance policies
- **Compensation and Ownership** - Stock ownership requirements, stock option grant policies, and performance-based compensation
- **Financial Disclosure** - Audit/consulting relationships, regulatory compliance history, overall transparency of financial statements, and related-party transactions

Each individual factor is weighted based upon demonstrated impact on long-term stock performance. The model assigns a score between 1 and 100 to each company. The end result is a model for ranking every stock we evaluate based upon each firm's corporate governance policies.

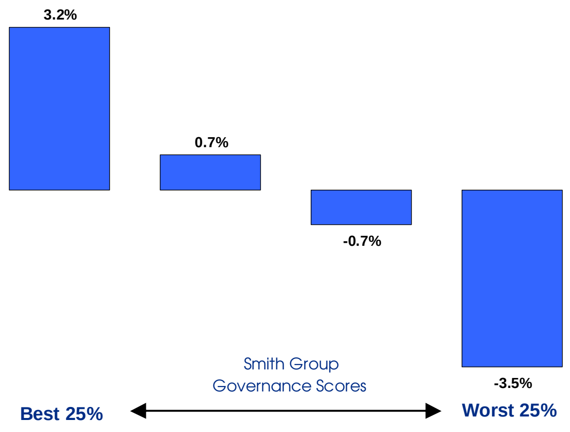
Does it work?

We used the Smith Group Corporate Governance Model to score each company in the Russell 3000 for the entire period in which the scores have been in production. This period covers 3.75 years beginning 12/31/2002 and ending in the most recent quarter, 09/30/2006.

Figure 1 on the following page shows annualized performance of the Smith Group Corporate Governance Model vs. the Russell 3000 by quartile. The firms with the best governance scores (the top 25% made up of approximately 750 companies) had annualized returns 3.2% *above* the benchmark. Companies in the worst 25% experienced annualized returns 3.5% *below* the index. It is also important to note that the relationship between performance and the governance ranking maintained linearity through the quartile groups.

Another important finding in our research is related to identification of "torpedoes", or companies that experi-

Figure 1. Performance vs. Benchmark:
Annualized Excess Returns



Source: Wilshire Atlas, Universe: Russell 3000 equally weighted universe, Monthly quartile return spreads from 12/31/02 to 9/30/06

ence a relative stock price decline of over 30% in a six month period. Companies with poor governance scores had a much higher incidence of this occurrence. In fact, the bottom quintile (worst 20%) of scores had a 2.5 times greater incidence of "torpedo" stocks than did the top quintile.

How do we use these rankings in managing portfolios?

Our testing indicates that the governance score contains valuable information about future stock performance. We are extracting that value by including the score in our portfolio selection process.

We use the governance score to screen out firms with poor governance from our universe of buy candidates.

> Smith Group's investment philosophy is built around earnings growth and positive earnings surprises
>
> Good corporate governance plays an important role in those outcomes, and builds credibility that the market rewards with higher prices

The governance score also plays a role in our sell discipline. If a stock's score falls into an unattractive range while we own it, it becomes a likely sell candidate.

The governance score also provides our Portfolio Managers with an excellent starting point from which to conduct more in-depth, qualitative governance analysis of a firm.

Conclusion

The Smith Group Corporate Governance Model provides additional support to the theory of a link between corporate governance data, firm performance and favorable stock returns. This link exists because of the potential for conflict between a corporation's owners and its managers. The variety of governance styles, from shareholder-oriented to management-oriented, gives us another lens with which to view firms. Continuing to refine our understanding and use of this lens will allow Smith Group to more intelligently construct equity portfolios, lowering risk and raising returns for our clients.

There are many opportunities for further research in this area. Much of the governance data has only become available in recent years. As more time passes, testing of longer periods will be important to understanding the link between governance policies and stock returns.

Since there is continual updating of disclosure requirements placed on corporations, governance models will need to be enhanced and updated regularly to take advantage of the latest information available.

The work done thus far gives an indication of the value of continued work. Quantitative corporate governance analysis is an important new field and should not be ignored. The potential payoff is too great.

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[1] Gompers, Paul A., Joy L. Ishii and Andrew Metrick. "Corporate Governance and Equity Prices." Quarterly Journal of Economics 118(1). February 2003: 107-155.

[2] Brown, Lawrence D. and Marcus L. Caylor. "Corporate Governance and Firm Performance." Institutional Shareholder Services website. <<http://www.issproxy.com>> December 2004.

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