PZENA Investment Management

ASSESSING CORPORATE GOVERNANCE

A Review of the Literature

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For Professional Investors Only

EXECUTIVE SUMMARY

We examine the extent to which there is an empirical link between good corporate governance and company performance[1]. From a review of academic literature, we find that there is limited evidence of a relationship between widely accepted parameters of 'good' governance and company performance. These 'good' governance parameters are a defined set of principles that can be ranked relative to other companies (see table 1).

Assessing good governance and its impact on company performance appears to require a more nuanced case-by-case assessment predicated on a fundamental understanding of the business and commitment to active ownership. In this form, governance can still be foundational to investment analysis, possibly even the difference between a good and a bad investment.

INTRODUCTION

As ESG-integrated value investors, we approach the identification and analysis of ESG issues through the lens of financial materiality in the context of companies experiencing temporary pain where we see a path to earnings recovery. To the extent that ESG issues have contributed to a temporary value dislocation, it makes sense that improvement in ESG credentials could help drive alpha.

When thinking about how ESG issues affect a company, it strikes us that governance is foundational. If governance is poor, then it is unlikely that other issues, including those of an environmental and social nature, are being managed effectively. While we have always believed that 'governance matters' for a given investment, we had not previously sought out evidence to back up that belief. We therefore decided to examine the academic literature on corporate governance to see what, if any, connection existed between good governance and company performance[2].

GOVERNANCE DEFINED

In researching this relationship, it became clear that the difficulties start with the definition of 'good' governance. Good governance is a set of processes or organizational features that, on average, improve decision-making and reduce the likelihood of poor outcomes arising from strategic, operating or financial choices, or from ethical or behavioral lapses within an organization[3]. However, 'good' governance generally seems to have come to mean the degree to which a company has adopted certain structural features (see Table 1) that increase board independence and shareholder rights, under the assumption that these are synonymous with good governance.

Table 1

'Good' Governance Principle	Definition
CEO/Chairman separation	The CEO and Board Chairman of a company should not be the same person
Dispersed Ownership	Companies should adopt one-share-one-vote structures and minimize influential shareholders (e.g. family/founder firms) because this disadvantages minority shareholders
Board Independence	The board should be comprised of a majority of independent directors
Smaller Boards	The smaller the board, the more effective it can be
De-Classified Boards	Boards should put directors up for election each year
Board Diversity	Boards should have an appropriate number of diverse (race, gender etc.) members. For gender, boards should target at least 30% (and moving towards 40%) women
Pay-For-Performance	Executive pay should be closely tied to company performance through short and long-term metrics

Much of the literature connects these structural features back to the corporate scandals of the 1980s and the desire to prevent a recurrence. This was the impetus for building a set of principles, based in logic, that appeared to define 'good' governance. Since then, the proposed principles have gone largely unquestioned; absent a long enough history of data, there have been limited ways to prove or disprove their effectiveness. There is now an entire industry of ESG service providers dedicated to comparing companies on these structural features and/or assigning scores to each company's success or failure at implementation. It has become a self-fulfilling cycle, whereby we continue to pursue the current definition of 'good' governance structures because that is where the focus of the data is.

That is not to discount the importance of good governance. Governance clearly matters and is foundational to sound investment analysis. In the most extreme cases, poor governance can lead to permanent capital impairment and company collapse, as was the case at Enron in the early 2000s. In some cases, a temporary lapse in governance can create the value opportunity. However, it is notable that not all companies with governance scandals appear to have obviously poor governance on paper and in many cases governance failures come down to the decisions of a few key people. This illustrates the complexity of analyzing corporate governance and it is therefore not surprising that during our literature review of the topic, we found limited evidence of a set of consistent parameters that define 'good' governance.

THE EVIDENCE

CEO/CHAIRMAN SEPARATION

The separation of the CEO and Board Chairman is one of the core tenants of most definitions of 'good' governance. Most companies find themselves moving to this structure under pressure from shareholders and proxy service providers. However, the academic evidence does not find a clear link between CEO-chair separation and improved company performance[4]. This is despite this being one of the easier parameters of 'good' governance to test statistically. Indeed, there is some evidence in the literature that a company forced to separate the roles can actually underperform[5].

This does not mean that CEO-chair separation is not ever desirable, and in some cases the logic can be compelling: for example, if there has been a history of missuse of power by the management team and specifically the CEO. But importantly, the absence of this structure is not necessarily a sign of poor governance.

DISPERSED OWNERSHIP

The ideal company is often viewed as one with dispersed ownership and a one-share, one-vote structure. It is assumed that influential shareholders can undermine the interests of minority shareholders and therefore have a negative impact on shareholder returns. Dual-class shares are particularly disliked because they grant a small group of shareholders voting rights that exceed their economic interests. However, these assumptions are not necessarily backed up empirically in the academic literature.

Many studies find the impact of influential shareholders on company performance to be either neutral, or slightly positive for family owners in countries with strong legal rights[6]. There are reasons to believe that influential shareholders can be a positive influence. In the case of founder firms, the founder likely has detailed knowledge of the company that might be the reason the company was initially successful. Even if the influential shareholder is not a founder, higher company ownership means a greater incentive to actively monitor and engage management. Logistically there is also the difficulty of selling a large stake in a company over a short period of time, arguably making larger shareholders prone to support decisions in the long-term company interest. Studies also find a positive impact from shareholder activism in the short term and long term, which underlines the positive role shareholders can play in influencing company performance[7].

When it comes to dual-class shares, there are studies that find no clear link to lower shareholder returns[8]. Including US technology companies in the studies seems to lead to significant outperformance, though this is neutralized if these companies are removed[9]. Some other studies find that companies with dual-class shares have similar long-term performance to companies with a single class of stock[10]. Dual-class share structures may become detrimental when the majority of shares have no voting rights, but this is hard to test empirically (this is a recent phenomenon, associated with the rise of technology IPOs). The Snap IPO was one of the more high-profile controversies, given the decision to sell only nonvoting shares.

Overall, the evidence points to the fact that ownership structures are less important than the people operating them. It may make more sense to focus on the influential shareholders themselves – i.e. who they are and how they exercise their influence – than whether or not the company has them.

BOARD INDEPENDENCE

Board independence is one of the most foundational elements of 'good' governance today. ESG rating providers penalize companies without a majority independent board and the proxy voting service providers set thresholds for board independence by region.

The academic evidence of connection to company performance is mixed but more positive than for some of the other principles of 'good' governance. Some studies find a positive link up to a 50% threshold for the board and then after that it diminishes again[11]. One study found a more positive connection between board independence and total shareholder returns in Europe (ex-UK) and North America and a more negative link in Asia and LatAm. These findings are consistent with the aforementioned importance of strong legal rights[12]. Other studies have found a positive link between board independence and preventing misconduct but no connection to shareholder return[13]. There does, however, seem to be stronger evidence for the independence of audit committees[14].

These findings make sense in that, while some independence might be desirable for management accountability purposes, a fully independent board might be ineffective because it lacks company insiders with vested interests and specific knowledge of the company. As such, more independence is not always preferable, but a simple majority of board independence may strike the right balance between independent oversight and deep company expertise.

SMALLER BOARDS

The strongest area of evidence across 'good' governance parameters is that companies with smaller boards outperform. This makes sense because, in general, the larger the group the more disconnected discussions can become. By this logic, investors should prefer companies with a smaller board, though this is not always possible, as some countries set the board size by regulation. In terms of the ideal number of board members, one study found that companies are more successful when they have a board size between 8-12[15]. There appear to be some exceptions to this, for example complex industries can sometimes benefit from a bigger board[16]. This makes sense to the extent that more complex industries may require more varied board expertise.

DE-CLASSIFIED BOARDS

Classified boards are considered a poor governance practice because they prevent an activist investor from taking majority control of a board in a single election and because two years are required for a proxy contest. There is mixed evidence of the impact on company performance in the academic literature. There is some evidence that a classified board can decrease shareholder value by decreasing merger activity, entrenching management and lowering firm value[17]. There is also evidence that a classified board can protect valuable business relations, protect against unsolicited offers and boost firm value[18].

BOARD DIVERSITY

Evidence of a link between gender diversity and company financial performance is decidedly mixed[19]. Some studies have found benefits at critical mass, some show outperformance is possible when a company is leading on gender diversity and others have not found a link to improved company performance at all[20]. Peer-reviewed meta studies have shown that greater gender diversity is associated with accounting returns yet had no impact on market or financial performance[21]. Gender diversity has also been a relatively recent focus of boards, due to a combination of national quotas, targets and investor pressure. Perhaps more time is needed to fully interpret the data. Racial diversity is an even more recent focus and in our experience is top of mind in some regions more than others. It is important to note that promoting diversity on boards does not necessarily have to be good for company performance for it to be a worthwhile endeavor.

PAY-FOR-PERFORMANCE

Executive pay is one of the most contentious and complex aspects of corporate governance. In theory executive pay is meant to be closely tied to company performance. So much so that pages of company annual filings are dedicated to explaining this connection. Yet, the academic literature suggests pay structures are still not aligning executive pay with shareholder interests. This is understandable given some of the flaws with executive pay packages: all metrics have unintended consequences and can be gamed; pay time horizons are shorter than the investment cycle of most companies; and finally, the complexity of pay packages itself undermines the notion of any clear and transparent connection to performance.

The academic literature finds a stronger link between CEO equity ownership and performance, in contrast to the weak evidence on pay and performance[22]. This suggests that simple share ownership may be a better (albeit likely still imperfect) way to connect CEO pay to performance. This could be facilitated through direct share ownership, allocated restricted shares or a long-term incentive plan (LTIP) with a long-term horizon and lock-up period.

INVESTMENT IMPLICATIONS

NO ONE DEFINITION OF GOOD GOVERNANCE

This literature review has shown that there is no single definition of good corporate governance that appears to lead to outperformance at either the company or stockholder level. The findings do not, however, undermine the importance of good governance analysis in the investment process. Rather, they call into question the way 'good' governance has come to be defined as a finite set of structural board features.

Investors should therefore be wary of assuming one country or region's governance principles are better than others; legal structures may be just as, if not more, important. This is, in some ways, self-evident, given that successful companies can be found all over the world, not just in regions that have come to embody the standard principles of 'good' governance.

While there may be no one definition of good governance, the absence of it can clearly lead to permanent capital impairment. In that sense, good governance can be thought of as an effective risk management tool for any investment. Viewing governance through this lens elevates the importance of active ownership through engagement and proxy voting. The empirical evidence would suggest that using these tools, shareholders can have a positive impact on the long-term trajectory of a company.

GOOD GOVERNANCE IS MORE QUALITATIVE THAN QUANTITATIVE

Given that there is no one set of governance principles that define good governance, governance analysis appears to lend itself to a more qualitative rather than quantitative assessment. One need only look at the wide disparity between different ESG ratings providers to see the flaws in a purely quantitative approach to ESG integration. Instead, there are likely a variety of choices and tradeoffs unique to each company. Assessing good governance seems to require a case-by-case judgment of the way the company is run and the context within which it operates.

Some of the qualitative aspects that may be important to consider include:

I. Actions and judgement of the management team (e.g., strategic priorities, values & beliefs)
II. Alignment of shareholder/company interests over the long term
III. Stewardship and effectiveness of the board members (e.g., relevant experience, relationship to management)
IV. Operating context (e.g., jurisdictional legal rights, stakeholder accountability)

BE WARY OF THE DESIRE TO STANDARDIZE/MECHANIZE ESG

A qualitative focus does call into question some of the ways in which the ESG industry has attempted to standardize/mechanize the evaluation of ESG criteria. ESG scores are, by definition, quantitative and rely on the measures of 'good' governance that have been shown in the literature to have a questionable connection to company performance. ESG scores are no substitute for building a relationship with management teams and boards, as well as understanding the details of how a business is run.

In the same way, country-specific corporate-governance codes and proxy-voting guidelines can give the illusion of a gold standard of corporate governance but this ignores the need for more qualitative and case-by-case judgements. When constructing a proxy-voting policy, there is a balance between providing no guidance at all (to allow everything to be case-by-case) and being overly prescriptive (and thereby reliant on the misleading structural principles of 'good' governance).

Finally, there appears to be an ongoing tension between this need for more nuance and the desire of regulation to further codify and standardize ESG investing. For example, EU SFDR is pushing the financial services industry into a very specific set of metrics to prove the ESG credentials of a fund, which includes the commonly accepted principles of 'good' governance. This is understandable to the extent that it is much easier to regulate that which can be standardized, measured and tracked, such that companies are directly comparable on a set of metrics. However, this also appears to be pushing the industry further away from investment insights connected to long-term company performance.

CONCLUSION

This research supports something we had implicitly believed but for which we had not previously sought out the empirical evidence. That is that good governance matters but comes in many forms and is not reducible to a series of standardized metrics. Rather it is a judgement of the quality of a business and the management team making the strategic and operational decisions. This type of analysis lends itself to a bottom-up, fundamental research process predicated on strong active ownership.

We hope this paper can play a role in shifting the narrative in the investment community. Our goal is to pursue financial returns through strong ESG integration. That requires us to consider the elements of good governance that really matter for company success, rather than 'good' governance metrics that lack an empirical connection to company performance.

Endnotes

1. As measured by company financial performance metrics or total shareholder return

2. The academic literature looks at a variety of individual company financial performance metrics and shareholder returns

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