Institute for governance
of private and public organizations

Two flawed studies about controlled corporations by ISS and IRRCI

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(Opinions expressed herein are strictly those of the authors)

Toward Value - Creating Governance®

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The performance of controlled companies has been a contentious issue. For different reasons, various parties have worked hard at convincing the investor class that capital structures other than one-share, one-vote would produce inferior results for shareholders. Consequently, most investment funds frown upon such structures, at best tolerate them, and, at worst, have adopted policies of non-investment in these companies.

The Investor Responsibility Research (IRRC) Institute and ISS, the proxy management firm, have been most strident in their opposition to "controlled" corporations and have produced studies supposedly buttressing their position.

Thus, in October 2012, they published a study purporting to assess the relative performance of controlled and non-controlled companies listed on exchanges in the United States (the S&P 1500 Composite Index).

The study received little notice in the media but circulated widely in the financial community as it claimed that the "findings" demonstrated the inferior performance of "controlled" corporations.

The statistical findings of this so-called research are summarized in the following table (page 8 of their report).

TABLE 1

Total Shareholder Return (TSR)
per IRRCI/ISS Study

Ownership	1-Year Avg. TSR	3-Year Avg. TSR	5-Year Avg. TSR	10-Year Avg. Avg. TSR
Non-Controlled	14.81	12.96	1.22	9.76
Controlled	16.33	13.08	1.55	9.28
Controlled: Multiclass	17.48	12.35	0.93	7.52
Controlled: Single Class	13.78	14.91	3.31	14.26

The authors should have conceded that, in most cases, *controlled corporations produce better results than non-controlled ones*. Yet one of their key findings reads as follows "***Contrary to theory, non-controlled firms outperform controlled firms over a 10-year period***". That "outperformance" amounts to an average TSR of 9.76 versus 9.28, surely a statistically non-significant difference! Nothing reveals more clearly the biased authorship of this report.

So on goes the "study", sloppy in design, *amateurish and misleading* in its statistics, and *biased* in its interpretation. Had that report been submitted as a term paper by first-year MBA students, it would have received a fail grade.

FLAWED STUDY REDUX

Yet, in March 2016, the Investor Responsibility Research Center Institute (IRRC) published a follow-up study to their October 2012 piece, titled "*Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review*".

That study is just as flawed as the previous one, with a string of basic errors[1]:

- *no statistical tests are carried out to check if any of these differences are significant;*
- *the table reports the "average" and does not show, as any competent researcher would, the median for each group;*
- *to achieve minimal relevance, the statistical analysis must take account of several variables which may explain any difference in raw results: type of industry, age of corporations, disproportionate representation, etc.*

As with the previous "study", emphasis is always put on any statistic supporting the authors' bias, as evidenced by the following excerpt of their Figure 1.

FIGURE 1

Excerpt from Executive Summary

> **Controlled Companies Generally Underperform on Metrics That Affect Unaffiliated Shareholders**
>
> **Controlled companies underperformed non-controlled firms over all periods reviewed (one-, three-, five- and 10-year periods) with respect to total shareholder returns, revenue growth, return on equity, and dividend payout ratios.** However, controlled companies outperformed non-controlled firms with respect to return on assets. Results for returns on invested capital were mixed: controlled companies outperformed marginally (by less than a percentage point) for most time periods, but underperformed over the 10-year period. EBITDA growth at controlled firms outperformed non-controlled company growth rates for the five- and 10-year periods, while non-controlled firms outperformed over the shorter time frames. Balance sheet metrics were also mixed.

Source: IRRC Institute, *Controlled Companies in the Standard & Poor's 1500*, March 2016, p.10

1 Allaire, Y. *Notes on a flawed study*, IGOPP, November 6, 2012 (p.3).

Indeed, the title claims that the controlled firms "Generally Underperform", and the chosen metrics described as favorable for the non-controlled firms are in bold. The reader has to keep reading to find out that controlled firms outperformed non-controlled firms on other key metrics of performance. Tables 2 to 5 reproduce some of the results presented graphically in their report.

TABLE 2

Average total shareholder returns (TSR) by control type

As of fiscal year end(s) on 12/14/15

	Non-Controlled	Controlled	Controlled: Multi-class Structure	Controlled: Single-class Structure
1-YR AVG. TSR	10.0	8.4	7.7	10.3
3-YR AVG. TSR	19.8	19.5	20.6	15.9
5-YR AVG. TSR	15.5	14.7	15.6	11.9
10-YR AVG. TSR	8.5	6.9	7.4	5.7

Source: IRRC Institute, *Controlled Companies in the Standard & Poor's 1500*, March 2016, (adapted from graph p.26)

TABLE 3

EBITDA Growth by control type (outliers excluded)

As of fiscal year end(s) on 12/14/15

	Non-Controlled	Controlled	Controlled: Multi-class Structure	Controlled: Single-class Structure
1-YR EBITDA Growth	10.7	11.9	1.5	41.7
3-YR EBITDA Growth	-0.4	9.9	6.3	20.4
5-YR EBITDA Growth	9.3	55.5	59.7	43.5
10-YR EBITDA Growth	10.9	38.8	40.2	34.7

Source: IRRC Institute, *Controlled Companies in the Standard & Poor's 1500*, March 2016, (adapted from graphs p.29-30)

TABLE 4

Return on invested capital ratio by control type

As of fiscal year end(s) on 12/14/15

	Non-Controlled	Controlled	Controlled: Multi-class Structure	Controlled: Single-class Structure
1-YR AVG ROIC	8.1	8.5	8.2	9.4
3-YR AVG ROIC	8.3	8.8	8.5	9.6
5-YR AVG ROIC	8.5	9.1	9.1	9.2
10-YR AVG ROIC	7.9	7.3	7.8	5.9

Source: IRRC Institute, *Controlled Companies in the Standard & Poor's 1500*, March 2016, (adapted from graph p.33)

TABLE 5

Return on assets ratio by control type

As of fiscal year end(s) on 12/14/15

	Non-Controlled	Controlled	Controlled: Multi-class Structure	Controlled: Single-class Structure
1-YR AVG ROA	5.0	5.7	5.6	6.0
3-YR AVG ROA	5.1	5.9	5.8	6.1
5-YR AVG ROA	5.2	6.1	6.2	6.0
10-YR AVG ROA	4.9	5.2	5.6	4.1

Source: IRRC Institute, *Controlled Companies in the Standard & Poor's 1500*, March 2016, (adapted from graph p.34)

For TSR, one form or the other of controlled corporations shows a better performance than the non-controlled corporations, except for the 10-year period.

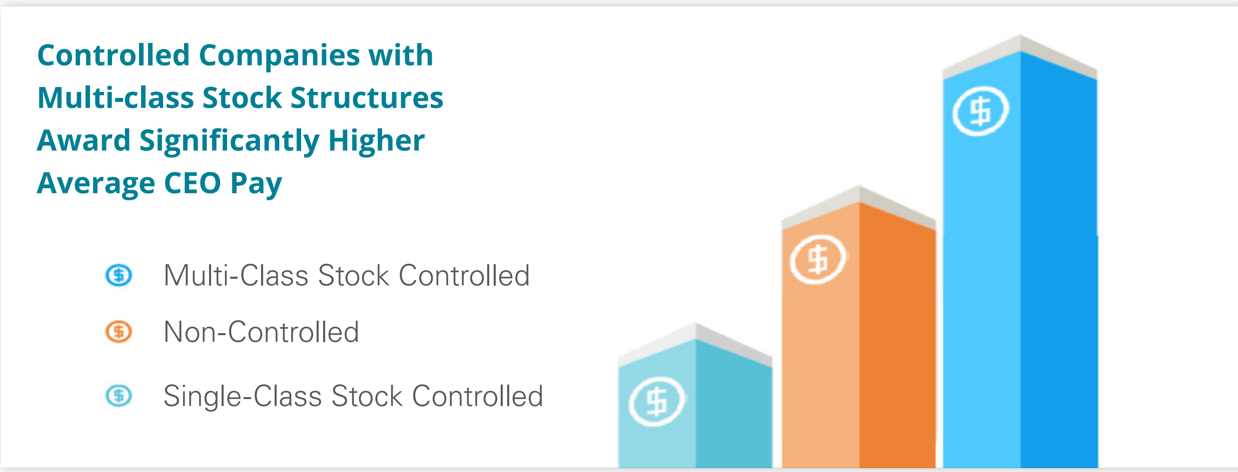
For key performance metrics such as EBITDA growth, ROA and ROIC, the controlled corporations outperform the non-controlled companies in most instances. Then again, no statistical tests are performed to tell us whether these differences are statistically significant or not. Nor were any statistical analyses carried out to isolate the influence of key variables such as industry membership and age of the company.

EXECUTIVE PAY

The 2016 version of the report replicates the biases found in the precedent version. For a casual reader flipping through the executive summary, Figure 2 would lead to the conclusion that non-controlled corporations pay their CEO far less than multi-class stock controlled companies but more than single-class stock controlled corporations.

FIGURE 2

Average CEO pay

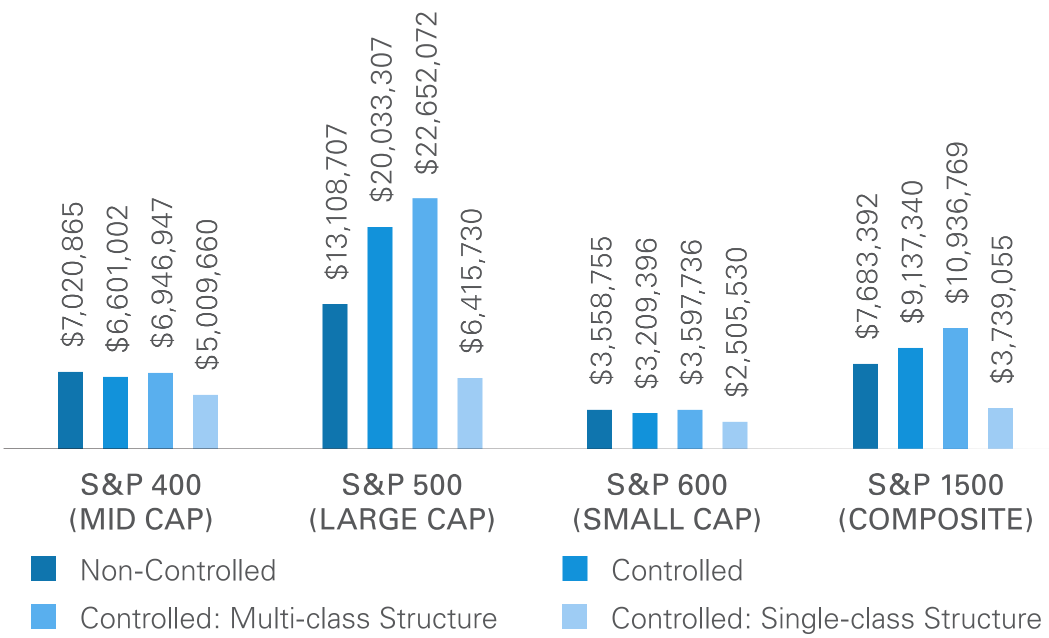


Source: IRRC Institute, *Controlled Companies in the Standard & Poor's 1500*, March 2016, p.13

But a more detailed analysis, presented in their Figure 3, dampens that conclusion. The controlled single-class structure pays CEO less than all other structures for all categories of firms.

FIGURE 3

Average CEO pay by control type & size
(as of most recent fiscal year on 10/25/15)



Source: IRRC Institute, *Controlled Companies in the Standard & Poor's 1500*, March 2016, p.68

And then the authors in a fit of transparency admits that "*the median CEO pay at all controlled companies, including both single- and multi-class stock controlled firms, **is lower** than at non-controlled companies by $1,21 million*" (p.14 and 66, emphasis added), which is exactly the **opposite** of the title blared out in their Figure 2.

As with the 2012 study, these results cry out for a more competent analysis, one that would factor in the impact of industry classification, age of company, and so forth.

CONCLUSION

Unfortunately this new version is just as flawed as the previous effort. The authors could be given some credit for a more transparent document this time around, a transparency which only serves to underscore the weakness of their "results" and the biased nature of their affirmation and conclusions.

Perhaps, this version, had it been submitted as a term paper by a first-year MBA student, would get a passing grade for it has the merit of making the flaws of its analysis so clear.

About IGOPP

THE REFERENCE IN GOVERNANCE MATTERS

Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business), the Stephen Jarislowsky Foundation and the Autorité des marchés financiers, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

OUR MISSION

- Strengthen fiduciary governance in the public and private sectors;
- Make organizations evolve from a fiduciary mode of governance to a **value-creating governance®;**
- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

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- **Policy papers**
- **Training**
- **Research**
- **Knowledge dissemination**

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