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"Good" Governance and Stock Market Performance

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(Opinions expressed herein are strictly those of the authors)

"GOOD" GOVERNANCE AND STOCK MARKET PERFORMANCE

Did the quest, one might dare say the obsession, with implementing "good" governance in public corporations result in better stock market performances for those companies that have adopted the best governance practices?

Numerous studies, mostly American, have tried to show a convincing relationship between governance and performance, usually with disappointing results.[1]

Indeed, it is not surprising that such an undertaking was doomed to fail. The economic and stock market performance of a company over the years is the joint product of macro-economic, cyclical, competitive, industrial and strategic factors; it reflects as well the residual influence of good or bad decisions made over the years. In spite of all the sophisticated statistical tools marshalled to try to isolate and capture the ineffable and fleeting effect of "good" governance (assuming of course that such an effect is indeed at work), these undertakings have generally been unsuccessful.

And yet, for 14 years, the **Globe and Mail's Report on Business (ROB)** has computed and published a governance score for each of the some 230 largest companies listed on the Toronto Stock Exchange. The annual publication of the scores as well as the ranks assigned to every corporation has become a business ritual attended to by corporate leaders and the governance industry.

This overall score, with 100 as a maximum, is the sum of scores on four dimensions of governance:

1. Board composition (32 points out of 100)
2. Shareholding and compensation (29/100)
3. Shareholder rights (28/100)
4. Disclosure (11/100)

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[1] The most frequently cited study supporting the thesis of a positive effect of governance on stock market value is that of Gompers, Ishii, and Metrick 2003. This study claims that an "abnormal" stock market performance of 8.3% is associated with firms showing "good" governance. However, the study does not measure the quality of governance as it is commonly understood, but instead, classifies firms on the basis of whether protective measures against hostile takeover bids are in place. What Gompers et al. show (albeit in a very questionable way), is that stock markets place a premium on firms which are not shielded from unwanted takeover bids.

Each of these aspects of governance is defined and captured through a series of variables (37 in total in 2015), each one given a number of points. Generally, these variables do touch upon all the desiderata of impeccable fiduciary governance. Over the years, the scoring system has adapted and evolved in sync with the changing and ever increasing requirements of *"good" governance*.

Be this as it may, we felt it would be interesting to survey, once more, how the **ROB** governance scores were related to the stock market performance of the largest Canadian corporations.

Summary of descriptive statistics used

As shown in Table 1, this study is based on several variables and measures.

TABLE 1
Descriptive statistics – Score for 2015

	Average	Median	n
Total ROB score for 2015*	72.48	74	234
TSR† over 3 years	4.87%	5.03%	223
TSR† over 5 years	4.43%	7.90%	210
Tobin's q†	1.75	1.32	230
M/B ratio†	2.12	1.45	229
Total assets (in billions of $)	$25.9	$3.9	230

*Note that the publication of the ROB's results for 2015 is in fact based on the state of governance of the companies as reflected in their reports for 2014.
†Data is adjusted by removing 1% of the extreme values at the top and the bottom of the distribution.
TSR = Total Shareholder Return; Tobin's q = the firm's market value divided by its book value; M/B ratio = market value of shareholders' equity divided by book value of shareholders' equity.

Several measures of the relationship between governance score and stock market performance

Several relationships were investigated:

1. *The relationship between the overall governance score and the* ***relative*** *stock market performance over the past 3-5 years*; this standard measure is not very attractive as it assumes that the quality of the governance for this year could have influenced stock market performance in past years. The results presented in Table 2 show a negative, though not statistically significant, correlation

between the overall governance score and the stock market performance of the corporations.

It is interesting to note that the only significant correlation is obtained for the size of the corporation measured by its assets. The bigger the corporation, the higher its governance score tends to be. Could it be that the largest corporations allocate more resources to satisfy the desiderata for good governance as measured by the **ROB**?

TABLE 2
Correlation coefficients†
Total governance score (2015) and performance measures

	Correlation coefficient	n
3-year adjusted TSR	-0.0039	223
5-year adjusted TSR	-0.0276	210
Tobin's q	-0.0953	229
M/B ratio	-0.0977	229
Ln (total assets)	0.4184***	230

Note: adjusted TSR is calculated as follows: TSR compounded annually for 3 or 5 years, divided by the TSR of the benchmark index, in this case the iShares S&P/TSX 60 index, compounded annually for 3 or 5 years.
*means <.10; **means <.05; ***means <.01

† Data is adjusted by removing 1% of the extreme values at the top and the bottom of the distribution.

2. *The relationship between the overall governance score and stock market performance **in subsequent years***; to the extent that the quality of governance influences stock market performance, it seems logical that this relationship should become apparent in the following years. Thus, we have compared the governance score obtained by a corporation in 2010 with its stock market performance (adjusted for the S&P/TSX index) over the following 3-5 years as well as with measures of company valuation (Tobin's q and M/B) in 2014.

This analysis can only be carried out for firms included in the ROB's list of 2010 (based on the information for 2009) which were still in the S&P/TSX index at the end of 2014, or about 121 firms.

Table 3 sets out this analysis and shows that there is no significant correlation except, again, for the size of the firm measured by its assets.

TABLE 3
Correlation coefficients†
Total governance score (2010) and performance measures

	Correlation coefficient	n
3-year adjusted TSR	0.0771	120
5-year adjusted TSR	0.1406	119
Tobin's q (2014)	0.0187	121
M/B ratio (2014)	-0.0050	121
Ln (total assets 2014)	0.3122***	121

Note: adjusted TSR is calculated as follows: TSR compounded annually for 3 or 5 years, divided by the TSR of the benchmark index, in this case the iShares S&P/TSX 60 index, compounded annually for 3 or 5 years.
*means <.10; **means <.05; ***means <.01

† Data is adjusted by removing 1% of the extreme values at the top and the bottom of the distribution.

3. *The relationship between **the improvement** in the **ROB** governance score of the firms between 2010 and 2015 and their stock market performance*; indeed, it would be plausible to assume that an appreciable improvement in the firm's governance score over a period of five years would be associated with a better stock market performance.[2]

   However, as Table 4 again shows, there is no statistically significant correlation between the measures of stock market performance and the improvement in governance over the period from 2009 to 2014.

TABLE 4
Correlation coefficients†
Δ Score (2015-2010) and performance measures

	Correlation coefficient	n
3-year adjusted TSR	-0.0388	120
5-year adjusted TSR	0.0446	119
Tobin's q (2014)	0.0542	121
M/B ratio (2014)	-0.0341	121
Ln (total assets 2014)	-0.1208	121

Note: adjusted TSR is calculated as follows: TSR compounded annually for 3 or 5 years, divided by the TSR of the benchmark index, in this case the iShares S&P/TSX 60 index, compounded annually for 3 or 5 years.
*means <.10; **means <.05; ***means <.01
† Data is adjusted by removing 1% of the extreme values at the top and the bottom of the distribution.

[2] It is interesting to note that of the 123 firms in the list in 2010 and in 2015, 111 received a better score in 2015, with an average improvement of 11 points (out of 100).

Of course, we tortured the data with multiple regressions to determine whether the addition, for instance, of the industrial sector to which each company belongs could change the conclusions. There was no change — the governance scores showed no significant association with stock market performance.

4. *Maybe, despite the lack of a significant correlation for the overall score, such a relationship could be found for one of the four components of the overall score.*

   In fact, as shown in Table 5, the results obtained for each component are virtually identical to the results of the overall score (see Table 2).

TABLE 5

Correlation coefficients – Components of the governance score (2015) and performance measures†

	Disclosure	Shareholder rights	Shareholding and compensation	Board composition	n
TSR 1 year	0.0845	0.0228	0.0390	0.0468	228
TSR 3 years	-0.0482	-0.0331	0.0476	-0.0092	223
TSR 5 years	-0.0243	-0.1113	0.0035	-0.0553	214
Tobin's q (2014)	-0.0398	-0.0805	-0.0750	-0.0968	230
M/B ratio (2014)	-0.0152	-0.1289*	-0.0591	-0.0903	229
Ln (total assets 2014)	0.3708***	0.2275***	0.4226***	0.3399***	230

*means <.10; **means <.05; ***means <.01

† Data is adjusted by removing 1% of the extreme values above and below the distribution.

Finally, what about corporations that have share classes with unequal voting rights?

In 2015, the **ROB** has identified about 30 firms, out of the 230, that have share classes with greater voting rights than another share class. How good/bad was the performance of these 30 firms for their shareholders?

Firstly, we had to exclude Alimentation Couche Tard from the results because its astronomical stock market performance over the last five years made any comparison meaningless.

Table 6 shows the results:

TABLE 6
Comparison* of the averages and medians of the total performance for the shareholders† (TSR)
Based on the nature of the rights granted to the shareholders

	TSR 1 year		TSR 3 years		TSR 5 years	
	Unequal rights	Equal rights	Unequal rights	Equal rights	Unequal rights	Equal rights
Average	-5.930%	-11.647%	11.348%	5.115%	8.660%	3.779%
Median	-1.570%	-13.130%	12.330%	4.100%	10.355%	6.590%
n	30	201	29	197	28	185

*We removed Alimentation Couche-Tard from the above calculations because the exceptional performance of the firm during this period yielded an abnormally high average.
†Source for the TSRs: <http://www.FPinformart.ca>, as at December 15, 2015.

Regardless of the period (1, 3 or 5 years), and whether averages or medians are compared, the firms having a class of shares with unequal voting rights showed stock market performances largely superior to the performances of the conventional firms (although without reaching the usual threshold for statistical significance).

Conclusions

The economic and stock market performances of a corporation are the result of many factors of a cyclical, macro-economic, strategic or competitive nature and reflect as well as decisions made in the more or less distant past. Thus, it would be surprising to find a clear, significant statistical relationship between the quality of fiduciary governance and stock market performance.

What, then, are the benefits of this tireless quest for better corporate governance?

One may well assume that an alert and competent board will improve the decision-making processes of the corporation, prudently oppose overly risky initiatives by the management, steer it away from pitfalls, and root out questionable practices.

None of this may translate in better stock market performance but the company, as a result of board vigilance, may have avoided serious problems and its possible downfall.

Of course, the fiascos and scandals in the worlds of finance and business over the past 20 years may justify some degree of scepticism in this regard. But while all the notorious cases of fraud and mismanagement have received abundant media coverage, there are few opportunities to praise a board of directors when it has helped the corporation avoid misfortunes as a result of ill-advised practices, poor decisions and perilous choices. It is so because these board actions are rarely made public.

But for boards to play this kind of role, the members must not only be "independent" but also and especially legitimate and credible, traits and quality which are difficult, nary impossible, to capture, no matter how exhaustive the scoring process.