

# Outperformance thanks to good corporate governance

**The quality of corporate governance is today held to be among the most important non-financial factors with a sustainable impact on a company's value. This tenet has now been proven for the first time, using econometric methods. There is a significant correlation between corporate governance and equity performance.**

By Olaf Weber\*

Since the end of the 1990s, investor interest has been directed increasingly at corporate governance. What has prompted this interest is not so much management misconduct as the realization on the part of many institutional investors that, given the rules of incorporation and the volume of invested assets under management, the value of their portfolios can only be enhanced by means of direct and intense influence on the development of the individual companies. Particular emphasis has since been given to matters of corporate governance, although until very recently no direct connection could be established between corporate governance and share price movements. At best, a correlation was found between certain aspects of corporate governance and gross results, but here too testing proved inconclusive owing to a dearth of reliable quantitative data of sufficient historical depth.

## Analysis of correlations

This gap has now been closed by a study which furnishes empirical evidence of a correlation between corporate governance and share performance. The study drew on the corpus of corporate governance data found in ASSET4, which quantifies key value-determining non-financial corporate data in a novel, newly developed rating system that facilitates measurement and comparison. Of the 278 criteria covered, 67 include corporate governance (CG) data in the categories of administrative functions, structure, directors' emoluments, strategies and shareholder rights. A subset of 160 companies in the MSCI World Index was selected for the study, including all SMI constituents. Within this universe, the different corporate governance categories were weighted and optimized in such a way as to allow a forecast of total returns (price performance and payouts) in 2004 based on CG data from 2001.

## Shareholder rights and board structure as key determinants

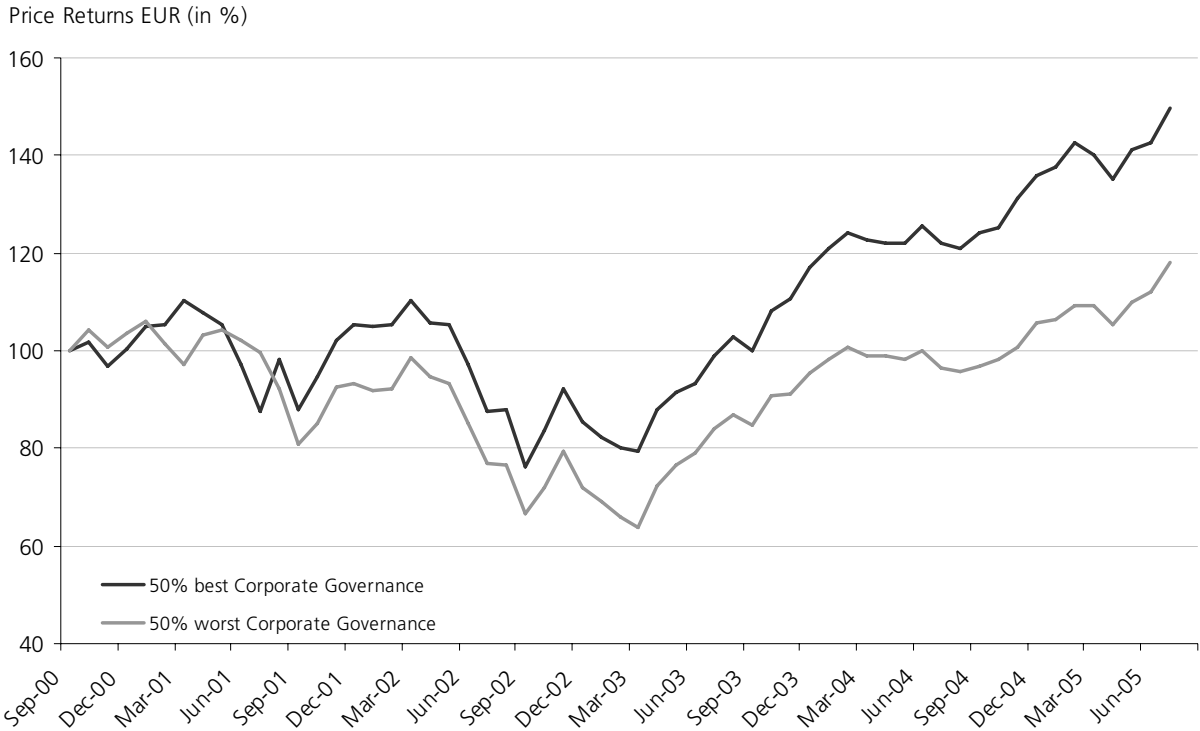
The 160 companies were listed by ranking. Taking the median as cutoff line, they were divided into two portfolios, one containing the half with the best rankings and the other the half with the worst rankings. The performance of each of these two portfolios was determined and plotted in a graph over time. On the basis of this optimization, the

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80 companies in the top half of the rankings performed significantly better than those in the bottom half. In the period from July 2000 to July 2005, the top 80 achieved a 32% outperformance (total return). The SMI stocks outperformed by an even more impressive 38% (see chart). It is interesting to note that not all corporate governance criteria have a comparable influence on performance. During the period under review, shareholder rights (e.g. share categories, anti-takeover rules, ownership makeup) and the structure of the board (e.g. size, composition, independence, experience) correlated most strongly with a company's total return, while the board's actual functions and corporate strategy played less of a role. It was surprising, however, that of all the corporate governance categories examined, remuneration policy had the least impact on company performance. The weighting of the individual criteria proved relatively constant over the observation period. It can be reasonably assumed that the current weightings will shift only very marginally going forward and that the individual corporate governance categories will continue to provide reliable indicators of future stock market performance.

**Weighted ASSET4 algorithm, focus: corporate governance**



Source: ASSET4

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