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20 years

The Frontier Line

Thought leadership and insights from Frontier Advisors

Does good governance mean good performance?

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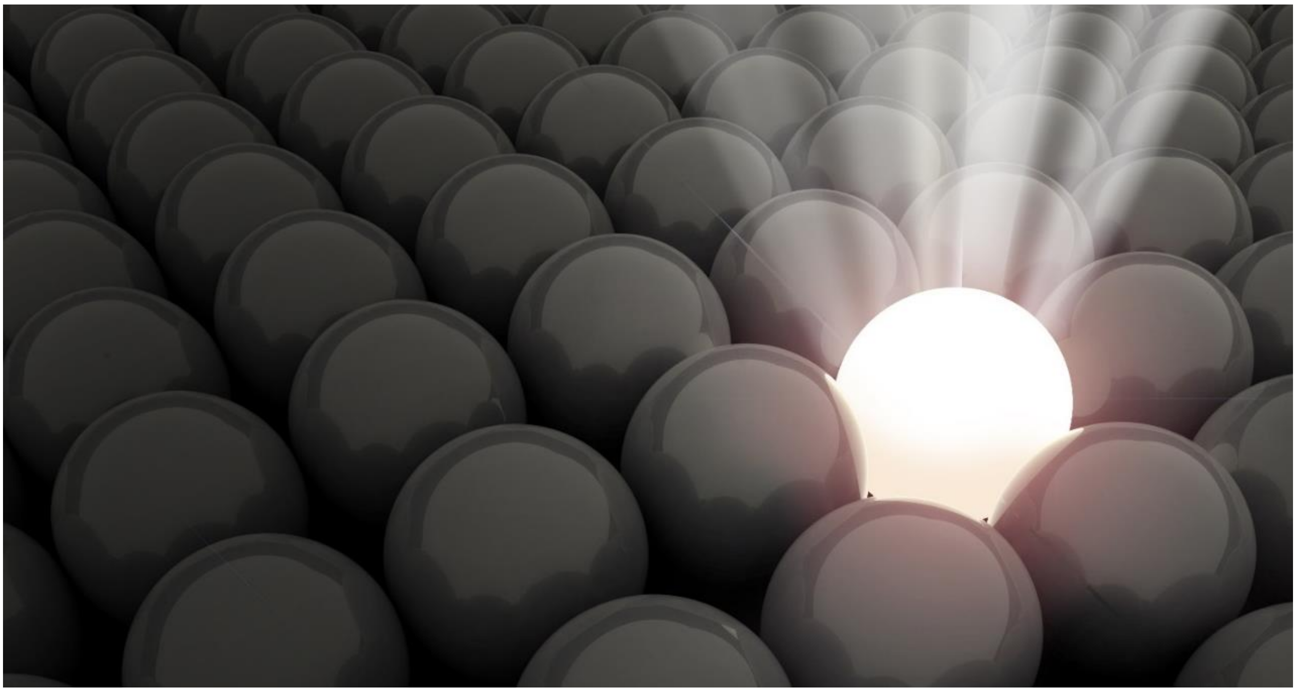

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Introduction

Readers of issue 92 of The Frontier Line ("The Secrets to Good Investment Decision Making") might recall a section of this paper which asked the question "are governance and performance linked?" This issue of The Frontier Line seeks to answer this question in greater detail.

Governance is the foundation framework connecting decision makers around a specific area. Investment governance is the process for overseeing and making decisions around investments.

If governance is about a process leading to outcomes, then it seems intuitive that a good process should lead to good outcomes.

As Justice Owen stated at the HIH Insurance Royal Commission in 2003, "Good governance processes are likely, in my view, to create an environment that is conducive to success…"[1].

We believe more than ten years on, that assessment remains just as relevant.

So, it follows that a strong governance structure should provide the opportunity for good investment decisions, while a weak governance structure would lead to greater confusion and poorer outcomes.

While there have been studies on this topic, few have included empirical research and many have been limited in scope, making it difficult to evaluate the effectiveness of pension fund/superannuation governance.

This issue of The Frontier Line sets out to outline the empirical research which has been undertaken to date. While it is hard to draw definitive and scientifically robust conclusions, we aim to see if any links can be drawn between the quality of governance at a superannuation fund and its performance.

1 Report of the HIH Insurance Royal Commission in 2003.

Measuring good governance - funds

The term “governance” is all-encompassing and can mean different things to different people. Asserting the best way to measure governance in a quantifiable and definitive way remains difficult and may be the reason why there has been such limited empirical data to date.

While empirical research can be a valuable way to gain further understanding, the reliability and validity of this data should be viewed with caution.

In some cases the available indicators measuring governance may not be an accurate measure for all governance issues. In addition, most of the empirical data to date is based on survey questions of pension funds in the US, UK and Canada, answered by senior executives/CEOs of the pension funds, relying entirely on the self-analysis of the funds themselves. It is likely some surveyed pension funds may overstate views regarding their governance structure than might truly be the case.

Ambachtsheer, Capelle and Lum, 2006, found that when pension funds were asked to assess their own oversight, management and operations structures, “there was a tendency in a survey of this nature to rate on the high side.”[2] This methodology also relies on the survey questions being well defined, clear and understood by the respondents, which may not always be the case.

The pension funds surveyed all vary significantly in regard to their size, risk appetites, objectives and philosophies, which may result in varying performance objectives. Some, for example, are defined benefit pension schemes which aim to maximise returns taking into account their long-term liabilities, while some are defined contribution schemes which may also aim to maximise returns but over different time frames.

Additionally, the surveys only reflect the views of a small number of pension funds which were prepared to take part in the governance survey, which may in some cases be a reflection of their confidence in their governance.

The studies also don’t appear to focus on the details of each fund’s governance structure and whether for example, investment decisions are best made at an Investment Committee, a Board, or an internal group level, however this is less relevant in our view.

While we acknowledge it would be beneficial to have more accurate and reliable data which represents a larger sample size of funds, we do still believe the data available can provide useful information and valuable insights in regard to governance and performance.

2. Keith Ambachtsheer, Ronald Capelle and Hubert Lum, “Pension Fund Governance Today: Strength, Weakness, and Opportunities for Improvement”, Financial Analysts Journal, 2006.

Measuring good governance - funds

One of the earliest works in this area dates to 1994 at a conference in New York where 50 pension fund CEOs were asked, "if you could wave a magic wand and get rid of all the barriers that stand between you /your fund and better organisational performance, how much do you think your fund performance would improve".

The median response was 0.66% per annum.[3]

These pension funds were also asked to list the key reasons preventing their funds from achieving better performance, which are summarised in Table 1.

To summarise, these executives described poor decision making processes, inadequate resources, and lack of clarity of focus or clarity in the fund's mission, as the key barriers to their fund's performance.

Table 1: Reasons limiting fund performance

Barrier	Cited
Poor process (including structure, communication, and inertia)	98%
Inadequate resources	48
Lack of focus or of clear mission	43
Conservatism	35
Insufficient skills	35
Inadequate technology	13
Conflicting beliefs	8
Difficult markets	8
Lack of innovation	5
Suppliers	5

Source: "Improving Pension Fund Performance", Association for Investment Management and Research, 1998.

3. Keith Ambachtsheer, Craig Boice, Don Ezra, and John McLaughlin, "Excellence Shortfall in Pension Fund Management: Anatomy of a Problem", 1995.

Measuring good governance - funds

A study by Ambachtsheer, Capelle and Scheibelhut in 1997 of 80 Canadian and US pension funds, used a metric called "risk-adjusted net value added" (RANVA) as a proxy for a pension fund's organisational performance.

RANVA is a measure introduced by Ambachtscheer in 1996 which used data from 98 pension funds with four years of continuous performance data. The measure takes into account the fund's liabilities, asset mix policy and implementation components, to come up with the fund's net value added by the asset mix decision and the net value added by implementation of the decision.

Using this metric, it was found the pension funds in the study underperformed their benchmarks by an average of 0.60% per annum over the 1993 to 1996 period. The study concluded that the underperformance was due to, among other things, the quality of the fund's organisational design.[4]

A subsequent study in 2006 by Ambachtsheer, Capelle and Lum attempted to assess this further by surveying 81 pension fund executives across a number of countries including Australia, New Zealand, Canada, Europe and the US.

Respondents were asked to evaluate the oversight, management and operations of their pension funds by assigning a ranking (from six to one, six being the most positive) which was then averaged to produce a "CEO score" and was used as a proxy for good governance.

The study also obtained the five year performance data for these pension funds from CEM Benchmarking, an organisation that measures the cost effectiveness of pension fund organisations around the world. The study used a metric called Net Value Added (NVA), supplied by CEM Benchmarking as a proxy for performance.[5]

4. Keith Ambachtsheer, Ronald Capelle and Tom Scheibelhut, "Improving Pension Fund Performance", Association for Investment Management and Research, 1998.
5. Keith Ambachtsheer, Ronald Capelle and Hubert Lum, "Pension Fund Governance Today: Strengths, Weaknesses, and Opportunities for Improvement", Financial Analysts Journal, Working Paper, October 2006.

Measuring good governance - funds

Chart 1 shows the relative frequency of CEO scores for the 2005 study and the ranking of responses for the same questions from the earlier study in 1997.

The Chart shows the average CEO score for 1997 was 4.8 and for 2005 was 4.9, which suggests these respondents are consistently likely to assign their funds high rankings to the survey questions (given the assigned rankings were between one and six).

Indeed, over this period the incidence of very high scores increased sharply.

This study concluded that with perfect quality and performance metrics (this study used CEO scores as a proxy for governance quality and NVA as the proxy for organisation performance), a positive statistical association between the two (governance quality and organisation performance) would surely exist.

It also found that neither the CEO scores nor NVAs are perfect metrics.

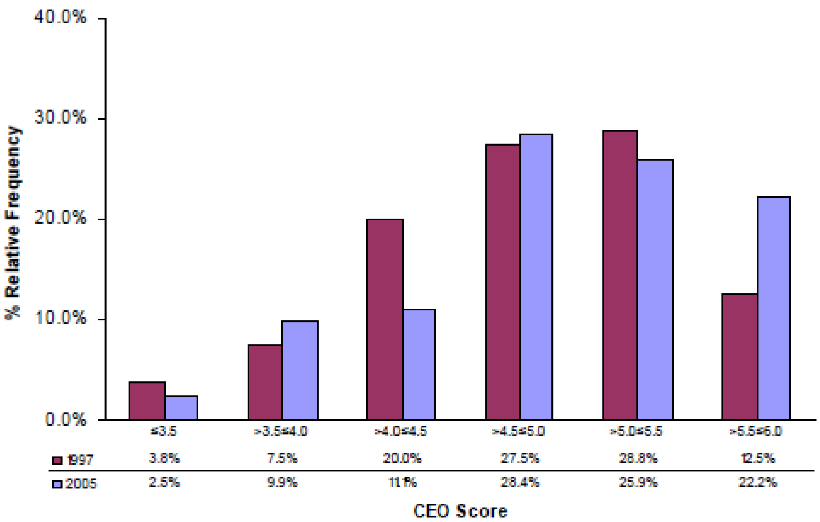
Nevertheless, a generally positive statistical association between the two metrics was identified in the study. The "poor-good" governance gap, as assessed by pension fund CEOs (or equivalent) themselves, has been "worth" as much as 1-2% of additional return per annum.[6]

Additionally, the authors themselves believe this result is likely to understate the real value-added potential of high-performance pension fund governance and management, stating they have "seen some pension funds achieve long-term NVA results around 3%+ per annum which displayed good governance practices ."[7]

A 2007 study by Clark and Urwin of pension funds with over $5 billion in assets under management, concluded that strong governance is linked to strong performance.[8]

Similarly, a study by Mercer of pension funds across the UK, assigned a lessening of pension fund deficits to a strengthening on governance at the pension fund.[9]

Chart 1: Distribution of CEO scores for 1997 and 2005



Source: "Pension Fund Governance Today: Strengths, Weaknesses, and Opportunities for Improvement", Financial Analysts Journal, Working Paper, October 2006.

6. *Ibid*
7. *Ibid*
8. Gordon Clark and Roger Urwin, "Best Practice Pension Fund Governance", Journal of Asset Management, Vol 9. 2008.
9. Mercer, "Global Governance of Retirement Plans Survey 2006: Meeting the Challenge of Implementation: Europe", 2006.

Measuring good governance - companies

There are a greater number of studies analysing the performance of companies in the listed market environment and specifically the relationship between performance and the governance practices of those companies. Some of these studies provide insightful findings.

Corporate governance

The Australian Treasury released a paper in 2009 entitled "Corporate Governance and Financial Performance in an Australian Context". This paper analysed the relationship between a company's adoption of the Australian Securities Exchange (ASX) Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations, and the subsequent shareholder performance, operating performance, and one year sales growth.

The paper covered the top 300 Australian listed companies in 2004, 2005 and 2006. Its conclusions were "that companies with better corporate governance outperform poorly governed companies, particularly in relation to earnings per share and return on assets. Furthermore, we find companies that are fully compliant with the ASX Corporate Governance Principles perform better than companies that are only partially compliant."[10]

However, the paper also noted "the governance structures of a firm are endogenous, making it difficult to draw causal inferences. For example, while it is possible companies that choose to comply with the ASX Corporate Governance Principles will perform better because of it, it is also possible companies that perform better are more likely to choose to comply as it is easier for them to do so when things are going well."[11]

The Australian Treasury also conducted its own literature review including studies from the US, Australia, Germany, Great Britain, Korea and Switzerland and found positive links between the good governance of companies and good performance. [12]

Looking overseas, a survey in the McKinsey Quarterly, 2000, found investors would pay 18% more for shares of a well-governed UK or US company than for shares of a similar, more poorly governed organisation. The premium was 22% for Italian organisations and 27% for firms in Indonesia.[13]

In terms of stock prices, a 2006 paper entitled "Better Governance = Better Performance?" by Kouwenberg tested the introduction of the good governance code introduced in Thailand in 2002 and found a positive relationship between stock price returns in 2003-05 and adoption of the code.

The research found (among other things) firms that followed most of the 15 good governance principles had a higher stock market value in the period 2003-2005 compared to firms that did not implement them.

10. The Australian Treasury, "Corporate Governance and Financial Performance in an Australian Context", 2009.
11. *Ibid*
12. *Ibid*
13. Jonathan Barnes, "Putting a Value on Good Governance", CFA Magazine, May-June 2004.

Measuring good governance – companies

The stock return of the top 20% "good governance" companies in the period 2003-2005 was 19% per year better than the stock return of the bottom 20% companies. [14]

A US study by Lawrence Brown in 2004 used the Corporate Governance Quotient (CGQ) supplied by Institutional Shareholder Services to evaluate the quality of corporate boards and the impact their governance practices may have on performance.

The study found that firms in the bottom decile of industry-adjusted CGQ had five year returns that were 3.95% below the industry average, while firms in the top decile of industry-adjusted CGQ had five year returns that were 7.91% above the industry-adjusted average.

The difference in performance between the two groups was 11.86%.[15]

Across the Atlantic, the Association of British Insurers (ABI) studied 343 FTSE companies over a four year period.

The ABI concluded the companies which exercised good governance (based on its measurement) produced higher risk adjusted returns and their share price was less volatile over the four year period of the study. "ABI believes that the superior governance practices led directly to the strong performance."[16]

14. Roy Kouwenberg, "Better Governance = Better Performance?", Mahidol University, College of Management, 2006. .
15. Lawrence Brown, "The Correlation between Corporate and Company Performance", Georgia State University, 2004.
16. Mariano Selvaggi and James Upton, "Governance and Performance in Corporate Britain, " ABI Research Paper 7, ABI Research and Investment Affairs Department, 2008.

Conclusion

There will always be ongoing discussion regarding the existence, or otherwise, of a correlation between good governance and successful performance.

While it does seem intuitive that good governance and processes should create the opportunity for good outcomes, many challenges exist in finding a way to measure good governance and as such there is limited empirical research to support this.

This paper has identified a number of empirical studies which have tried to estimate the true economic value of good governance in regard to the performance of pension funds and listed companies.

While it is clear the empirical research to date is limited in scope and has its shortcomings, it is also clear that challenges remain in effectively assessing and analysing governance issues.

Empirical data

Even though the empirical data should be viewed with caution, it provides valuable insights into the relationship between governance and performance.

These studies, even with their limitations, do support a link between governance and performance, albeit less so in the institutional investor space.

While nothing can guarantee good investment outcomes (and luck has certainly been known to play a part in explaining good returns at times), it certainly appears that well governed funds and companies will experience superior investment performance over the long-term.

Future performance

While future performance cannot be predicted and is difficult to control, a key element of performance which can be controlled is the establishment of a well-defined governance framework.

As we have seen, a clear investment governance system continues to be an important factor driving performance and must be continuously evaluated and assessed for its ongoing effectiveness and relevance.

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