Governance Data: Where is the Alpha?

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Research Summary

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Investors commonly acknowledge that corporate governance, defined as a system of rules, practices and processes that sets how a firm is managed and controlled, has material impact on equity performance. Yet, despite its incontestable importance, corporate governance's quality and impact are somehow hard to assess. Several characteristics come into play, including heterogeneous corporate histories, cultures and structures, the different regulatory framework between countries (even in Europe), and company sizes.

In our research paper *Corporate governance and its impact on European equity performances*[1]; published in June 2022, we aim to explore using a quantitative approach the relationship between corporate governance and equity performance by going beyond the classic approach that relies on the existence of allegedly good governance programmes.

To assess the difficult-to-interpret aggregated governance framework, we used granular data collected by Proxinvest, a French and European voting advisory agency, specialising in general meeting, corporate governance and shareholder engagement issues. Data used covered a period from 2015 to 2021 and included around 440 European companies, from 16 European developed market countries.

These data can be classified into three principal themes with material impact:

Board Structure

Directors' Compensation

Shareholders' Voting Rights

For each governance indicator, we separated the universe into two subsets based on the value of the indicator. For each subset, we created an equally-weighted portfolio with annual rebalancing. We then aggregated the two portfolios, being long on the portfolio with the highest indicator value and short on the portfolio with the lowest indicator value. To verify whether our results were biased by sector or size effects, we performed the same test as described above while neutralising those effects. All portfolios were calculated in EUR, from January 2017 to December 2021.

Our study confirmed the important impact that corporate governance has on equity performance. To varying extents, most of the themes we have identified in the paper have significant influence while others may have only mixed impact. Among the most significant indicators, we can mention the level of a senior management bonus cap and the total overall compensation of the CEO, the number of board meetings held, the size of the board and the average mandate term.

We can conclude that it is profitable for investors to incorporate corporate governance considerations when building investment strategies. Our study considered a relatively short period of time (five years), yet was very rich from a financial data standpoint, as we included the drawdown in 2018, the bull market in 2019, COVID-19 and its economic effects, ending with the eventual recovery we witnessed after March 2020 and the strong sector rotation in European markets. As high-quality corporate governance is hard to produce, further research will be needed to assess and monitor how corporate governance will affect equity performances in the coming years.

[1] L. Tran, C. De Franco, A. Demarolle, J. Nicolle. Corporate governance and its impact on European equity performances. June 2022.

Governance Data: Where is the Alpha?

Board Structure

Results *(annualised alpha)*:

Category	Indicator	Annualized Alpha: "Direct" (Long High/Yes, Short Low/No)	Sector Neutral	Size Neutral	Δ Direct/Sector	Δ Direct/Size
Board Diversity	Gender Diversity	0.9%	0.1%	0.6%	0.7%	0.3%
	Nationality Diversity	0.9%	0.2%	0.6%	0.8%	0.4%
Board Neutrality	Independence	1.1%	1.6%	1.2%	-0.5%	-0.1%
	Remuneration	-2.6%	-2.7%	-3.4%	0.1%	0.8%
	Stock Holdings	3.1%	3.1%	3.1%	0.0%	0.0%
Board Experience & Organization	Average Tenure	3.2%	2.3%	2.6%	0.8%	0.6%
	Mandate Term	-3.2%	-2.8%	-2.9%	-0.4%	-0.3%
	Number of Meetings	-3.9%	-2.1%	-4.4%	-1.8%	0.5%
	Size	-3.2%	-2.5%	-3.2%	-0.7%	0.0%

- **Board Gender Diversity** *(+0.9%)*: our study found a positive, but relatively weak relationship between high gender diversity and equity performance. It is, however, reasonable to expect that this relationship may weaken over time because of upcoming legislative and regulation outcomes on minimum gender diversity targets for European companies.
- **Board Nationality Diversity** *(+0.9%)*: our results showed that greater nationality diversity in the board improves equity performance. This might highlight the importance of expertise and knowledge of foreign culture and markets brought in by non-national board members (for example, to better define international strategies, expand in foreign markets, or represent more efficiently the interests of foreign shareholders).
- **Board Independence** *(+1.1%)*: our results show that a high level of board independence appears to contribute positively to equity performance. This aligns with the common expectation that high board independence is a key factor in protecting shareholder values.
- **Board Remuneration** *(-2.6%)*: our results suggest that high board remuneration consistently penalises equity performance. In fact, if the fee paid by the company to the member as compensation for being on the board is significant in relation to the member's net worth, it can become a subconscious factor affecting their judgment.
- **Stock Holdings** *(+3.1%)*: results shows that companies that require a minimum stock holding for board members perform better. Board members who own a company's stock could be more aligned with shareholders and show greater interest in the company.
- **Average Tenure** *(+3.2%)*: our results show that companies with longer director tenure outperform those with shorter tenure. This suggests that long-tenured directors have more understanding and experience in company operations that help improve their oversight and advisory capabilities.
- **Mandate Term** *(-3.2%)*: results show that companies with shorter mandate terms for board members tend to perform better compared to companies with members that have been in place for longer. A shorter mandate term puts more power in the hand of shareholders to exercise their owner's rights by re-electing existing or appointing new board members that better represent their interests. It may also be related to the ability to bring onto the board new members with diverse skills and experience, improving the overall ability of the board in decision making and oversight.
- **Number of Meetings** *(-3.9%)*: companies with fewer board meetings per year appear to perform better. These observations suggest that an excessive number of meetings reduces board efficacy by impeding the cohesion and contribution of each member in discussion and decision-taking.
- **Board Size** *(-3.2%)*: our results show that companies with a small board appear to significantly outperform those with large boards.

Governance Data: Where is the Alpha?

Directors' Compensation

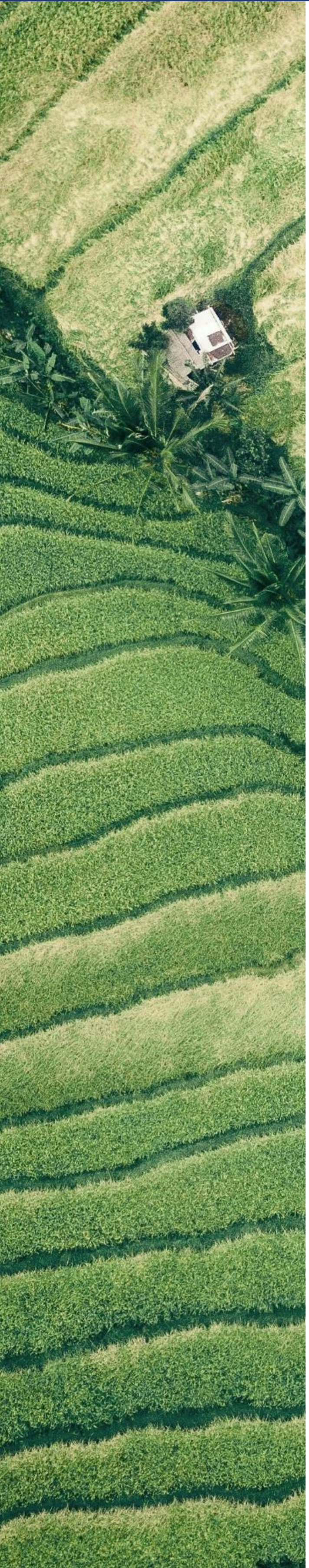
Results *(annualised alpha)*:

Category	Indicator	Annualized Alpha: "Direct" (Long High/Yes, Short Low/No)	Annualized Alpha: Sector Neutral	Annualized Alpha: Size Neutral	Annualized Alpha: Δ Direct/Sector	Annualized Alpha: Δ Direct/Size
Absolute Compensation	Annual Bonus	-2.0%	-2.8%	-2.8%	0.8%	0.8%
	Base Salary	-1.6%	-2.1%	-2.5%	0.5%	0.9%
	Long-Term Compensation	-2.1%	-2.9%	-2.4%	0.8%	0.3%
	Other Compensation	-2.3%	-3.0%	-1.3%	0.6%	-1.1%
	Total Compensation	-3.1%	-3.2%	-3.0%	0.0%	-0.1%
	Senior Management Bonus Cap	-4.7%	-5.6%	-4.5%	0.9%	-0.2%
Relative Compensation	Base Salary as % Total	2.8%	2.8%	3.0%	-0.1%	-0.3%
	Bonus Salary as % Total	-1.0%	-1.7%	-1.1%	0.7%	0.0%
	Long-Term as % of Total	-0.9%	-0.4%	-0.7%	-0.5%	-0.2%
	Other as % Total	0.6%	-0.6%	0.2%	1.3%	0.4%

- **CEO Total Compensation** *(-3.1%)*: companies with low CEO total compensation significantly outperformed companies that award their CEO with large total compensation packages. This finding could suggest that excessive compensation signals an agency problem in a weak governance structure that could negatively affect the company's performance.
- **Senior Management Bonus Cap** *(-4.7%)*: the result suggests that a lower bonus cap arrangement can be a highly effective tool and hence contributes significantly to equity performance. Setting and maintaining an appropriate bonus cap for senior managers can play an important role in controlling management's attempts to misappropriate company resources by paying excessive bonuses.
- **Compensation Package** *(Base Salary (-1.6%), Annual Bonus (-2.0%), Long-Term (-2.1%) and Other Compensation (-2.3%))*: our results show that whether we consider the base salary, the bonus, long-term or other types of compensation, companies that have a more parsimonious compensation policy and award relatively less to their senior managers tend to perform better. Interestingly, the biggest gap is observed for the Other Compensation pillar, which tends to be company-specific and may eventually hide sub-standard practices in CEO compensation policies.
- **Compensation relative to Total** *(Base Salary (+2.8%), Annual Bonus (-1.0%), Long-Term (-0.9%) and Other Compensation (+0.6%))*: a clear pattern emerges from our results: companies that pay a more significant part of CEO total package in the form of base salary show better performance. Meanwhile, when an annual bonus or other form of compensation represents a significant proportion of total compensation, equity performance tends to lag. This confirms the intuition that a high base salary proportion of the total package can serve as well-deserved compensation to effectively motivate the CEO, while avoiding managerial short-termism linked to inherently short-term incentives (such as a bonus), which possibly has harmful effects on the company's long-term growth.

Governance Data: Where is the Alpha?

Shareholders Voting Rights



Results *(annualised alpha)*:

Indicator	Annualized Alpha				
	"Direct" (Long Yes, Short No)	Sector Neutral	Size Neutral	Δ Direct/Sector	Δ Direct/Size
Non-Voting Rights	-2.0%	Not Applicable		Not Applicable	
Multiple Voting Rights	3.8%				
Multiple Voting Rights subject to Holding Period or Register	-3.2%				

- **Non-Voting Rights** *(-2.0%)***:** there is a nearly unanimous view against non-voting shares among regulators and scholars as it goes against the fundamental right of shareholders to protect their investments. Our results support this view, as we find that companies without non- voting shares perform better. However, we must acknowledge that across our data sample, companies with non-voting shares are relatively few. The results could therefore be affected by idiosyncratic factors of this small minority.
- **Multiple Voting Rights** *(+3.8%)***:** the debate has been nuanced for multiple voting rights. Multiple-voting shares as a control-enhancing device mechanism can facilitate power abuse by controlling shareholders. But support for multiple-voting shares is growing recently as short-term shareholders often focus on short-term results and such short-termism can have negative impact on long-term company growth while rational and long-term shareholders will adopt strategies and policies that better serve the interests of the company in the long run. Our results support this argument: companies with multiple voting shares show better performance.
- **Multiple Voting Rights subject to Holding Period or Register Mechanism** *(-3.2%)***:** when comparing different multiple voting provisions - loyalty voting regimes and other provisions such as different share classes - we observe that companies with other multiple voting provisions appear to generate better performance than companies with loyalty voting regimes. One possible theory to explain this phenomenon is that, even if the availability of this feature does not systematically materialise, its existence establishes an effective barrier to prevent potential hostile takeovers, hence letting management to focus on more long-term strategies.

Legal information