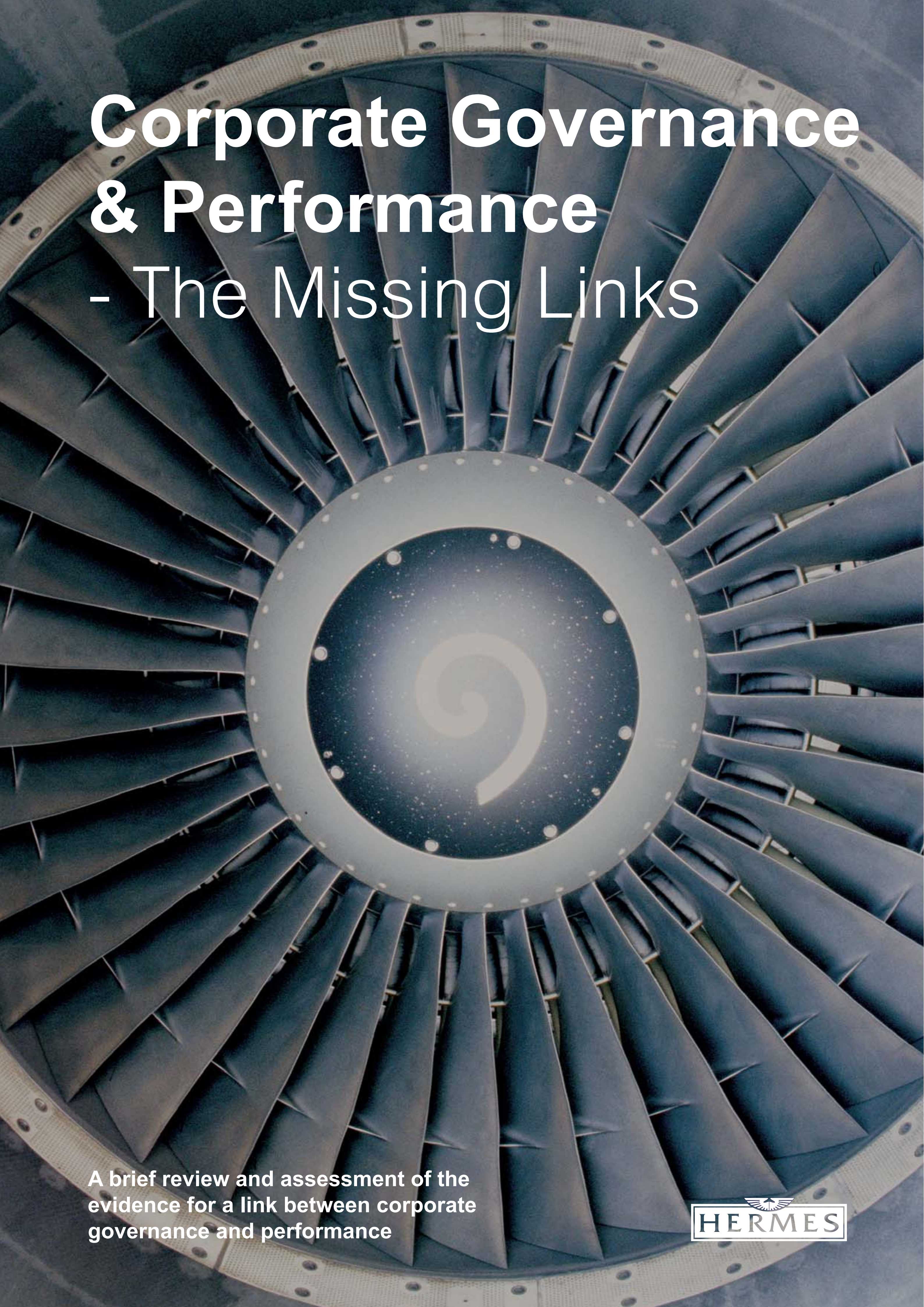

Corporate Governance & Performance

- The Missing Links

A brief review and assessment of the evidence for a link between corporate governance and performance

HERMES

Contents

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Introduction

Companies with governance structures that allow shareholders to hold their management to account, and those that have active, interested and involved shareholders will ultimately perform better and be worth more than those where either of these factors is missing.

The question of whether there is a link between corporate governance and performance is significant for a fund manager such as Hermes which undertakes corporate governance activities on behalf of three of the UK's five largest pension funds. Such funds are the classic long-term investors who will be shareholders for decades and, as they represent thousands of individuals who depend on them for their long-term financial well-being, have a strong interest in the sustainable, wealth creating capacity of the companies in which they invest.

The corporate governance activities carried out by Hermes on behalf of its clients are based on the fundamental belief that companies with governance structures that allow shareholders to hold their management to account, and those that have active, interested and involved shareholders will ultimately perform better and be worth more than those where either of these factors is missing. At the very least, we are convinced that sensible corporate governance activities may prevent the destruction of value. In our view, the key to the long term success of a business is a constructive dialogue between companies and investors, commonly described as active ownership. Management and boards which have a dialogue with and are accountable to their owners will tend to operate more effectively in the long term interests of the business and its investors.

Given this fundamental belief, the evidence for a link between corporate governance and performance is of great importance to Hermes and its clients. There has been much research in this area in recent years, which has often come to inconclusive results. We will review some of the findings in this chapter. We will then discuss the difficulties with research into and other evidence on the relationship between corporate governance and performance and explain possible reasons for inconclusive results of some of the studies. We will also highlight some of the evidence supporting our view that it is a combination of a company's governance structure and active ownership that matters in terms of performance.

Before reviewing the existing research and evidence it is necessary briefly to consider the methodological and evidentiary difficulties that studies in this area face. To begin with, there are many different interpretations of both 'corporate governance' and 'performance'. The term 'corporate governance' has come to mean many things. Traditionally and at a fundamental level, the concept refers to corporate decision-making, control and accountability, particularly the structure of the board and its working procedures. However, the term corporate governance is sometimes used very widely embracing a company's relations with several different stakeholders or very narrowly referring to a company's compliance with the provisions of best practice codes. The problem that researchers face is not only to define what is meant by 'corporate governance' but also what amounts to 'good' or 'bad' corporate governance. Similarly, the term 'performance' may refer to rather different concepts, such as the development of the share price, profitability or the present valuation of a company. As such, the body of research into the link between corporate governance and performance contains studies that seek to correlate rather different concepts of corporate governance and measures of performance. We would define good

Introduction - *continued*

If corporate governance is simply regarded as a risk factor, its significance for the performance and ultimately the valuation of a company, which follows from the relationship between a company's Equity Risk Premium and its market value, is immediately apparent.

corporate governance simply as good management, involving accountability to and a constructive dialogue with investors, as well as consideration of the interests of other stakeholders where appropriate. However, many of the studies that we have reviewed use their own definition of corporate governance and it is necessary to keep that in mind when assessing the research and drawing conclusions.

Evidentiary difficulties of research into and evidence on the relationship between corporate governance and performance include the issue of causation, which is notoriously hard to prove, and the limited availability of reliable historic data. We note that improved corporate governance may only have an effect on the performance of a company in three, five or even ten years, and that studies that cover only a few years of data may thus come to wrong conclusions.

If corporate governance is simply regarded as a risk factor, its significance for the performance and ultimately the valuation of a company, which follows from the relationship between a company's Equity Risk Premium and its market value, is immediately apparent. There is a direct inverse relationship between the Equity Risk Premium and the market valuation of a company. As such, it follows that by decreasing a company's Equity Risk Premium, for example, by improving its corporate governance structure, its market value can be improved. The relationship between a company's Equity Risk Premium and its valuation also seems to be the basis for the findings of McKinsey's 'Global Investor Opinion Survey' (2000 (updated in 2002)), which is the most widely quoted opinion-based research into the link between corporate governance and performance as measured by the valuation of the company. McKinsey surveyed over 200 institutional investors and found that 80% of the respondents would pay a premium for well-governed companies. The size of the premium varied by market, from 11% for Canadian companies to around 40% for companies operating in countries where the regulatory backdrop was less certain, such as Egypt, Morocco, and Russia. The UK and the US scored 12% and 14% respectively. Although the study is opinion-based and therefore of limited evidentiary value, the finding reflects a growing perception amongst market participants that well-governed companies, which are perceived to be run in the interests of investors, may benefit from a lower cost of capital.

However, knowledge of the relationship between the Equity Risk Premium and valuation in itself is not sufficient for investors to embrace a corporate governance based investment strategy that seeks to improve the performance and ultimately the value of investee companies. To begin with, whilst governance risk may be measured in different ways, both quantitatively and qualitatively, its interrelation with and precise effect on the Equity Risk Premium is difficult to assess. Moreover, there are difficulties with identifying corporate governance changes that reduce the governance risk and then the practical problem of bringing about the necessary improvements. As such, in terms of the relationship between corporate governance and performance, the knowledge that corporate governance affects the Equity Risk Premium is only a starting point.

Recent research assessing the link between corporate governance and performance in Asian markets (Gill and Allen (2005)) points to another difficulty with looking at governance simply as a risk factor. It found that companies and markets with high levels of corporate governance do not necessarily outperform those with low levels when markets are rising, especially when there are strong liquidity inflows into markets. The researchers explain this finding with a negative correlation between the performance of companies with high levels of corporate governance and the appetite of investors for risk. They point out that one reason for this is that well-governed companies tend to have already strong valuations when markets start rising. Moreover, the study suggests that when liquidity enters markets, it raises risk appetite and effectively reduces the risk premium, thus making investment in less well-governed companies more attractive. According to the research, it is only when markets are falling that companies and markets with high levels of corporate governance outperform those with low levels, as investors abandon risky companies.

From this brief discussion, it follows that there are two important questions that an investor must be able to address before trying to use corporate governance as part of an investment approach that seeks to improve the performance and ultimately the value of investee companies, namely: What exactly are the corporate governance issues that matter for a particular company at a certain time and how can positive change be achieved? It seems that research into the relationship of corporate governance and performance has by and large failed until today to recognise appropriately both issues and to incorporate them effectively into methodology. Given these missing links, it is perhaps not surprising that the results of some of the research are inconclusive. In the following two sections, we review and assess evidence based on governance-ranking research and consider the performance of companies included in focus lists and shareholder engagement funds. We also provide a case study of how shareholder engagement works in practice. On the basis of our review and our assessment of existing research and evidence, we then provide our views on the two issues and identify what we consider to be the two missing links in the research into the relationship between corporate governance and performance. ■

What exactly are the corporate governance issues that matter for a particular company at a certain time and how can positive change be achieved?

Governance-ranking based research into the link between corporate governance and performance

The most valuable research focuses on a relatively small set of governance standards and seeks to identify which standards are directly related to performance.

Overview of governance-ranking research

Governance-ranking research seeks to establish a link between one or more governance ‘factors’ or ‘standards’ and performance. In the following discussion, we will use the expression ‘standards’ to refer to a broad range of criteria on the basis of which the quality of governance may be assessed. The rankings are generally based on an assessment of the presence of certain factors (for example, a poison pill provision) or compliance with certain requirements (for example, that half of the board members are independent non-executive directors). Standards are used as a proxy objectively to measure a company's governance quality. The focus on certain standards by reference to which the quality of corporate governance can be objectively measured has superficial attractions. However, it also causes problems and distortions in the findings of the research trying to link corporate governance and performance. To begin with, any single governance standard may for a number of reasons be unrelated to the performance of companies in a particular market during a given period of time. Research that focuses on a single standard, such as the composition of boards, in isolation, may thus lead to incorrect conclusions. Moreover, such research does not effectively capture the general benefits that may result from active ownership involving engagement regarding a larger set of standards. More complex research considers a range of governance standards against which the corporate governance qualities of the companies investigated are assessed. The selection of a set of governance standards introduces a subjective element into governance-ranking research. In addition researchers may attach different weight to the standards investigated for the purposes of the ranking that underlies the studies, introducing further subjectivity.

Many of the studies that suggest that there is no link between corporate governance and performance focus on a single governance standard (for example, Bhagat and Black (1999) and (2002), Dalton et al (1998) and Dulewicz and Herbert (2003)). For the reasons explained above, such a result is perhaps unsurprising. Similarly, research involving a ranking based on compliance with too many potentially insignificant governance standards may distort the finding of a link between certain 'core' standards and performance. We therefore believe that the most valuable research focuses on a relatively small set of governance standards and seeks to identify which standards are directly related to performance.

The most celebrated governance-ranking study, which supports the proposition that there is a link between the quality of corporate governance, measured in terms of shareholder rights, and performance was carried out by Gompers et al (2003). The research is based on an assessment of the governance of 1,500 US companies using 24 governance 'provisions' analysed by the Institutional Investors Research Center (IRRC) during the 1990s. The IRRC tracks both company level rules and coverage under six state take-over laws. The 24 provisions fall into five broad groups: Measures for delaying hostile bidders, voting rights, director protection, other take-over defences and state laws. The study found that if a fund had taken long positions in companies scoring in the top decile of their governance ranking and short positions in companies in the bottom decile, it would have outperformed the market by 8.5% per year throughout the 1990s. The research also supported the proposition that companies with a good governance ranking were higher valued and had higher profits than those with a bad ranking. Prior to Gompers et al, Millstein and MacAvoy (1998) had found that over five years, well-governed companies (identified on the basis of CalPERS ratings) outperformed by 7%. Support for a link between good governance practice and shareholder returns was also found in research conducted by Governance Metrics International in 2003 and 2004. Drobetz et al (2004) replicated the finding of Gompers et al in respect of the German market. The research by Bauer et al (2004), based on an analysis of corporate governance data on a sample of European companies included in the FTSE Eurotop 300, provided somewhat mixed support. They found a positive relationship between the corporate governance standards investigated and share price and company value but not operating performance.

Following on from the research by Gompers et al, Bebchuk et al (2004) investigated which of the 24 governance provisions tracked by the IRRC are correlated with company value and shareholder returns. They identified six such provisions: four concerning the extent to which a majority of shareholders can impose its will on the management and two relating to mechanisms that facilitate the defence of a hostile take-over. Based on their assessment of the six provisions, they then constructed an 'entrenchment index' and investigated the empirical relationship between this index and performance. They found that increases in the level of this index are consistently associated with economically significant reductions in the valuation of companies measured by Tobin's Q and that companies with higher index levels were associated with significant negative abnormal returns during the 1990-2003 period. Most significantly, Bebchuk et al found that the six provisions on which their entrenchment index was based fully explained the correlation identified by Gompers et al between the 24 IRRC provisions and reduced company value and lower share returns during the 1990s.

In contrast to the research by Gompers et al and Bebchuk et al, the research into the link between corporate governance and performance carried out in recent years by Deutsche Bank (Deutsche Bank (2006), (2005a), (2005b), (2004a), (2004b) and (2003)) covers several of the main markets including Asia, Continental Europe, the UK and the US. Deutsche Bank's recently updated UK research (Deutsche Bank (2005b) and (2004a)) is based on an assessment of the governance of the FTSE 350 companies at the end of 2000, 2003 and June 2005 using 50 differently weighted corporate governance standards. It found a clear link between the quality of corporate governance and share price performance of the companies considered. During the four and a half year period investigated, the top 20% of the companies in terms of governance structure and behaviour outperformed those in the bottom 20% by 32%. Deutsche Bank also carried out a momentum analysis in which companies were ranked on the basis of how their governance practices evolved over the period investigated. Here the outperformance of the companies which were consistently in the top 20%, as compared to the companies consistently in the bottom 20%, was 59%.

During the four and a half year period investigated, the top 20% of the companies in terms of governance structure and behaviour outperformed those in the bottom 20% by 32%.

Governance-ranking based research into the link between corporate governance and performance *- continued*

Deutsche Bank's research also showed that there was a positive relationship between the historic governance assessment of the companies and their profitability (ROE).

Furthermore, the study found that companies which improved from the lowest quintile outperformed those companies that remained in the lowest quintile by 7%. Deutsche Bank's research also showed that there was a positive relationship between the historic governance assessment of the companies and their profitability (ROE). For example, the top 20% companies (average 2005 ROE estimate of 20.9%) were significantly more profitable than the bottom 20% (average 2005 ROE estimate of 10.9%). Similarly, the research found that the profitability of the top companies was significantly better than that of the bottom companies using ROA and EBITDA margin. However, the research did not find a clear relationship between the quality of governance and investors' current valuations, measured by P/E, P/CF and P/BV, as opposed to the historic share price performance. This would seem to support the view that the knowledge that corporate governance affects the Equity Risk Premium in itself is only a starting point in respect of the link between corporate governance and performance.

In an academic study, Bauer et al (2005) investigated the importance of corporate governance for Japanese companies. Using a unique data set provided by Governance Metrics International, which rates firms on six different corporate governance categories, the researchers analysed whether companies with a high governance ranking perform better than companies with a low governance ranking. They measured corporate performance by share price, company value and operating performance. Using an overall index, the authors found that corporate governance positively affects share price and company value but negatively affects operating performance. They suggest a number of explanations for the finding regarding operating performance, for example, the possibility that companies with good governance tend to apply more prudent accounting policies leading to more conservative financial reporting. Moreover, using the individual corporate governance categories, the study found that they differently affect the variables investigated. For example, whereas provisions towards financial disclosure, shareholder rights and remuneration matter in terms of share price and company value, provisions falling into the market for control category reduce company value. The authors explained this by the fact that take-overs in Japan are rare and hence any provisions in this area are futile.

Most recently, clear support for the proposition that corporate governance matters in terms of performance was found by a Goldman Sachs study on Australian companies (Goldman Sachs (2006)). The research, which used corporate governance rating data from Corporate Governance International, tested the investment returns from buying companies that are top rated and selling those that are bottom rated. The study found that such an investment strategy would have generated a 10.9% return above the passive market return for the period from September 2005 to May 2006. The research, which was back tested over a period from August 2001, also sought to identify which of the five proxies of good corporate governance used by Corporate Governance International matter in terms of returns. According to the study, the overall structure of the board and the skills of its members are the most relevant governance factors in terms of excess returns. The study also examined the relevance of corporate governance ratings as a forward indicator for the likelihood of earnings surprises. The research found that in the June 2005 reporting season, top rated companies reported average positive earnings surprises of 2.6% versus an average negative earnings surprise of -0.4% for low rated companies. Thus, a further finding of the study was that corporate governance ratings can help investors to assess the potential for companies to surprise on their earnings.

Assessment of governance-ranking research

Most of the governance-ranking research provides support for the proposition that good corporate governance improves performance and ultimately the value of companies. We acknowledge that there is some research falling into this category that raises doubts on the existence of a link between corporate governance and performance. We also note that the governance-ranking studies are based on the assessment of certain governance standards in the past and thus on historic data. The standards investigated and often the weights attached to them vary between the studies. Moreover, as the standards assessed depend on the regulation applicable in a particular market and may vary over time, it is difficult to draw general conclusions.

Some of the more sophisticated research partly addresses these issues by considering international standards and using momentum analysis. However, particularly the finding by Bebchuk et al, which suggests that corporate governance activities may need to be focused on certain 'core' standards effectively to improve performance (Bebchuk et al (2004)), needs to be treated with care. The governance provisions investigated by the IRRC are principally concerned with mechanisms enabling management to prevent or to delay take-overs. As the regulation of take-overs differs significantly between the main world markets, the six provisions identified by Bebchuk et al in respect of the US may not be of similar relevance elsewhere. Before any general conclusions are drawn, research replicating the finding by Bebchuk et al in respect of markets other than the US is required to identify those specific governance standards that are directly linked to performance. In spite of these qualifications, the governance-ranking research on the whole supports the proposition that good corporate governance enhances performance, and ultimately the value of companies.

Having said this, there remains a fundamental question regarding research that seeks to establish a link between corporate governance and performance, which is based on corporate governance ratings and rankings, namely, whether standards that are meant objectively to measure the corporate governance quality of a specific company matter in respect of the performance of that particular company. Before considering the issue at the company level, there is of course the question whether it is sensible to use the same set of standards to assess governance quality in different markets with their respective legal frameworks and best practice recommendations. For example, how much do we learn about the corporate governance quality of a German company by the fact that the majority of the members of its supervisory board are not independent as internationally defined, because of a law which requires that half of the board members must be

Most of the governance - ranking research provides support for the proposition that good corporate governance improves performance and ultimately the value of companies.

Governance-ranking based research into the link between corporate governance and performance *- continued*

What is the conclusion of the view that the most appropriate and effective corporate governance structure for a company is contingent on a number of factors that differ not only between markets and sectors, may change over the life cycle of a company but generally seems to be highly company specific?

employee representatives? Not a lot, it would seem. Nevertheless, the standard 'majority independence' continues to be widely used to assess the quality of corporate governance across the world.

Moreover, the typical ownership structure of companies varies significantly between markets. There are different problems, or agency conflicts, in companies that are closely held and controlled by one shareholder (majority shareholder v. minority shareholders) than in those that have a dispersed shareholder structure (management v. shareholders). This makes comparisons of the quality of corporate governance across markets with different ownership structures based on the same set of standards even more questionable. Research into the link between corporate governance and performance which takes this important consideration into account is rather limited to date (for an example, see Beiner et al (2004), a study that finds a positive relationship between corporate governance and Tobin's Q).

Even in respect of companies in the same market - and thus subject to the same regulation - with similar ownership structures, different governance standards may matter in terms of performance, for example, because they operate in different sectors with particular opportunities or threats. Clearly, the governance structure of a steel manufacturer may need to be different from that of a management consultancy. Finally, it seems intuitive that certain governance arrangements, such as combining or separating the roles of chairman and CEO, may be more or less appropriate for companies at different stages of their life cycle and in particular in crisis situations. What seems clear from this discussion is that in terms of the most appropriate governance structure, one size does not fit all companies

What is the conclusion of the view that the most appropriate and effective corporate governance structure for a company is contingent on a number of factors that differ not only between markets and sectors, may change over the life cycle of a company but generally seems to be highly company specific? If one subscribes to this view then it becomes clear that producing reliable corporate governance ratings and rankings, which are useful across different markets and sectors, is very challenging. As a consequence, the task to produce robust evidence that adherence to certain corporate governance standards may enhance the performance of companies and ultimately create value for shareholders is even more difficult than previously assumed – and perhaps impossible. The findings of the research carried out by a group of independent academics on behalf of the Dutch Corporate Governance Research Foundation for Pension Funds (SCGOP) in 2004 makes this very clear (de Jong et al (2004)).

If one believes that corporate governance can be used as part of an investment technique to improve performance and ultimately to increase the value of investee companies, there must be something in addition to the skill of identifying companies with objectively measured high or low governance quality. On the basis of the evidence we review in the next section, we would argue that other things being equal, the difference can be made by active, interested and involved shareholders. ■

Further evidence for a link between corporate governance and performance: Effectiveness of shareholder engagement

Performance of companies in focus lists

Focus lists are issued by a number of investors and investor groups. In essence, they attempt to induce the management of the companies listed to address performance or governance related problems by publicising them. The inclusion of a company in a focus list generally also represents a statement of intent of the issuer of the list to engage with the companies listed to encourage improvements. The rationale for focus lists is that by publicising the problems of companies and announcing an intention to engage with them to address the failings, their performance may improve at some point after they are included in a list. In addition, the expectation that a company's problems will be addressed following its inclusion in a list can lead to an immediate positive market reaction.

The best-known focus list is issued by CalPERS. The so-called 'CalPERS effect', that is, the improvement of a company's performance following its inclusion in the CalPERS focus list, was first described in 1994 (Nesbitt (1994)). This research, which was updated in 1995, 1997, 2001 (Nesbitt (2001)) and 2004 (Hewsenian and Noh (2004)), is generally regarded as the most compelling in this area. Until the most recent update of the research, it showed that companies included in the CalPERS focus list substantially outperformed in the five years after their inclusion in the focus list (by 41% in the original 1994 study and by 14% in the 2001 update). Results from the 2004 update provide more limited support for the long term positive effect showing excess returns of just 8% over the five year period after listing.

Studies of the 'CalPERS effect' were also undertaken by Anson, White and Ho of CalPERS (2003, 2004). In their 2003 study they found that there was a significant short term price impact after companies were included in the CalPERS focus list. The study documented that the average excess return, defined as the return earned over and above the risk adjusted return required for the focus list companies, earned by each company in the focus list for the 95 days period after inclusion in the list was 12%. As such, the authors concluded that the focus list had a significant short-term wealth enhancing effect. In their 2004 paper, Anson et al revised their original paper focusing on the longer term wealth effect of including companies in the CalPERS focus list. They found that on average a company that is included in the focus list earns a return over and above its risk adjusted rate of return for the one year period after publication of the list that is 59% greater than the risk adjusted rate of return that shareholders would normally expect to receive for their investment. The authors thus concluded that the focus list approach of CalPERS adds significant value to the investee companies targeted.

The methodology used by Anson et al has been questioned in the literature (Nelson 2005). However, there is very recent independent academic evidence to back up their findings. Barber analysed the gains from CalPERS corporate governance activities relating to the companies in the focus list from 1992 to 2005. He concluded that through these activities CalPERS had added an estimated $3.1 billion of value to its investments over that period (Barber 2006). Research into the effects of other focus lists also showed that after a company's inclusion in such a list its performance improved (Opler and Sokobin (1998)).

Companies included in the CalPERS focus list substantially outperformed in the five years after their inclusion in the focus list.

Further evidence for a link between corporate governance and performance: Effectiveness of shareholder engagement - *continued*

Since its inception in 2002, the European Focus Fund has outperformed its benchmark by 3.9% on an annualised basis (net of fees) (to 30 June 2006).

The research on the performance effect of focus lists supports the view that the process of publicising problems of companies and, when appropriate, active engagement by investors with such companies to address the failings identified can improve their performance. We consider that this finding in itself provides a sound justification for investors to act as active owners. We note that there is some research that does not fully support the proposition that inclusion of a company in a focus list is likely to improve its subsequent performance. Such inconclusive results may be explained by the fact that companies included in a focus list may not have the potential to respond to investor oversight and pressure (Caton et al (2001)). More limited support provided by some research may also be explained by other factors determining the success of investors' engagement with companies, such as the shareholding structure. Certain companies, for example, those with a family block holding, are less susceptible to change through engagements. The performance of shareholder engagement funds, which can take a company's potential to respond to constructive proposals and other factors, such as the shareholding structure, into account when selecting companies for investment and engagement, provides the most valuable evidence that corporate governance matters in terms of performance.

Performance of shareholder engagement funds

The success of shareholder engagement funds is the most compelling evidence supporting the proposition that active ownership with the objective of improving corporate governance can lead to better performance and ultimately a higher value of investee companies. Shareholder engagement funds invest in under-performing companies with governance problems which have the potential for improvement. As such, their performance provides a real life test involving a significant financial commitment to the proposition. By engaging with such companies and, if necessary, by using their ownership rights, active investors seek to encourage corporate governance improvements that they consider will ultimately lead to an increase in the value of their investment. Hermes' Focus Funds take this approach. They invest in companies that are fundamentally sound but under-performing as a result of weaknesses in their strategy, governance or financial structure. The Focus Fund team then engages with the companies' executive and non-executive directors and liaises with other shareholders and stakeholders as appropriate. Significantly, the Focus Funds team works constructively and co-operatively with the boards of investee companies and does not seek to micro-manage them. Indeed, the shareholder engagement programmes are intended to assist boards in taking tough decisions rather than to take such decisions for the boards and to support them in implementing decisions once taken. Thus, over a period of time and through a constructive dialogue, the Focus Fund team uses its influence as owner to help resolve the problems causing under-performance.

Hermes' original UK Focus Fund has out-performed the FTSE All Share Total Return Index by 3.1% on an annualised basis (net of fees) since its inception in 1998 (to 30 June 2006). Similarly, since its inception in 2002, the European Focus Fund has outperformed its benchmark by 3.9% on an annualised basis (net of fees) (to 30 June 2006). In the US, Relational

Investors LLC, out-performed its benchmark by 6.3% on an annualised basis (net of fees) since inception (to 30 June 2006). We believe that the outperformance of shareholder engagement funds in difficult market conditions - effectively using active ownership to improve corporate governance as an investment technique - provides the strongest evidence in support of the view that there is a link between corporate governance and performance.

The effectiveness of the investment approach taken by Hermes' Focus Funds in terms of returns for shareholders was recently investigated by four independent academics (Becht et al (2006)). The researchers were given unlimited access to Hermes' resources, including letters, memos, minutes, presentations, transcripts/recordings of telephone conversations and client reports, documenting its work with the companies in which Hermes' UK Focus Fund invested in a period over five years (1998-2004). They reviewed all forms of public and private engagement with 41 companies. One of the main objectives of their research was to determine if the achievement of the Focus Fund's engagement objectives, generally substantial changes in the governance structure of target companies, such as significant asset sales, divestments, or replacement of the CEO or chairman, is ultimately value increasing. The researchers found that when the engagement objectives led to actual outcomes, there were economically large and statistically significant positive abnormal returns around the announcement date. Excluding events with confounding information, such as earnings announcements or profit warnings, the mean abnormal returns were 5.3% in the seven day window around the announcement date. There were thus large positive market reactions to events initiated through the intervention of the Focus Fund. Importantly, the researchers also established that the Focus Fund succeeded in accomplishing its desired outcomes in the large majority of cases. On the basis of their findings the researchers concluded that shareholder activism can produce corporate governance changes that generate significant returns for shareholders. Using a novel research methodology, the researchers were also able to show that a high proportion of the Focus Fund's strong outperformance was attributable to activism and not stock picking. The independent academics thus found a clear link between shareholder activism and fund performance.

The strong performance of Hermes' Focus Funds and the results of the recent independent study of the investment approach they take support our fundamental belief that companies with active, interested and responsible shareholders are more likely to achieve superior long-term returns than those without. Hermes has extended its successful Focus Fund approach and also carries out engagements with selected companies held as part of its clients' indexed core holdings thus leveraging the unique resource it has built up since the early 1990s. In the following section, we describe one of these engagements, which we carried out between 2000 and 2003.

The researchers concluded that shareholder activism can produce corporate governance changes that generate significant returns for shareholders.

Further evidence for a link between corporate governance and performance: Effectiveness of shareholder engagement - *continued*

Shareholder engagement in practice: Premier Oil plc

By 2000, Premier Oil plc (“Premier”) had become a cause c l bre amongst those concerned with governance and more particularly with the social, ethical and environmental responsibilities of business. Most concerning, Premier's share price had dramatically underperformed the market for several years and it appeared unable to deliver on its stated strategy. Working with the company, with other shareholders, and with NGOs, Hermes helped the company to resolve these issues.

Working with the company, with other shareholders, and with NGOs, Hermes helped the company to resolve these issues.

Hermes accelerated its engagement with Premier in mid 2000. For several years previously Hermes had communicated its concerns over the company's board structure and had voted against the re-election of several of the non-executive directors whom it did not regard as being independent. On the governance side, the fundamental issue was that the company was dominated by two major shareholders, Amerada Hess, a US company, and Petronas, the Malaysian National Oil Company, each of which held 25% of the shares. Not content with the control and influence they wielded as such major shareholders, each of them also had two non-executive directors on the board. Two further non-executive directors were also deemed non independent.

These board problems were reflected in a failure by the company to address some of the severe problems that Premier was facing. The strategy was not clear to shareholders: it appeared that the strategy proposed in November 1999 when Petronas invested in the company (and on the basis of which independent shareholders had approved that investment) was not being followed, and it was not apparent to investors that an alternative had been developed. The company was in a strategic hole: it was not large enough to compete in production and downstream work with the emerging super-major oil companies, but it was also not as lightweight and fleet-of-foot as it needed to be in order fully to exploit the exploration opportunities opened up by the super-major’s focus on larger-scale fields. Its freedom of action was also limited by the company’s high level of gearing.

In addition, the company had allowed itself to become exposed to major ethical and reputational risks as a result of being the lead investor in the Yetagun gas field in Myanmar. Myanmar, formerly known as Burma, was a country ruled by a military dictatorship which had refused to accept the results of democratic elections in 1990, where summary arrest, forced labour, and torture were widely reported, and which had therefore become a pariah state. Premier's involvement in the country had brought public criticism of the company from a range of sources including Burmese campaigners, Amnesty International, trade union groups and, not least, the UK government. It was not clear to shareholders that the company was effectively managing the reputational and ethical risks it faced as a result of its involvement in Myanmar.

To begin exploring these concerns, Hermes held a meeting in mid-2000 with Premier's corporate responsibility and finance directors. This provided an opportunity to understand Premier's considerable positive work on the ground in Myanmar – which included building schools, funding teachers, AIDS education and environmental remediation. While Hermes recognised that positive work, there were continuing concerns. The board had not publicly stated that it believed it was effectively managing all the risks that were associated with its presence in Myanmar, and nor did Hermes have the confidence that the board as currently constituted could give shareholders the reassurance that they needed in that regard.

When Hermes had analysed all these issues, it came as no surprise that, in the absence of a clear strategy and with a restrictive capital structure, with the lightning rod of its involvement in Myanmar not clearly being managed and a board which did not seem designed to address these issues in the interests of all shareholders, Premier's share price had dramatically underperformed the market for several years. The next step in Hermes' engagement was a letter to the chairman of Premier, Sir David John, requesting a meeting to discuss the full range of concerns.

While Hermes was awaiting that meeting, it was approached by two separate groups asking it to engage on the social, ethical and environmental issues raised by Premier. The first group consisted of its clients, principally led by trade union pension fund trustees. The second was from NGOs who were focusing on disinvestment from Myanmar/Burma. Subsequently Hermes had discussions and met with representatives of both groups. Though Hermes did not share the rather limited engagement agenda of the NGOs, the meetings provided it with useful information and contacts for its engagement.

The meeting with Sir David John took place in January 2001, and was a frank and honest one. It was rapidly apparent to Hermes that Sir David understood its concerns. In December 2000, the company had already added a new, fully independent non-executive director. Sir David assured Hermes that further developments on the governance side were in train. Hermes approved of these developments, but queried whether they would ultimately be adequate to address all the issues identified. Sir David was also willing to discuss strategic and ethical concerns. Importantly, he agreed to the request of Hermes personally to meet representatives of the NGO Burma Campaign (until that point their contact with the company had only been through the corporate responsibility director).

Hermes followed up this meeting with a detailed and direct letter outlining its concerns and asking Sir David to begin addressing them in the interests of all shareholders. Sir David's prompt response assured Hermes that the board would continue to work for a solution to "enable the true value of the company to be reflected in the share price". In March 2001, Premier added another fully independent non-executive, a banking executive with extensive experience in Asia, and Malaysia in particular.

At the AGM in May 2001, Sir David made a very important public statement with regard to the shareholding structure of the company. It was an acknowledgement that the presence of two 25% shareholders was a burden on the company's share price – a point Hermes had clearly made in a meeting with him – and a statement of intent about seeking a resolution to this problem. He said: "We believe that the current share price remains low relative to the underlying value of the business partly as a result of the concentration of share ownership. The board is continuing to seek ways to reduce the discount on assets for the benefit of all shareholders."

Importantly, the chairman agreed to the request of Hermes personally to meet representatives of the NGO Burma Campaign.

Further evidence for a link between corporate governance and performance: Effectiveness of shareholder engagement - *continued*

Further positive steps occurred in October 2001. The company began to clarify its strategic position by selling assets in Indonesia and restructuring its position in Pakistan, having gained shareholder authority at an EGM.

Throughout this time Hermes was in close contact with pension funds in the United States who were engaged with Amerada Hess over their shareholding in Premier, and hence their involvement in Myanmar/Burma. Hermes pointed out to them that Amerada's statements appeared to be at odds with its understanding of UK law, and with statements made at the time of Premier's shareholders' circular at the time of its refinancing. Separate discussions were thus begun privately with Amerada to progress these issues.

The first year of Hermes' engagement had brought some progress but had failed fully to address Premier's fundamental problems. Hermes met Sir David and the chief executive officer in early 2002. This was an impressively frank meeting, where they were willing to be more open with Hermes about the work they had been undertaking to resolve Premier's problems. Over the years since 1999, they had proposed a number of solutions to the company's strategic impasse, but each had been in some way barred by one or other of the major shareholders. They were, however, confident that both shareholders now had a different attitude and that a resolution in the interests of all investors could now be achieved – though it might take a number of months.

Following this meeting Hermes sent Sir David a further forthright letter expressing its concerns at the actions of the major shareholders and putting in writing its offer to lend him support in the negotiations, should that prove valuable. Hermes formally offered to call on its contacts at global institutions and share with them its concerns that certain of the directors of Premier had not proved themselves to be the friends of minority investors. Hermes hoped that the implication of potential difficulties this might cause for fundraising by companies with which those directors were involved could bolster Sir David's hand in negotiations. Hermes also raised again its concerns that public statements by Amerada – that its investment in Premier was somehow ring-fenced from Myanmar and that its directors did not participate in any discussions on the company's involvement in that country – seemed to be out of line with UK company law and the fiduciary duties of directors to all their shareholders.

The company's preliminary results announcement in early March 2002 highlighted the positive progress the business was making operationally, but more importantly it detailed the progress being made in relation to the company's fundamental problems. It made clear the roadmap the company was using to solve its problems, talking about shedding mature assets in return for the exit of the major shareholders, and turning itself into a focussed, fleet-of-foot exploration company once again. The statement read: "We are in specific discussions with our alliance partners on creating a new Premier, better balanced to achieve our objectives. While the restructuring process is complex and involves careful balancing of the interests of all shareholders, we are committed to finding a solution before the end of this year and I am hopeful this will be achieved."

The company's preliminary results announcement in early March 2002 highlighted the positive progress the business was making operationally, but more importantly it detailed the progress being made in relation to the company's fundamental problems.

As part of Hermes' usual series of financial analysis meetings following preliminary or final announcements, it next met representatives of Premier – this time the chief executive officer and the finance director – on 27 March 2002. This meeting gave Hermes further encouragement that genuine progress was being made, as they suggested that the major shareholders both now clearly understood that any deal that they agreed would have to be approved by independent shareholders without them having the right to vote. Therefore, any deal would have to offer minorities full value to be allowed to proceed. The implication that Hermes took away from this meeting was that negotiations were now on track to reach a resolution.

That resolution was announced in September 2002. Premier said that it was to "swap assets for shares", with Petronas taking the Myanmar operation and a share of Premier's Indonesian activities, and Amerada a further segment of the Indonesian interest (in which Premier retained a stake). This was in return for cancelling their 25% shareholdings, and losing their right to appoint non-executive directors – as well as a substantial cash payment from Petronas. Thus the shareholding and governance issues were resolved in one step, and the cash was to be used dramatically to cut Premier's debt burden. By the same action, Premier reduced its oil and gas production activities and focussed on fleet-of-foot exploration. And finally it had withdrawn from Myanmar in a way which was fully acceptable to the Burma Campaign, other NGOs, and to the UK government.

However, most critically for minority shareholders, the share price of Premier rose 10% on the announcement. Indeed, news of Premier's change in direction had been anticipated by the market for many months. As a result, Premier's share price doubled (relative to the oil and gas sector) during the period of our engagement, netting an excess return to Hermes clients of over £1 million, and more than 50 times that sum to other minority shareholders. The price continued to rise thereafter until September 12 2003 when the reconstruction was completed with the exit of the major shareholders and a 10:1 share consolidation. Premier is now established as a strong independent company and continues to create value for its shareholders. ■

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Assessment of the research and evidence for a link between corporate governance and performance

We consider there to be sufficient evidence in support of our view that good corporate governance improves the long-term performance and ultimately the value of companies.

Focus list research and the effectiveness of shareholder engagement in general and the performance of shareholder engagement funds in particular provide convincing evidence for a link between active ownership that seeks to improve corporate governance and better performance of companies thus targeted. Unlike the evidence for a link between corporate governance and performance established by governance-ranking research, this evidence would seem to be relevant regarding markets with different regulation and for companies operating in different sectors. Indeed, the results of focus list research and the success of shareholder engagement suggest that compliance with certain standards is less important than the extent to which ownership oversight and, if necessary, pressure is exercised. The evidence in this category thus supports the proposition that it is not simply the absolute quality of governance, but also the process of active ownership and oversight of management that is important in terms of performance and value creation. This process is important not only in respect of companies where performance or governance related problems have been identified and possibly addressed but as an ongoing and general approach to the management of investments with the objective of preventing the occurrence of such problems.

Governance-ranking research, which focuses at least in principle on objectively measurable corporate governance standards, provides clearer evidence than focus list research and the performance of shareholder engagement funds in respect of a link between corporate governance strictly defined and performance. However, in our experience, weaknesses in strategy and financial structure and governance-related problems strictly defined often go together. Moreover, there may be a relationship between a company's adherence to standards and active ownership. This leads us to the main qualification of the existing body of research, namely, the question of causation. It is notoriously difficult to prove causation, even where research establishes a correlation between corporate governance and performance. The issue of causation arises not only with regard to the significance of certain standards, but also in the extent to which active ownership influences the governance structure and possibly the running of investee companies. We note that the authors of many of the studies we have reviewed acknowledged that there was a need for further empirical work addressing the issue of causation. We recognise the problems with the available body of research and studies. Nevertheless, we consider there to be sufficient evidence in support of our view that good corporate governance improves the long-term performance and ultimately the value of companies.

Conclusion

The corporate governance activities that Hermes undertakes on behalf of it clients are based on the belief that both companies' adherence to certain governance standards and particularly active ownership to improve corporate governance will lead to better performance of investee companies and ultimately increase their value. The belief that good corporate governance may help to prevent major corporate disasters is less controversial than the proposition that it can actually create additional value for an investor. However, in spite of some evidence to the contrary, we are convinced that active ownership based on corporate governance is an investment technique that can effectively improve performance and ultimately increase the value of a portfolio of investee companies. Indeed, this belief underlies Hermes' engagement programmes both in relation to its Focus Funds and its clients' passive and actively managed core investments. What is the foundation for this belief?

At the beginning of this chapter we set out two fundamental questions that an investor needs to be able to address before trying to use corporate governance as part of an investment approach which seeks to improve the performance of investee companies, namely: What exactly are the corporate governance issues that matter for a particular company at a certain time and how can positive change be achieved? Having reviewed the relevant research and other evidence available, we are now in a position to describe how these issues can be addressed and what resources are required. In fact, we can identify the missing links in the research into the relationship between corporate governance and performance.

One size does not fit all: Towards a contingent model of corporate governance

Even the best corporate governance ratings and rankings are just a starting point for further company specific analysis by specialised personnel taking the particular circumstances of a company into account before passing judgement regarding the quality of its governance. The main problem with ratings, particularly if used for different markets and across sectors, is that they seek to be objective. It is highly questionable whether standards that are meant objectively to measure the corporate governance quality of a certain universe of companies matter in respect of the performance of a particular company. We believe that the most appropriate and effective corporate governance structure for a company is contingent on a number of factors that differ between markets and sectors, may change over the life cycle of a company and generally seem to be highly company specific. As such, an assessment of the governance quality of a company based on objective criteria will - depending on the relevance of the standards used - be unreliable at best.

To assess effectively the corporate governance quality of a specific company and identify areas where changes could improve performance and thus add value, an investor needs a significant number of personnel with a wide range of qualifications, skills and experience, including direct experience of corporate management. We would note that this is not normally available to fund management companies or rating agencies. In this regard the finding of the momentum analysis of Deutsche Bank, which suggests that companies that

Both companies' adherence to certain governance standards and particularly active ownership to improve corporate governance will lead to better performance of investee companies and ultimately increase their value.

Conclusion *- continued*

There will be the need for institutional investors to co-operate more closely in respect of corporate governance and engagement and to pool their capabilities.

improve their corporate governance arrangements over the period under investigation very significantly outperform those that do not, is of great interest. It provides support for the view that relevant areas for governance improvement need to be determined on a case by case basis and that it may be informed investors that are best placed to identify the relevant performance enhancing factors. However, identifying areas where changes could lead to improved performance is only part of the role of active, interested and involved shareholders.

Investors play an important role in using corporate governance as an investment technique

A detailed, company specific corporate governance analysis to identify changes that could unlock value should only be part of an effective corporate governance based investment strategy. In terms of creating (or at least preserving) value, the most important part of the investors' role seems to be engaging in a constructive dialogue with companies to encourage governance changes where necessary or at the very least taking an active interest in and overseeing their affairs. In our view it is not simply the quality of the governance arrangements that is important in terms of performance but to a significant extent the appropriate engagement of investors with companies on a wide range of issues as part of an active ownership approach involving continuous oversight of the management. The performance of companies included in CalPERS focus list and the success of Hermes' Focus Funds provide firm support for this view. In order to make their corporate governance based investment strategies work, both CalPERS and Hermes devote significant resources to that end. At Hermes more than 50 people with a wide range of qualifications, experiences and skills are involved in corporate governance analysis and engagement work. This suggests that going forward, there will be the need for institutional investors to co-operate more closely in respect of corporate governance and engagement and to pool their capabilities. Only by doing so will the potential of a corporate governance based investment strategy be fully realised. ■

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