December 20, 2007

There Is No Connection Between Corporate Governance and Corporate Performance

Since the modern corporate governance movement began in 1985 with the birth of the Council of Institutional Investors and Institutional Shareholder Services, corporate governance advocates and activists have argued that their version of best corporate governance practices improve corporate performance. Year after year, academics, many of whom are the most radical of the governance advocates, have produced statistics designed to show that golden parachutes, poison pills, staggered boards, independent directors who are CEOs (or former CEOs), CEOs who are also chairman and the balance of the annual bad governance lists published by CII, ISS and others like CalPERS and TIAA-CREF result in lower stock prices, poor relative performance and excessive executive compensation. When confronted by examples of increased shareholder value, superior performance and compensation that clearly is merited by performance, they have rejected them as "anecdotal" and not worthy of academic consideration.

Now three leading academics, Professor Sanjai Bhagat of the University of Colorado at Boulder – Department of Finance, Professor Brian Bolton of the University of New Hampshire, Whittemore School of Business & Economics and Professor Roberta Romano of the Yale Law School have reviewed and analyzed most of the studies of the relationship between corporate governance and performance and have concluded that they in fact ***do not*** prove the proposition they are cited for. Their paper can be downloaded at *http://www.wlrk.com/docs/ThePromiseandPerilofCorporateGovernanceIndices.pdf*.

The best way to summarize the conclusions of Professors Bhagat, Bolton and Romano is to quote the abstract of their study:

> The aim of this paper is twofold, to analyze the performance of corporate governance indices in predicting corporate performance, and to consider the implications for public policy that follow from that assessment. We highlight methodological shortcomings of the extant papers that claim a relation between particular governance measures and corporate performance. ***Our core conclusion is that there is no consistent relation between governance indices and measures of corporate performance.*** Namely, there is no one "best" measure of corporate governance: the most effective governance institution appears to depend on context, and on firms' specific circumstances. It would therefore be difficult for an index, or any one variable, to capture critical nuances for making informed decisions. ***As a consequence, we conclude that governance indices are highly imperfect instruments for determining how to vote corporate proxies, let alone for portfolio investment decisions, and that investors and policymakers should exercise caution in attempting to draw inferences regarding a firm's quality or future stock market performance from its ranking on any particular corporate governance measure. Most important, the implication of our analysis is that corporate governance is an area where a regulatory regime of ample flexible variation across firms that eschews governance mandates is particularly desirable, because there is considerable variation in the relation between the indices and measures of corporate performance.***

Martin Lipton