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The rewards of virtue

Does good corporate governance pay? Studies give contradictory answers

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ONCE again, corporate-governance reform is back on the legislative agenda, not least in the United States. In 2002, after the scandalous collapses of Enron and WorldCom, Congress voted in the Sarbanes-Oxley act, which was intended among other things to beef up corporate risk-management. Now, the financial reforms being considered in Washington include several proposals intended to correct flaws in the oversight of firms that were revealed in the aftermath of the financial crisis. The reforms likeliest to become law include an advisory "say on pay" vote for shareholders on the remuneration of top executives, and measures to make it easier for shareholders to nominate candidates for election to company boards.

As always, these efforts to improve corporate governance have plenty of opponents. They argue that, contrary to the claims of the reformers, the changes would harm corporate performance by wrapping managers up in red tape. In the case of Sarbanes-Oxley, which was rushed into law with too little discussion of the details, the critics of reform had a point. The case for the latest proposals seems more straightforward, however, and has been debated for many years.

The controversy over corporate governance has been fuelled by a surprising lack of conclusive evidence that improving it actually pays, in the form of higher returns to shareholders. The study most cited by the reformers is "Corporate Governance and Equity Prices", published in 2003 by three economists, Paul Gompers, Joy Ishii and Andrew Metrick. This found that in 1991-99, investors going long on well-governed firms, as defined by an index combining 24 different aspects of corporate governance, while shorting poorly-governed ones, would have enjoyed an unusually high annual return of 8.5%.

Similarly strong returns were found for a trading strategy based on a narrower list of what reformers consider the six core elements of good corporate governance, such as making the company's whole board face re-election each year, and not having any "poison pill" defences against takeovers.

Critics of reform were never convinced. A new study co-written by Lucian Bebchuk, a Harvard professor who is also an activist for corporate-governance reform, gives rise to further doubts—at least at first glance. "Learning and the Disappearing Association Between Governance and

Returns," by Mr Bebchuk, Alma Cohen and Charles Wang, repeats the study by Mr Gompers and his colleagues for 2000-08. It finds that, in contrast with the 1990s, neither the 24-factor index nor the six-factor one would have helped investors beat the market.

Mr Bebchuk and his colleagues argue that the disappearance of the good-governance premium during the past decade is actually a sign that investors have woken up to the importance of governance. This, they think, was due to a huge increase in discussion of the issue in the media in 2001-02, following the Enron and WorldCom scandals and the publication of the Gompers study. As a result, they argue, early in the decade differences in the quality of governance between different firms were fully incorporated in their share prices. Since this adjustment was a one-off, well-governed firms' shares have not subsequently outperformed the market.

Not all reformers are convinced that the market has wised up, however. On April 22nd the Corporate Library, a governance-research organisation, published a study that found significantly higher returns in 2003-10 when it excluded from its portfolio firms that according to its governance ratings system were of "high" or "very high" risk. The crucial difference between this ratings system and the 24- and six-factor indices used by the other studies is that the Corporate Library says it researches firms for specific evidence of governance problems, whereas the indices rely on a box-ticking exercise.

Reformers hope that the latest study will put an end to the debate over whether good corporate governance is a virtue that pays. Doubters will surely try to dig up something in Corporate Library's methodology to undermine its conclusions. It is a debate that will run and run—which is, at least, better than brushing the issue under the carpet