Shareholders Wise Up

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Investing in companies that are well governed no longer guarantees the superior returns it once did, according to a study by three university professors. Harvard Law School’s Lucian A. Bebchuk, Tel Aviv University’s Alma Cohen, and Stanford’s Charles C. Y. Wang divided companies into two groups, ones with good governance and ones with bad, and compared their performance from 2000 to 2008. They found that investors gained little advantage by favoring well-governed companies versus putting their money into ill-governed ones.

This finding contrasts sharply with the results from a similar study done in 2003 by Paul Gompers of Harvard Business School, Joy Ishii of Stanford, and Andrew Metrick of Yale. Their comparison, based on average total annual returns from 1990 to 1999, found that well-governed companies outdid poorly governed ones by a margin of 8.5%.

The recent study used the same good- and bad-governance definitions developed for the 2003 report. Companies that eschewed poison pills, staggered boards, golden parachutes, and other management-entrenching policies that have become the bane of shareholder activists were considered to have good governance. Those that indulged in them qualified as bad.

Why the different results? The researchers hypothesize that by the end of 2001, thanks to governance scandals and reforms, investors had come to understand the financial impact governance practices can have on total returns and had factored them into share prices. Score one for the common sense of free markets.