New Indexes Seek to Link Corporate Governance and Diversity to Financial Performance

By William Baue
SocialFunds.com
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A Diversity index and joint FTSE-ISS indexes try to answer if diversity and corporate governance, respectively, correlate to financial outperformance.

Socialfunds.com – Acknowledgement of the relationship between corporate financial performance and such intangible business factors as corporate governance and diversity is evidenced by the recent advent of new stock indexes covering such factors. Yesterday, global index provider FTSE Group and corporate governance evaluator Institutional Shareholder Services (ISS) announced the launch of the FTSE ISS Corporate Governance Index (CGI) series. And earlier this month, DiversityInc, a magazine/website that examines the bottom-line benefits of diversity announced the release of its Top 50 Companies for Diversity Stock Index. How effectively these indexes will correlate financial performance to the particular attribute they cover is open to debate.

The FTSE ISS CGI assesses corporate governance performance using ISS's Corporate Governance Quotient (CGQ), a set of 61 criteria (55 in non-US markets) in eight categories, such as board, compensation, and "progressive practices."

"Our CGQ criteria were developed within a framework of corporate governance best practices, " said Cheryl Gustitus, senior vice president for communications at ISS. "Over a lengthy period, ISS consulted with a cadre of academics, institutions, issuers, and various industry constituents to vet its criteria."

Academic research has established a clear correlation between corporate governance performance and corporate financial performance. This correlation was first articulated by Harvard economists Paul Gompers and Joy Ishii and Wharton School professor Andrew Metrick in a 2003 paper that examined 24 Investor Responsibility Research Center (IRRC) corporate governance factors. ISS commissioned a study by Georgia State University professor Lawrence Brown and doctoral student Marcus Caylor that confirmed this correlation, and further examined with CGQ factors correlated strongest with financial performance.

Harvard professor Lucian Bebchuk, Alma Cohen, and Allen Ferrell took this last notion one step further is a 2004 paper, isolating six corporate governance factors that affect financial performance, of the 24 IRRC factors (which are similar to the CGQ factors). Among the isolated provisions were staggered boards, poison pills, and golden parachutes.

"Other provision among those followed by the IRRC do not matter for shareholder value and returns, " Prof. Bebchuk told SocialFunds.com.

In other words, tracking corporate governance factors that do not correlate to shareholder value or returns may simply add “white noise” to the index.

“We have always positioned CGQ as a risk management tool designed to assist institutional investors in evaluating the impact companies’ corporate governance practices could have on portfolio performance, “ Ms. Gustitus told SocialFunds.com. “Professor Bebchuk takes a different approach to his study.

As for the Diversity Index, it is based on DiversityInc’s 122–question survey used to determine its annual list of the Top 50 Companies for Diversity. The list, which is reconstituted yearly to reflect changes to the top 50 list, now comprises only 43 corporations, as seven are not publicly traded. DiversityInc retained Standard & Poor’s to calculate the index, which seeks to verify the link between diversity leadership and financial performance.

Over the one-year period ending October 15, 2004, the Diversity Index outperformed two if its three benchmarks, the Dow Jones Industrial Average and the NASDAQ 100. It generated competitive total return earnings compared to the third, the S&P 500.

“For those who have been skeptical about the payoff for being on the Top 50 list, we have finally proven that there is a direct link between the quality of a company’s diversity management and its profitability,” said Luke Visconti, co-founding partner of DiversityInc.

Of course, there is no guarantee that the Diversity Index will continue to support this link.

“I think that there is a risk that our index will underperform the three benchmark indexes, but there is a greater likelihood that, as our list becomes more competitive, our index will outperform all others,” Mr. Visconti told SoicialFunds.com. “The danger is in having a relatively small number of companies that comprise the index – this opens up some exposure to having a few sever laggards.”

DiversityInc believes there may be investors who are willing to bet on diversity to outperform.

“We will begin to discuss with the financial community the marketability of the index as a financial trading vehicle similar to a mutual fund or an Exchange Traded Fund,” said Mr. Visconti.