The Investor Rationale for Responsible Investment: Corporate Governance

As an institutional investor, Wespath Investment Management adheres to our obligation as a prudent fiduciary. As a division of the General Board of Pension and Health Benefits of The United Methodist Church, we also understand that financial transactions carry ethical implications. These two perspectives form the basis of our well-rounded investment strategy, which utilizes traditional financial metrics and also considers the impact of environmental, social and corporate governance (ESG) practices.

This paper, one of a series of Wespath research papers published at **wespath.com**, examines the relationship between shareholder value and corporate governance.

Introduction

For many years, socially responsible investors have engaged companies in dialogue on the importance of good corporate governance measures. The topic gained widespread support, however, after accounting irregularities and lax oversight resulted in the failure of several well-known corporations in 2000 and 2001.

In response, the New York Stock Exchange (NYSE) and NASDAQ stock exchanges revised their listing standards to require new levels of governance and oversight. In addition, Congress passed the Sarbanes-Oxley Act in 2002 which addressed such issues as director responsibility, auditor oversight, internal controls and enhanced financial disclosure to investors. The financial crisis in 2008-2009 resulted in the failure of more large companies, which led to passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.

Today, prudent investors understand that corporate governance is an indicator of the quality of management. It is an investment risk that can and should be managed. Through advocacy and proxy voting, Wespath supports best practices in corporate governance, including executive compensation that is tied to performance, appointment of an independent board chairperson, and a diverse board of directors that is elected annually by a majority vote of shareholders.

The Investor Perspective

Several studies have examined the effect of corporate governance practices on financial performance:

The "CalPERS Effect" on Targeted Company Share Prices, Wilshire Associates Incorporated, 2010: This analysis evaluated CalPERS' corporate governance effectiveness by measuring stock performance of the 142 companies engaged by CalPERS from 1987-2008. For the five years prior to CalPERS' engagement, the companies averaged returns 83% below their respective benchmarks (-30% annualized). For the five years after the initial engagement, the companies averaged returns nearly 13% above their benchmarks (2.4% annualized).

Did New Regulations Target the Relevant Corporate Governance Attributes? Reena Aggarwal, Rohan Williamson, Georgetown University, 2006: This study examined a set of 64 governance attributes for more than 5,200 firms during 2001-2005, which covers the period before and after Sarbanes-Oxley and other regulatory changes. After controlling for size and industry, the study found a positive and significant relationship between governance and firm value, and also found that new regulations were associated with higher firm value in firms that adopted the regulations prior to them being mandated. The authors described the results as “statistically and economically significant.” The study also revealed that, prior to the adoption of new regulations, the markets were already rewarding firms that had better governance.

Corporate Governance and Equity Prices, Paul Gompers, Joy Ishii and Andrew Metrick, National Bureau of Economic Research, 2001: This study demonstrated that firms with corporate governance practices favoring management tend to have lower price-to-book ratios, and that firms with corporate governance ratings in the bottom quartile had significantly below-average risk-adjusted returns during the 1990-1999 time period.

The following provides a closer look at a select number of corporate governance measures.

Separation of Chairperson and CEO:

Wespath believes that, among the largest U.S. companies based on market value, shareholders’ interests are best served when the board of directors is led by a non-executive chairperson. Such a structure has been supported by many corporate governance experts and advisors including The Corporate Library, Glass Lewis & Co. and Vanguard founder John Bogle.

We believe a non-executive chairperson brings added value to the company.

Corporate management in a global marketplace requires the full attention of the CEO and his/her management team. Given the time and effort that are required to effectively run the company, we believe it is neither wise nor prudent to dilute the focus of the CEO by also requiring him/her to serve as board chairperson.

Regulatory changes such as the enactment of Sarbanes-Oxley in 2002 and the 2003 revised New York Stock Exchange and NASDAQ listing requirements have significantly enhanced directors’ responsibilities. As a result, the role of the board has shifted from “advisory” to “monitoring,” and today’s boards need a chairperson who can lead the directors in providing independent oversight of management goals and performance.

In the 2008 Public Company Governance Survey of the U.S. National Association of Corporate Directors (NACD), 72.8% of directors serving on boards with an independent chairperson stated that companies greatly benefit from an independent chairperson, while only 6.7% said that companies do not.

Many shareholders prefer an independent, non-executive chairperson to oversee their interests. RiskMetrics (now MSCI) reports that in 2008, shareholder proposals seeking to separate the roles of chairperson and CEO received on average 31% of votes cast — a meaningful result for proposals that are opposed by management. RiskMetrics predicted this issue will continue to receive a considerable amount of investor attention in the coming years.

A recent report by Chairmen’s Forum cofounder Harry Pearce (through a collaboration with the Millstein Center for Corporate Governance and Performance at the Yale School of Management) recommended that corporate directors appoint a non-executive chairperson whenever a current combined chair/CEO vacates the position.

The SEC requires companies without an independent chairperson to explain in their proxy statement how their leadership structure provides sufficient management oversight and shareholder safeguards.

Advisory Vote on Executive Compensation, or “Say on Pay”:

For many years, investors expressed concern about rising executive compensation, especially when it was not sufficiently linked to corporate performance. Unfortunately, avenues to communicate this dissatisfaction were limited. Shareholders had the option of engaging in direct dialogue with the company or “withholding” their vote from board members that comprised the compensation committee.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act mandated that an advisory vote on executive compensation be held every one, two or three years. To implement the law, companies must hold an advisory vote on executive compensation in 2011. They are also required to set forth a management proposal to decide if future votes will be held every one, two or three years.

In general, Wespath supports an annual vote on executive compensation. However, in cases where compensation is negotiated on a bi-annual cycle, a vote every two years may be considered.

Dedicated Communication Channel

Say on pay establishes a dedicated channel for shareholders to register their views on executive compensation. Rather than casting a vote on compensation committee members and hoping the board of directors correctly interprets the meaning of the vote, the results of an annual advisory vote provides the board and management with clear and useful information about shareholder approval of the company’s senior executive compensation.

Say on pay is an important corporate governance measure. In a speech delivered on Wall Street on April 22, 2010, President Obama demonstrated his support by saying, “Say on pay will improve directors’ accountability to owners of the company by giving shareholders a way to express their views on executive compensation, and will allow boards and shareholders to work together to design compensation that gives executives strong incentives to maximize long-term firm value.”[1]

Concerns that shareholders would reflexively vote against management compensation plans have proven unfounded. The majority of shareholders have voted against pay packages in only limited circumstances.

Research

Say on pay is a relatively new issue; therefore, only limited research is available that examines its effect on shareholder value. However, in 2005, Moody’s Investor Service published a study which investigated “the empirical relationship between executive compensation and credit risk.” Examining non-financial corporations in the United States with senior unsecured bond ratings of B3 or higher, from 1993 through 2003, Moody’s found a link between the compensation paid to chief executive officers and overall credit risk. Specifically, Moody’s found that firms in the top 10% with respect to “high unexplained bonuses” and “high unexplained option grants” experienced “dramatically higher default rates and dramatically higher downgrade rates than did the middle 70% of the distribution.” For example, in the case of “high unexplained bonuses,” the default rate for the top 10% of companies was 1.8%, compared to only 0.1% for corporations which fell in the middle 20%.[2] It is reasonable to expect say on pay to offer shareholders a countermeasure against such enhanced risk.

Say on pay is broadly viewed as a method to enhance the transparency and accountability of the board’s compensation committee, and to ultimately link pay to performance. An analysis by Stephen Davis of

Yale's Millstein Center for Corporate Governance concluded that, in the United Kingdom (where advisory votes have been mandatory since 2003), the measure has resulted in "a marked rise in dialogue between corporate boards and management, on the one hand, and institutional investors on the other. This transformed the way compensation policies are constructed." Furthermore, "while top executive pay in the U.K. continues to outpace inflation and average workforce wage increases, advisory votes are widely seen as having been an important contributing factor in taming the rate of increase, curbing opportunities for 'pay for failure' and linking compensation dramatically closer to performance."[3]

Summary

Say on pay addresses executive compensation — an area of corporate governance that was previously untouched. As an investor who has actively sought say on pay access with several corporations, Wespath supports the inclusion of the issue in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Board Inclusiveness:

Wespath is a strong advocate for gender and ethnic diversity on corporate boards of directors. We believe a diverse board offers a wider range of experiences, is an indicator of best practices in corporate governance, and can strengthen a company's financial results.

Each day, businesses interact with a wide variety of stakeholders. Customers, employees, investors, suppliers, media, the local community — these are only a few of the groups that maintain corporate relationships. Leveraging the diverse opinions and experiences of such groups can lead to competitive advantage. Consider that more than 80% of purchasing decisions for the home are made by women, yet women are poorly represented on corporate boards.[4]

Statistics on Board Diversity

Diversity is often lacking at top levels of a corporation. An examination of corporate boards reveals that many corporations fail to employ diversity criteria when hiring executives or nominating members for the board of directors. In 2006, women held 14.8% of Fortune 500 board seats, and people of color held 12.6%.[5] To place these figures in context, 2009 statistics from the U.S. Department of Labor show that 48.6% of the labor force were women and 29% were ethnic persons.

More recent data regarding the number of women on boards shows little improvement. In 2009, 15.2% of Fortune 500 board seats were held by women.[6]

Research

Does board diversity affect firm value? This question was addressed in a 2003 study by researchers at Oklahoma State University who examined the relationship between these factors at Fortune 1000 firms. After controlling for size, industry and other corporate governance measures, the study found significant, positive relationships between the percentage of women or ethnic persons on the board and firm value.[7]

Data published by Catalyst in 2007 supports this finding. An analysis of the S&P 500 based upon the number of women directors and four-year average performance figures showed a correlation between key performance indicators (as described in the following chart) and board gender diversity.[8]

Board Gender Diversity

	Bottom Quartile	**Top Quartile**
Return on Equity	9.1%	13.9%
Return on Sales	9.7%	13.7%
Return on Invested Capital	4.7%	7.7%

It can be difficult to determine how board diversity affects performance. Outside of an academic environment, it is reasonable to conclude that well-managed corporations understand the value of a diverse board and have capitalized on the opportunity it presents. Therefore, when conducting financial analysis, board diversity can be viewed as an indicator of the quality of management.

United Methodist Instruction

The Social Principles address corporate governance in a broad sense, stating that "corporations are responsible not only to their stockholders, but also to other stakeholders: their workers, suppliers, vendors, customers, the communities in which they do business, and for the earth, which supports them." Additionally, acknowledgement is given to the importance of corporate policies and procedures by commending "corporations that voluntarily comply with standards that promote human well-being and protect the environment" (¶163I).

Resolution 4071, *Investment Ethics*, states "The Church also continues to advocate on such issues as…best corporate governance practices…" whereas Resolution 4052, *Economic Justice for a New Millennium*, recognizes that "corporations have become increasingly anonymous and unaccountable to their employees, to the communities in which they operate, and to governments." This resolution directs the General Board of Pension and Health Benefits "to work with the Interfaith Center on Corporate Responsibility and support its *Principles for Global Corporate Responsibility*…"

According to these Principles, a company's board of directors should be "characterized by independence …diversity of membership, transparency of decision making and accountability." Compensation and bonus packages are to be "tied to financial, social and environmental performance…" Above all, a company's governance structure should be "based on ethical values, including inclusivity, integrity, honesty, justice, transparency and responsiveness to shareowners and stakeholders."

Find Out More

If you would like more information on Wespath's investment products, services and commitment to responsible investment, please contact Derek Casteel at **1-847-866-4100** or via e-mail at **investmentinfo@wespath.com**

[1] Remarks of President Barack Obama, Wall Street Reform at Cooper Union, April 22, 2010, New York, NY.
[2] Jay W. Eisenhofer and Gregg S. Levin, "Does Corporate Governance Matter to Investment Returns?" Corporate Accountability Report, Vol. 3, No. 37 (Sept. 23, 2005). The Bureau of National Affairs, Inc.
[3] "Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable" Policy Briefing, Millstein Center for Corporate Governance and Performance, Yale School of Management, 2007.
[4] Pallavi Gogio, "I Am Woman, Hear Me Shop," *Business Week*, Feb 14, 2005.
[5] Board of Directors: Statistics, Diversity, Inc., www.diversityinc.com/content/1757/article/288/.
[6] Catalyst Census: Fortune 500 Women Board Directors, http://www.catalyst.org/publication/132/us-women-in-business.
[7] David Carter, Betty Simkins and W. Gary Simpson, "Corporate Governance, Board Diversity and Firm Value," *The Financial Review*, 2003, vol. 38, issue 1, p. 33-53.
[8] Lois Joy, Nancy Carter, Harvey Wagner and Sriram Narayanan, "The Bottom Line: Corporate Performance and Women's Representation on Boards," Catalyst, 2007.

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