

MACRO FACTORS IN CORPORATE GOVERNANCE

Lloyd Kurtz

Northfield Asia Research Seminar

Fall 2012

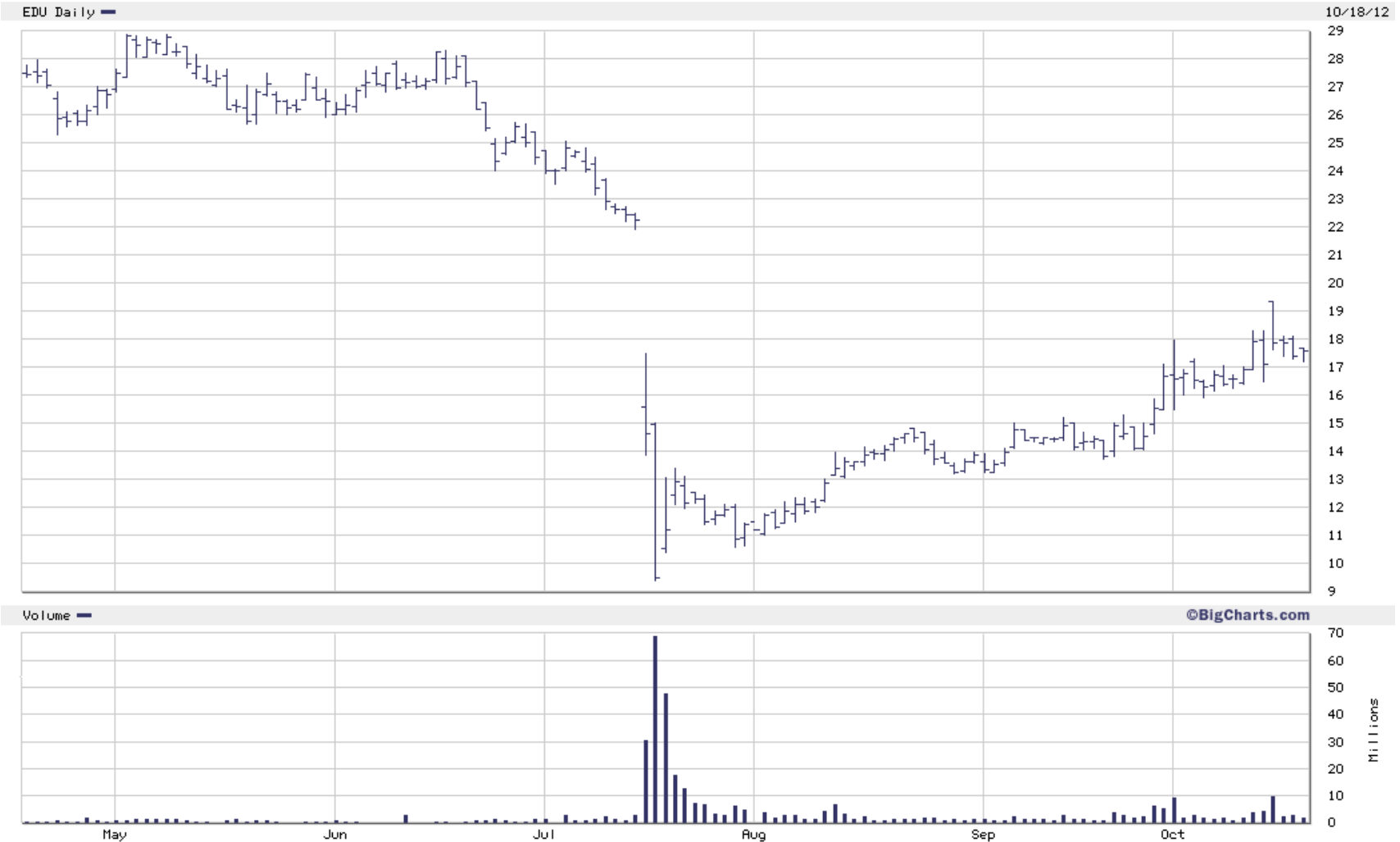
Topics

- Why Governance is Important
- Governance vs. Control
- The Agency Negotiation
- Macro Factors and the Agency Negotiation

Why Governance is Important

A Stock-Specific Issue

New Oriental Education & Technology Group ADS - NYSE



Systemic Issues (late 90s – early 00s)

- Healthsouth
- Tyco International
- Columbia/HCA
- Computer Associates
- Cendant
- Imclone
- Informix
- Worldcom
- McKesson/HBOC
- Enron

In the late 1990s and early 2000s, governance issues seemed to be driven primarily by management teams stretching to perform in a pressurized environment. Insider trading and earnings manipulation were key themes.

Systemic Issues (continued)

- Lehman

Lehman's Global Financial Controller confirmed that "the only purpose or motive [for Repo 105] was reduction in the balance sheet" and that "there was no substance to the transactions."

Lehman did not disclose its use – or the significant magnitude of its use – to the rating agencies, to its investors, or to its own Board of Directors.

- Examiner's Report

- Fannie Mae / Freddie Mac

"[T]wo of the greatest accounting misstatements in history..."

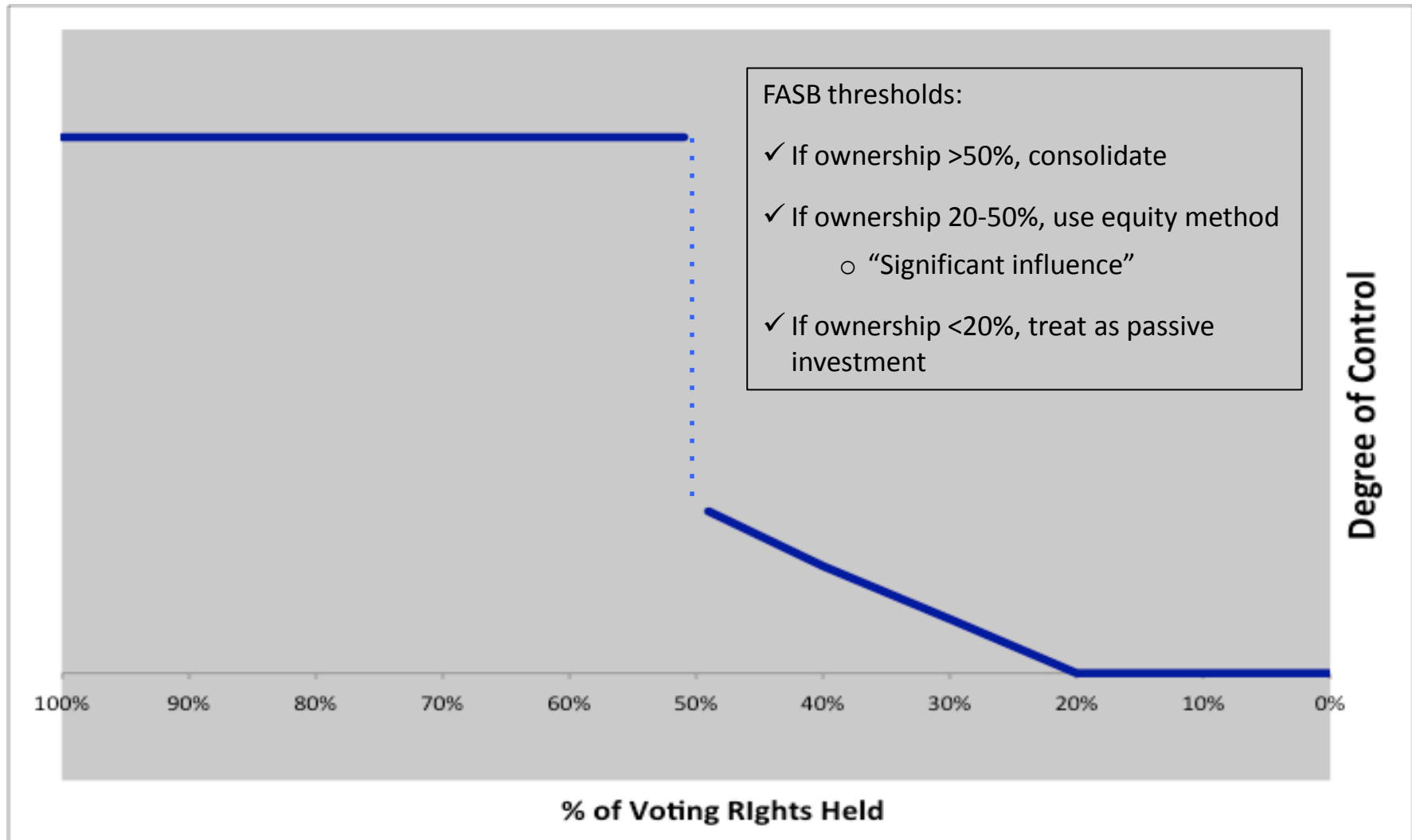
- Warren Buffett

Avoid Bad Governance Firms?

- Yes, entrenched managers underperform
 - Gompers, Ishii, and Metrick (2003)
- No, the effect disappeared in the 2000s
 - Goldstein (2006)
 - Bebchuk, Cohen, and Wang (2011)

Control vs. Governance

Control is Non-Linear



Ways to Have Control

- Own 51% of the stock
- Control 51% of the voting rights
- Capture the board
- Have inattentive owners

The 10 Largest U.S. Tech Companies

by market capitalization

- Apple - \$590 bn
- Microsoft - \$245 bn
- Google - \$244 bn
- IBM - \$238 bn
- Oracle - \$150 bn
- Intel - \$108 bn
- Qualcomm - \$101 bn
- Cisco - \$98 bn
- eBay - \$62 bn
- EMC - \$54 bn

*Total market value:
\$1.3 trillion*

*Value of next 119 technology stocks:
\$948 billion*

10 Largest U.S. Tech Companies

by degree of shareholder influence

Normal relationship

- ✓ IBM
- ✓ Intel
- ✓ EMC
- ✓ eBay – Omidyar retains 9% stake, but independent board

Hewlett-Packard, which has good governance ratings, dropped off this list in 2012 due to poor business results.

Some shareholder influence

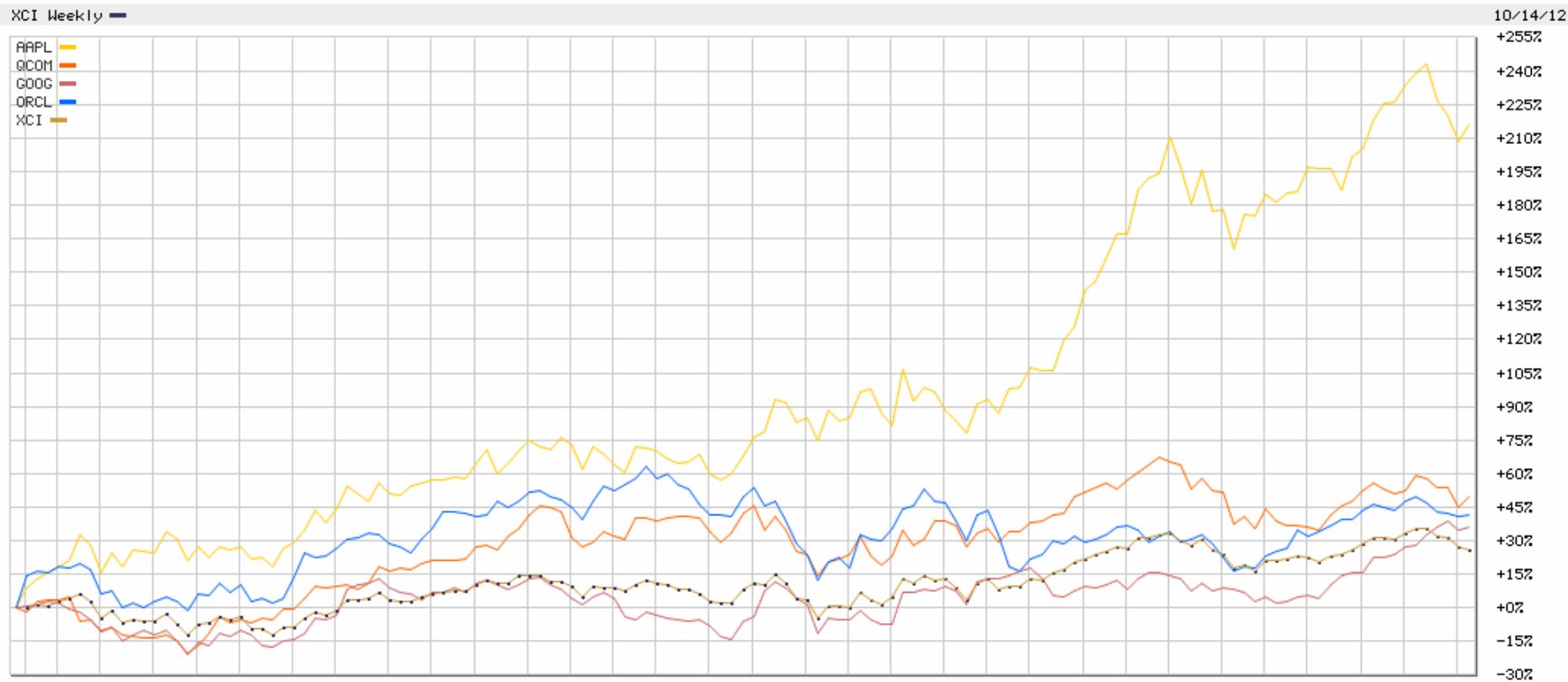
- ✓ Microsoft – Ballmer has high degree of control, but diminishing
- ✓ Cisco – Chambers has a high degree of control, but weak results have diminished this

Low or no shareholder influence

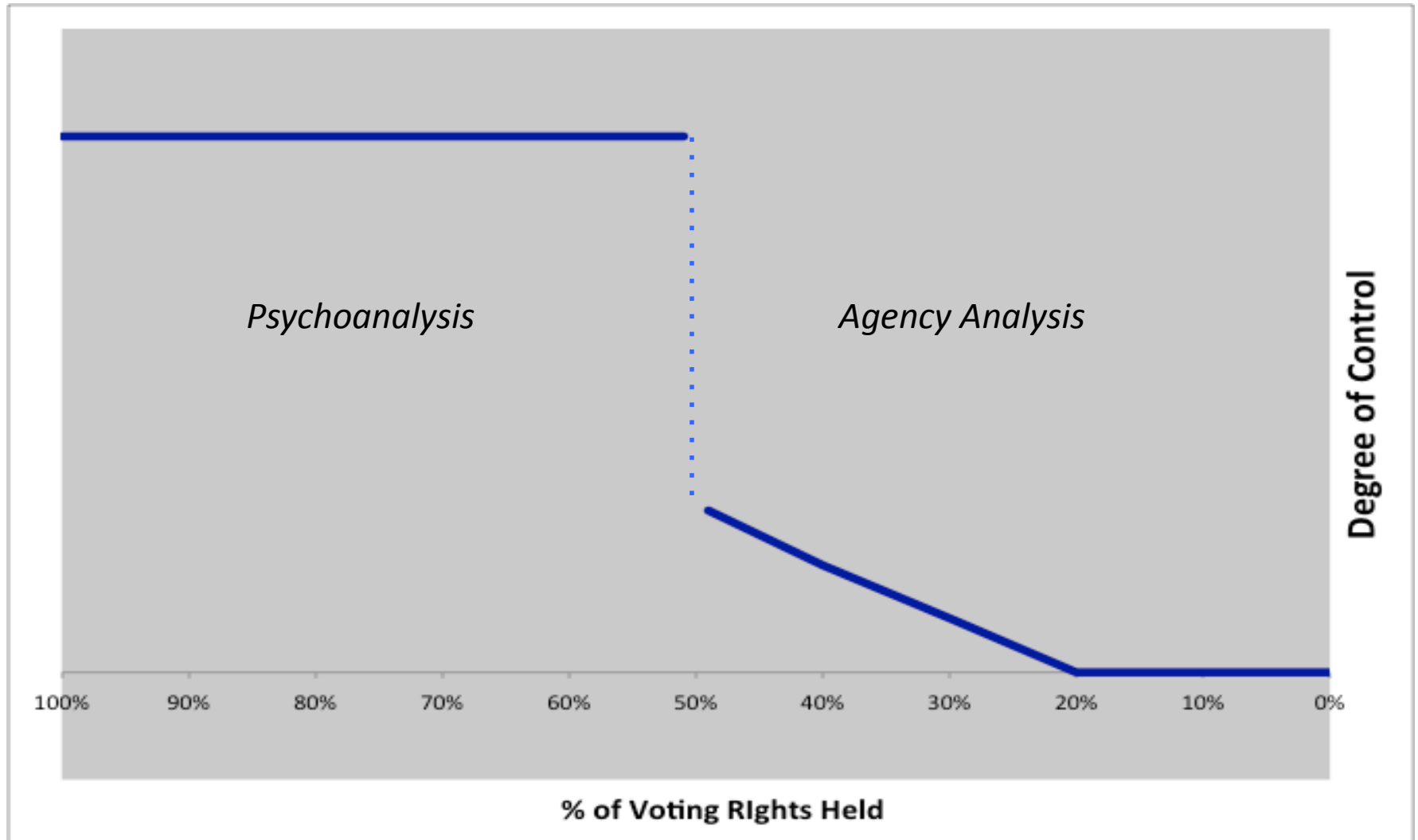
- ✓ Apple – Significant positive movement following death of Steve Jobs
- ✓ Oracle – Board capture, Ellison effectively controls the company
- ✓ Qualcomm – CEO is founder's son
- ✓ Google – Shareholders are formally excluded (non-voting)

When Bad Governance is Good

Four Governance Laggards vs. The Amex Computer Technology Index (Last 3 Years)

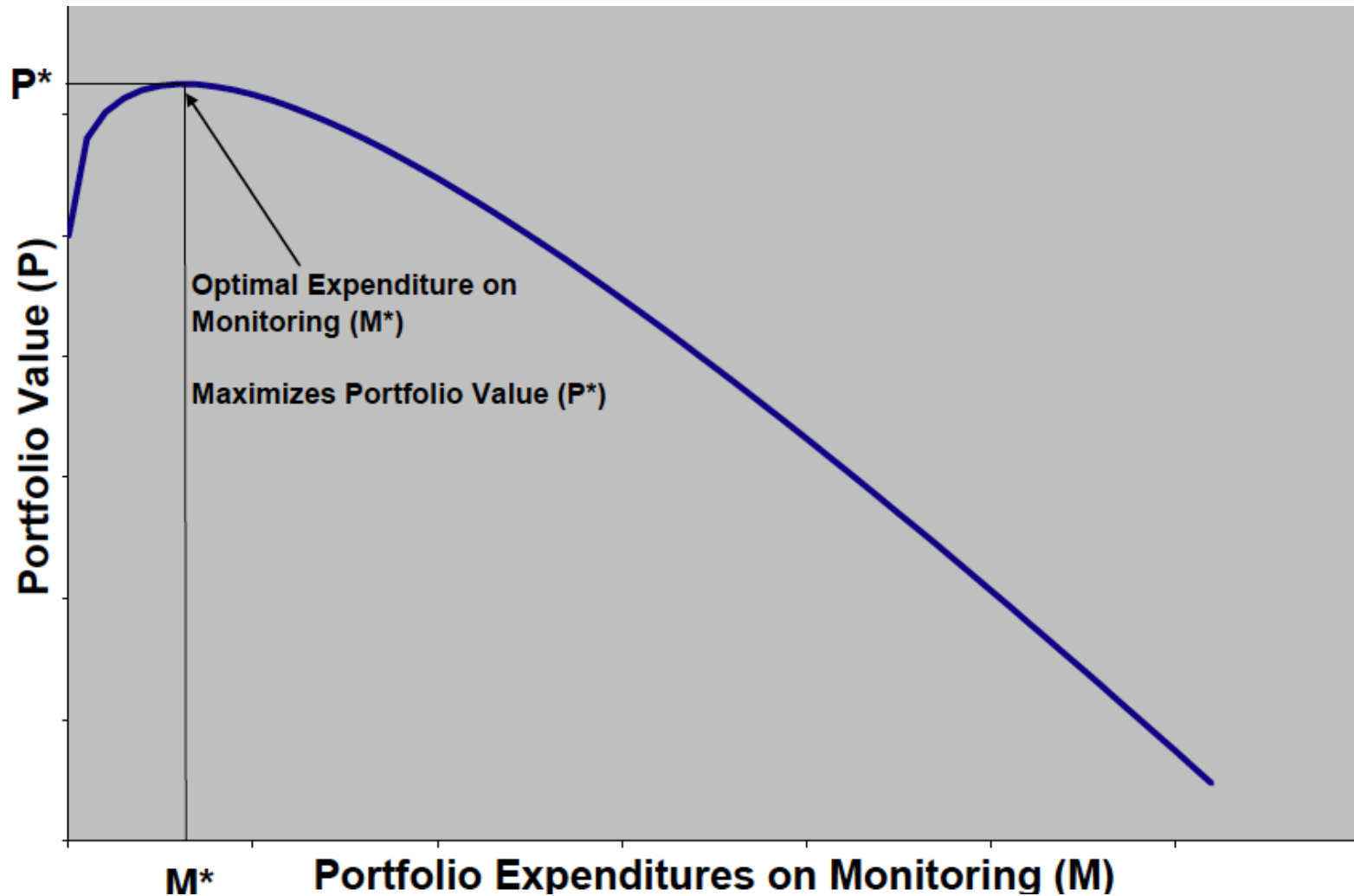


Different Approaches Required



The Agency Negotiation

Agency: Cost/Benefit of Monitoring

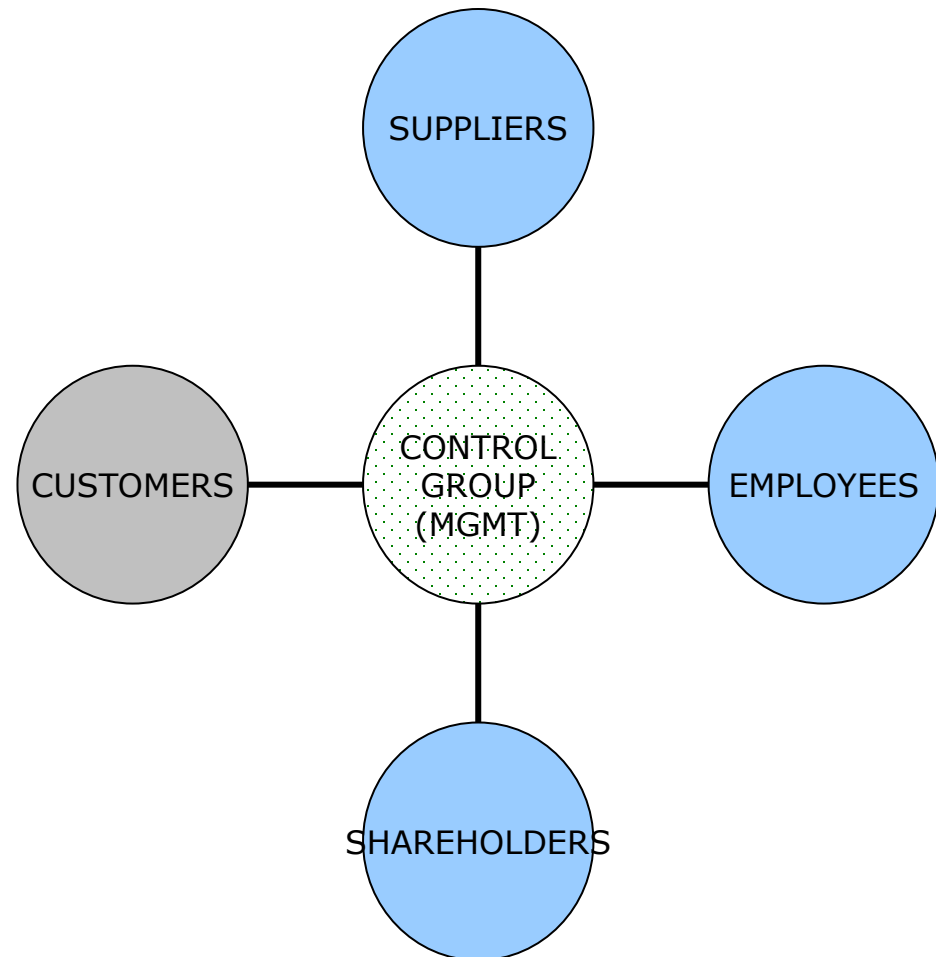


The Uniqueness of Managers

“[M]anagers are unique...because of their position at the nexus of contracts. Managers are the only group of stakeholders who enter into a contractual relationship with all other stakeholders. Managers are also the only group of stakeholders with *direct* control over the decision-making apparatus of the firm (although some stakeholders, and particularly the suppliers of capital, have indirect control).”

Commercial Stakeholders

This group of relationships is similar to the widely-used Input-Output Model, but I argue these relationships are dynamic, continuously negotiated, and heavily influenced by loyalty/voice dynamics.



Two Points on Agency

Managers will take what they can

- ✓ “[S]lightly less than 30 percent of public companies that used stock options for executive compensation manipulated at least one grant between 1996 and 2005. - Heron et al (2007)

Monitoring Helps

- ✓ “Opportunistic timing, we find, is correlated with three variables associated with greater influence of the CEO on pay-setting. In particular, CEO grant events and director grant events are both more likely to be lucky when the company lacks a majority of independent directors on the board, does not have an independent compensation committee with an outside blockholder on it, or has a long-serving CEO. - Bebchuk et al (2010)

Bases for negotiation

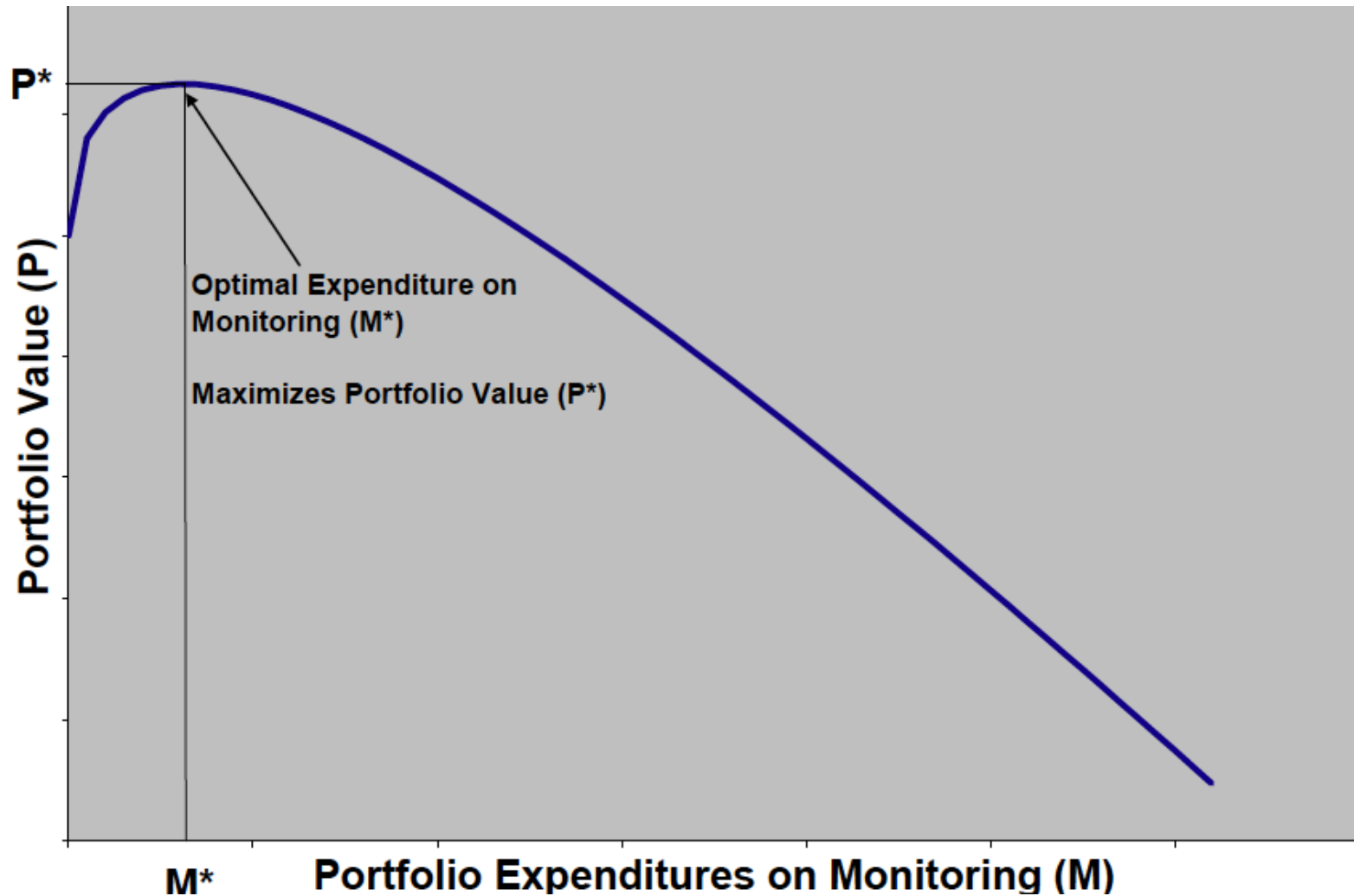
Absentee/Minority Owners

- ✓ Seeking to maximize their wealth
- ✓ Avoid manager misbehavior
 - Expropriation
 - Overinvestment
 - Overreach
- ✓ Optimize monitoring costs

Managers

- ✓ Seeking to maximize their wealth
- ✓ But also maintain their personal reputation
- ✓ Do what's right for the other stakeholders (Christensen et al)

Agency: Cost/Benefit of Monitoring



Macro Factors and Agency

Open Question

Do contextual factors, *e.g.*, the sensitivity of firm value to changes in macroeconomic factors, influence this negotiation?

Corporate Library/GMI Ratings

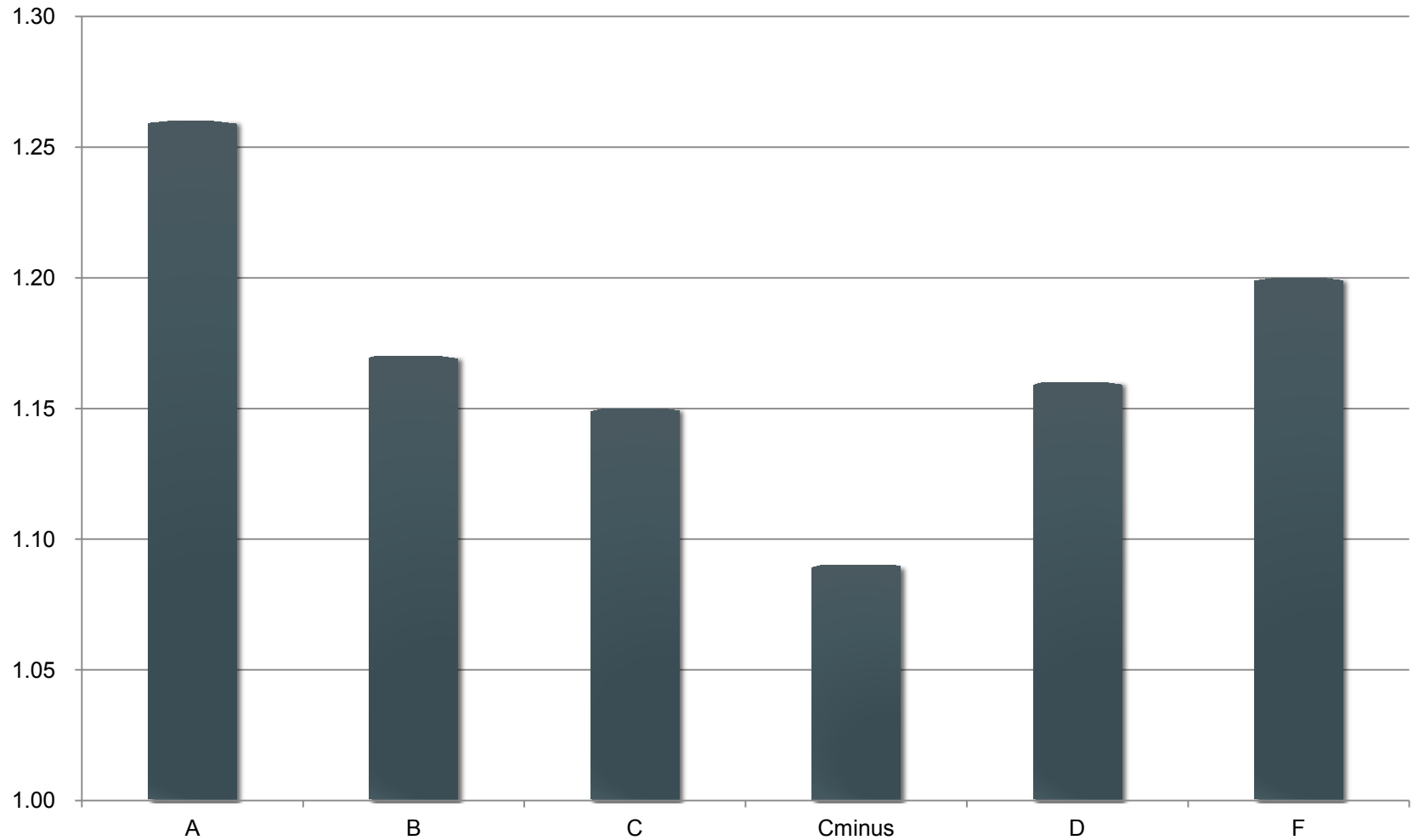
- Independent corporate governance research group, now part of Governance Metrics International (GMI)
 - ✓ Founded by Robert Monks and Nell Minnow in 1999
- S&P 500 ratings from 2003-2011
- Focus on investors and shareholders

Areas Evaluated

- Board Composition
- CEO Compensation
- Shareholder Responsiveness
- Accounting
- Strategic Decision-Making
- Litigation and Regulatory Filings
- Takeover Defense
- Problem Directors

CAPM Lens is Problematic

Beta of equal-weighted portfolios based on governance rating



Northfield Macroeconomic Model

$$R_{it} = \text{Int}_i + \beta_{1i} \text{IN}_t + \beta_{2i} \text{IP}_t + \beta_{3i} \text{HS}_t + \beta_{4i} \text{OP}_t + \beta_{5i} \text{EX}_t + \beta_{6i} \text{RP}_t + \beta_{7i} \text{SL}_t + \varepsilon_{it}$$

Model factor loadings are estimated using a time series regression of monthly stock returns against monthly changes in our seven factors. We use 60 months of history when available.

Independent Variables

First Stage

- Unanticipated inflation
- Credit risk premium
- Industrial production
- Slope of the yield curve

Second Stage

- Housing starts
- U.S. dollar exchange rate (trade-weighted)
- Oil prices

Independent Variables

First Stage

- Unanticipated inflation
- Credit risk premium
- Industrial production
- Slope of the yield curve

Second Stage

- Housing starts
- U.S. dollar exchange rate (trade-weighted)
- Oil prices



Are the beta coefficients on these variables different for portfolios with different governance ratings?

Null Hypothesis (example #1)

	<u>Unexpected Inflation</u>	<u>Industrial Production</u>	<u>Housing Starts</u>	<u>Oil Price</u>	<u>Exchange Value of \$</u>	<u>Credit Risk Premium</u>	<u>Slope of the Yield Curve</u>
A-B	0.60	0.02	0.82	0.40	0.14	0.25	0.17
A-C	0.16	0.39	0.86	0.28	0.83	0.64	0.98
A-Cminus	0.21	0.22	0.80	0.53	0.66	0.92	0.11
A-D	0.43	0.38	0.32	0.76	0.41	0.34	0.93
A-F	0.98	0.09	0.02	0.33	0.46	0.94	0.02
B-C	0.00	0.28	0.40	0.28	0.87	0.28	0.80
B-Cminus	0.79	0.73	0.49	0.19	0.62	0.88	0.88
B-D	0.14	0.42	0.82	0.46	0.05	0.17	0.10
B-F	0.21	0.54	0.63	0.49	0.66	0.90	0.58
C-Cminus	0.01	0.78	0.69	0.07	0.90	0.56	0.44
C-D	0.51	0.45	0.65	0.28	0.74	0.88	0.04
C-F	0.79	0.61	0.09	0.71	0.02	0.62	0.87
Cminus-D	0.58	0.43	0.55	0.15	0.42	0.58	0.86
Cminus-F	0.60	0.38	0.72	0.70	0.91	0.40	0.42
D-F	0.04	0.81	0.61	0.59	0.60	0.75	0.99

Null Hypothesis (example #2)

	<u>Unexpected Inflation</u>	<u>Industrial Production</u>	<u>Housing Starts</u>	<u>Oil Price</u>	<u>Exchange Value of \$</u>	<u>Credit Risk Premium</u>	<u>Slope of the Yield Curve</u>
A-B	0.80	0.47	0.73	0.02	0.57	0.54	0.90
A-C	0.26	0.93	0.89	0.31	0.92	0.55	0.03
A-Cminus	0.58	0.63	0.88	0.15	0.79	0.20	0.14
A-D	0.84	0.12	0.82	0.89	0.15	0.01	0.41
A-F	0.29	0.15	0.53	0.18	0.93	0.74	0.45
B-C	0.79	0.04	0.51	0.89	0.14	0.58	0.06
B-Cminus	0.17	0.63	0.98	0.72	0.15	0.77	0.26
B-D	0.96	0.72	0.57	0.93	0.72	0.93	0.02
B-F	0.91	0.39	0.36	0.83	0.39	0.84	0.50
C-Cminus	0.76	0.77	0.77	0.68	0.42	0.94	0.61
C-D	0.04	0.75	0.98	0.63	0.39	0.84	0.90
C-F	0.39	0.17	0.59	0.19	0.21	0.03	0.50
Cminus-D	0.79	0.22	0.88	0.89	0.79	0.16	0.11
Cminus-F	0.03	0.21	0.26	0.48	0.43	0.26	0.75
D-F	0.91	0.77	0.99	0.46	0.55	0.69	0.72

Results

	<u>Unexpected Inflation</u>	<u>Industrial Production</u>	<u>Housing Starts</u>	<u>Oil Price</u>	<u>Exchange Value of \$</u>	<u>Credit Risk Premium</u>	<u>Slope of the Yield Curve</u>
A-B	0.64	1.00	1.00	0.99	0.95	1.00	0.99
A-C	0.69	1.00	1.00	1.00	1.00	1.00	0.90
A-Cminus	0.54	1.00	0.98	1.00	1.00	1.00	0.96
A-D	0.71	1.00	1.00	1.00	1.00	1.00	0.97
A-F	0.65	1.00	1.00	1.00	1.00	1.00	0.64
B-C	0.57	0.63	0.73	0.90	0.96	0.98	1.00
B-Cminus	1.00	0.87	0.98	0.94	1.00	1.00	0.88
B-D	0.94	0.94	0.86	0.92	1.00	1.00	0.68
B-F	0.91	0.72	0.71	1.00	1.00	1.00	0.99
C-Cminus	1.00	0.80	1.00	0.53	0.98	0.99	0.92
C-D	0.81	0.96	0.72	0.63	1.00	0.97	1.00
C-F	0.93	0.66	0.81	1.00	0.95	1.00	0.88
Cminus-D	1.00	0.84	1.00	0.63	1.00	1.00	0.68
Cminus-F	0.99	0.58	0.84	1.00	0.74	0.77	0.98
D-F	0.82	0.79	0.84	1.00	0.67	0.66	0.99

The yellow cells represent cases where the difference in exposure appears statistically significant at the 90% level. While we might expect 10% of the cells to be highlighted spuriously, substantially more than half the cells appear significant. Many have significance levels approaching 1.

Findings

- Corporate governance arrangements vary with the economic context of the firm. The agency negotiation is clearly interacting with the macro factors.
 - ✓ We're silent on causality – it probably runs both ways.
- Simplistic accounts of governance from the perspective of control, management self-interest, or ethical theories are therefore incomplete.
- Assessing the economic context of the firm is critical to accurately assessing the appropriateness of governance practices.

References

- Barber, Brad. "Monitoring the Monitor: Evaluating CalPERS' Activism." *Journal of Investing*, Winter, 2007.
- Bebchuk, Lucian, Yaniv Grinstein, and Urs Peyer. "Lucky CEOs and Lucky Directors." *Journal of Finance*, 2010.
- Bebchuk, Lucian, Alma Cohen, and Charles C.Y. Wang. "Learning and the Disappearing Association Between Governance and Returns." Harvard Law and Economics Discussion Paper No. 667, June 1, 2011. *Journal of Financial Economics*, forthcoming.
- Christensen, Clayton, and Scott D. Anthony. "Put Owners in Their Place: Why Pander to People Who Now Hold Shares, on Average, Less than 10 Months?" *Business Week*, May 27, 2007. Accessed at http://www.businessweek.com/magazine/content/07_22/b4036100.htm.
- Jensen and Meckling. "Theory of the firm: managerial behavior, agency costs, and ownership structure." *Journal of Financial Economics*, 1976.
- Goldstein, Michael, Brian Cho, Nicole Price, Sungsoo Yang. "Does Corporate Governance Matter?" Empirical Research Partners, December 1, 2006.
- Gompers, Paul, Joy Ishii, and Andrew Metrick. "Corporate governance and equity prices." *Quarterly Journal of Economics*, 2003.
- Heron, Randall A., Erik Lie, and Todd Perry. "On the Use (and Abuse) of Stock Option Grants." *Financial Analysts Journal*, 2007.
- Hill, Charles and Thomas Jones. "Stakeholder-Agency Theory." *Journal of Management Studies*, March 1992.
- Karpoff, Jonathon, M. Wayne Marr, and Morris Danielson. *Corporate Governance and Firm Performance*. Charlottesville, VA: The Research Foundation of the Institute of Chartered Financial Analysts, 2000.
- Kurtz, Lloyd. "Stakeholder Analysis" in H. Kent Baker and John Nofsinger, eds., *Socially Responsible Finance and Investing*. New York: John Wiley & Sons, 2012.
- Page, Jean-Paul. *Corporate Governance and Value Creation*. Charlottesville, VA: Research Foundation of the CFA Institute, 2005.
- Valukas, Anton R. Examiner's Report, in re Lehman Brothers Holdings, Chapter 11 Case No. 08-13555, United States Bankruptcy Court, Southern District of New York, March 11, 2010.
- Varchaver, Nicholas. "What Warren Thinks." CNN Money, 4/14/2008. Accessed at: http://money.cnn.com/2008/04/11/news/newsmakers/varchaver_buffett.fortune/