

# DOES Corporate Governance MATTER TO CANADIAN INVESTORS?

**Markets and shareholders exhibit a significant reaction to information about a firm's governance practices.**

BY STEPHEN R. FOERSTER AND BRIAN C. HUEN

Corporate governance refers to the process whereby suppliers of capital (shareholders) attempt to ensure that managers of the firms in which they invest provide a sufficient return. It addresses the agency problem whereby the shareholders (principals) are the ultimate owners of the firm and want to ensure that managers (agents), who are separate from the shareholders, act in the shareholders' best interests rather than the interests of managers.

Recent high-profile scandals (e.g., Enron, WorldCom, and Tyco) have focused increased attention on the agency problem and corporate governance mechanisms. Subsequent to these incidents, U.S. lawmakers responded with tougher regulations such as the Sarbanes-Oxley Act of 2002. Canadian regulators have been in the process of drafting parallel initiatives, and while Canada has not fully enacted such regulations, cross-listed firms—which are quite plentiful—are subject to much of the U.S. regulation.

While the study of agency problems and corporate governance is not new, few studies have attempted to provide a direct link between corporate governance metrics and stock valuation. In addition, while much attention has been focused on the U.S., there has been very

little academic research (with the exception of King and Segal [2003]) investigating governance and stock valuation in a primarily Canadian context.

Our study attempts to provide a vigorous investigation in search of a link between corporate governance measures and stock valuation in Canada. However, we recognize that any such search should be embarked upon with a number of important caveats. First, a search for any causal link is inherently difficult: while we make no claim about the direction of any link between governance and value, our goal is to empirically investigate whether governance does matter to Canadian investors and whether any association between governance and stock performance can be established. A second major challenge in this area relates to the measurement of “good governance.” While the literature has provided some guidance in terms of important governance factors, there is no universally-accepted definition of what identifiable and measurable factors constitute good governance, or how any such measures should be weighted as part of the construction of an overall governance index.

A third challenge relates to timing. Should we expect to find any link between corporate governance

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and short-term stock performance, or longer-term performance? A fourth challenge relates to the measurement of value and performance. Some studies focus on valuation metrics such as market-to-book ratios or price-to-earnings ratios as proxies for relative values. Such measures rely on accounting-based data which clearly can have some limitations. Another simple approach of focusing on actual stock performance and examining “raw” returns ignores the possibility that returns can be driven by various risk factors inherent in stock investments (although theories as well as empirical investigations provide some directions in terms of risk-adjustments). Given these challenges, it may be surprising to find any links between governance and stock performance.

Nonetheless, in terms of addressing each of the challenges, we proceed as follows to perform a rigorous investigation of the relationship between this governance measure and stock valuation and performance in Canada. First, consistent with Gompers et al (2003), we “let the data decide” in terms of the direction of perceived causality between governance and performance. Second, rather than create our own index, we rely on a recently developed and independent Canadian governance index presented in a *Globe and Mail Report on Business* article investigating Canadian corporate governance. The investigation recently developed a corporate governance ranking of 270 of Canada’s largest firms, i.e., those in the S&P/TSX index as of September 1, 2002 (see McFarland [2002] and McFarland, Church and Nguyen [2002]). Third, we investigate a number of different time periods, from three months to five years. In addition, we use the release of the *Globe and Mail* article as an event study date to examine the awareness in the marketplace to governance factors and investigate the market’s reaction to this “new” information. Fourth, we rely on the well-known Fama-French (1993) factors to control for risk in our regression analysis. Despite all the challenges, we find evidence that corporate governance does seem to matter to Canadian investors.

## Review of Related Literature

While the literature on corporate governance is quite

broad, few studies have examined a direct link between corporate governance and stock valuation and performance. In a U.S. context, Core, Holthausen and Larcker (1999) focus on one key component related to corporate governance, CEO compensation, and attempt to measure the predicted “excess” compensation of CEOs as a function of board structure and ownership structure variables (i.e., in excess of controls for standard economic determinants of compensation). The predicted excess compensation measure is then used as an independent variable (along with control variables such as standard deviation of stock returns, market value, market-to-book and year and industry factors) to explain stock returns over subsequent one, three, and five-year periods. They find the predicted excess compensation variable to be significant and negative. In other words, when CEO compensation is determined to be excessive, the impact on stock returns is negative.

Gompers, Ishii and Metrick (2003) investigate a relationship between a broader measure of governance, as captured by their governance index, and stock valuations and returns. The governance index includes 24 factors, most related to management’s options to resist hostile takeovers, including poison pills, golden parachutes, and anti-greenmail provisions. After controlling for a number of well-known risk-related factors (see Fama and French [1993] and Carhart [1997]), they measure alphas and find that a portfolio of firms with the strongest shareholders rights outperformed a portfolio with the weakest shareholder rights by 8.5% per year during the 1990s.

Internationally, a German study by Drobetz, Schillhofer and Zimmermann (2003) develops a corporate governance rating for German firms and documents a positive relationship between the governance measure and firm value. The governance measure includes 30 variables related to corporate governance commitment, shareholders’ rights, transparency, management and supervisory board matters and auditing. Return expectations are proxied by historical returns and valuation measures such as dividend yields and price-earnings ratios.

In a Canadian context, King and Segal (2003) focus on a comparison of firms that interlist in the U.S. versus both non-listing Canadian firms as well as U.S. firms. They find that Canadian firms trade at

TABLE 1

## INDIVIDUAL FIRM REGRESSIONS

	Parameter estimates (t-stats)				adj R2
	intercept	(t-stat)	GS	(t-stat)	
<b>Excess of market</b>					
R-5-yr	1.0746	(1.47)	-0.0075	(-0.64)	-0.0028
R-1yr	-0.0448	(-0.31)	0.0023	(0.99)	-0.0001
R-3mo	0.0197	(0.23)	-0.0002	(-0.17)	-0.0036
R-2day	-0.0485	(-3.03)	0.0005	(2.03)**	0.0116
<b>Excess of industry</b>					
R-5-yr	1.3249	(1.77)	-0.0131	(-1.09)	0.0009
R-1yr	0.2359	(1.90)	-0.0018	(-0.90)	-0.0007
R-3mo	-0.1933	(-2.30)	0.0026	(1.95)*	0.0104
R-2day	-0.0391	(-2.55)	0.0004	(1.79)*	0.0082

Regression results based on the equation  $R_{it} = a + b GS_i + e_i$  where  $R_{it}$  is the aggregate return of individual firms in excess of either the market (TSX total return) or the industry sub-index over the indicated period. Various return periods include the five-year period January 1998 to December 2002 (R-5yr), the one-year period January 2002 to December 2002 (R-1yr), the three-month period October 5, 2002 to January 5, 2003 (R-3mo), or the two-day period (close of trading on Friday, October 5, 2002 to close of trading on Tuesday, October 8, 2002). The independent variable is the governance score (GS) index (see Appendix A). T-statistics are indicated in parentheses, whereby \*, \*\*, and \*\*\* indicate significance at the 10%, 5%, and 1% confidence levels respectively. The adjusted-R2 is also reported.

valuation discounts (as measured by price-to-book or price-earnings ratios) relative to U.S. firms. Those Canadian firms that cross-list are able to mitigate the valuation discount. An explanation for their results is that U.S. exchanges have more stringent listing requirements and thus encourage better corporate governance. McFarland, Church and Nguyen (2002) conclude that most Canadian corporations meet neither U.S. requirements nor existing Toronto Stock Exchange guidelines.

### Data and Methodology

The corporate governance survey conducted by the *Globe and Mail Report on Business* and published on October 7, 2002, was used as the ranking system of corporate governance effectiveness in the study. The companies involved in the study, totaling 270 Canadian publicly listed entities, were ranked based on four key factors that were considered to be critical to corporate governance effectiveness: board composition (out of 40), board compensation (out of 23), shareholder rights (out of 22), and public disclosure (out of 15). These scores were then added to determine a total score.

The criteria for data collection were determined in

order to provide a view of probable connection between share performance and corporate governance effectiveness in short-term, long-term and event-driven periods. As a result, the following time periods were considered as significant time periods for data compilation and analysis:

- January 1998 to December 2002:

This time frame was used to provide a view of the long-term share price performance of the companies in the universe.

- January 2002 to December 2002:

This time frame covered the calendar year around the *Globe and Mail* ranking.

- October 5, 2002 to October 8, 2002:

This time frame was the basis for an event-study of the impact of the release of the *Globe and Mail* article (dated Monday, October 7, 2002). The period covers prices from the close of trade before the release of

the article to the close of trade on the day subsequent to the release.

- October 5, 2002 to January 5, 2003: This time frame examines the quarter following the release of the *Globe and Mail* article.

Two sets of regression analyses were performed. The first set of regressions is a cross-sectional analysis at the firm level and is based on the following equation:

$$R_{it} = a + b GS_i + e_i$$

where  $R_{it}$  is the aggregate excess return (over the aggregate period  $t$ ) of individual firm  $i$  and  $GS_i$  is the governance score index for firm  $i$ . Excess returns were measured in two methods: first, in excess of the market return (TSX total return) or second, in excess of the TSX industry subindex.

The various return periods included the five-year period January 1998 to December 2002, the one-year period January 2002 to December 2002, the three-month period October 5, 2002 to January 5, 2003 (R-3mo), or the two-day "event" period (close of trading on Friday, October 5, 2002 to close of trading on Tuesday, October 8, 2002).

TABLE 2

**PORTFOLIO REGRESSIONS**

	alpha	(t-stat)	RMRF	(t-stat)	SMB	(t-stat)	HML	(t-stat)	adj R <sup>2</sup>
Q1	0.0098	(2.30)***	0.7708	(9.68)***	-0.1781	(-3.51)***	0.0860	(1.00)	0.631
Q2	0.0045	(0.50)	1.5032	(8.74)***	0.0577	(0.53)	0.1881	(1.01)	0.674
Q3	-0.0026	(-0.49)	0.5703	(5.74)***	0.2586	(4.08)***	-0.2347	(-2.19)**	0.565
Q4	0.0017	(0.37)	0.7778	(8.97)***	0.0973	(1.76)*	0.0762	(0.81)	0.717
Q5	0.0063	(1.56)	0.8290	(10.89)***	-0.0293	(-0.60)	0.0510	(0.62)	0.723

Regression results based on the equation  $R_{it} = a + b_1 RMRF_t + b_2 SMB_t + b_3 HML_t + e_{it}$  where  $R_{it}$  is the monthly portfolio return in excess of the t-bill return. Each portfolio is a weighted-value of 54 stocks based on rankings of the governance score (GS) index. Firms in the Q1 portfolio have the highest average GS, while firms in the Q5 portfolio have the lowest GS. RMRF, SMB, and HML are the Fama and French (1993) factors estimated based on the sample of Canadian data and represent the total return on the TSX index in excess of the t-bill return (RMRF), the return on the smallest (market value) quintile portfolio less the return of the largest quintile portfolio in the sample (SMB), and the return on the highest book-to-market quintile portfolio less the return on the lowest book-to-market quintile portfolio. T-statistics are indicated in parentheses, whereby \*, \*\*, and \*\*\* indicate significance at the 10%, 5%, and 1% confidence levels respectively. The adjusted-R<sup>2</sup> is also reported. Alpha is interpreted as a monthly abnormal portfolio return.

The second set of regressions is a time-series analysis and is portfolio-based, defined by the following equation:

$$R_{it} = a + b_1 RMRF_t + b_2 SMB_t + b_3 HML_t + e_{it}$$

where  $R_{it}$  is the return measure for portfolio  $i$  in month  $t$  in excess of the t-bill return, and  $RMRF$ ,  $SMB$ , and  $HML$  are the well-known Fama and French (1993) factors estimated based on our sample of Canadian data (270 firms) and represent the total return on the TSX index in excess of the Canadian t-bill return ( $RMRF$ ), the return on the smallest (market value) quintile portfolio less the return of the largest quintile portfolio in the sample ( $SMB$ ), and the return on the highest book-to-market quintile portfolio less the return on the lowest book-to-market quintile portfolio ( $HML$ ). The sample period is January 1998 to December 2002. Portfolio returns are a weighted-value of 54 stocks (one-fifth of the overall sample of 270 firms) based on rankings of the governance score (GS) index. Firms in the Q1 portfolio have the highest average GS, while firms in the Q5 portfolio have the lowest GS. This regression equation and methodology are similar to those employed in Gompers et al (2003).

### Results

We examine correlations among the individual firm measures. The governance score (GS) index, perhaps not surprisingly, is positively and significantly related to the size measure. In other words, larger firms tend to have stronger governance practices. In addition, a larger GS is

associated with firms that list on the NYSE, which is consistent with the more stringent listing requirements on the NYSE. However, there is not an association with simply listing on any U.S. exchange, such as Nasdaq; thus, it may be important to distinguish between the individual exchanges' requirements themselves rather than geographic location. Both the five-year and one-year return are positively and significantly related to measures of the market-to-book ratio, suggesting that "growth" stocks performed better over those time periods. Larger firms tended to be cross-listed on the NYSE.

The individual firm cross-sectional regression results based on the first equation are presented in Table I (see pg. 22). The first panel presents results based on excess of market returns while the second panel is based on excess of industry returns. None of the five-year or one-year results are significant, although there is a small but significant relationship between the excess of industry returns and the GS index over the final quarter of 2002, the period subsequent to the release of the *Globe and Mail* article. The event study results based on the two-day period (close of trading on Friday, October 5, 2002 to close of trading on Tuesday, October 8, 2002) around the release of the article suggest a positive and significant relationship between the stock performance and the GS index, although the adjusted R<sup>2</sup> is quite small. This result suggests a possible market inefficiency or a market reaction to the publicity. Interestingly, the article was based on public information but apparently was "news" to the marketplace in terms of a relative

ranking of governance.

Given the amount of “noise” in the individual firm data, it is perhaps not surprising to find weak results. In order to reduce the noise, and be consistent with other researchers, we analyze the data by forming value-weighted portfolios of firms based on the GS index. Portfolio regression results based on the second equation are presented in Table 2, which includes a number of risk proxies.

Alpha is interpreted as a monthly abnormal portfolio return after controlling for market return, size, and book-to-market risk factors. The only significant alpha is uncovered in the top quintile portfolio (Q1). The average abnormal monthly return is 0.98%. The average alpha of the remaining four portfolios is 0.24%. The difference of 0.74% is approximately 8.8% on an annual basis. These results suggest that the market does care about the governance practices of Canadian firms and investors in firms with stronger governance practices are rewarded over the long-term.

## Conclusions

Does corporate governance matter to Canadian investors? In the very short-run, perceptions do matter. Markets react statistically significantly, but only marginally economically to “news” related to corporate governance rankings. In the longer-term, good governance matters as well, although one must be careful to adjust for risk and to also consider a long enough time period.

We can conjecture that during the “technology bubble” of the late 1990s, many firms with very weak corporate governance practices (and certainly those listed on the Nasdaq rather than the NYSE) rewarded their investors handsomely for several years. Cynics have suggested that governance awareness comes in cycles and corresponds to periods of depressed markets.

Whether the apparent increased attention on corporate governance is a “fad” or is here to stay, only time will tell. The search for a strong link between governance and stock performance continues. ■

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