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TRANSCRIPT

ESG Now Podcast

“Does Governance Matter?”

Transcript, 17 July, 2024

Michael Disabato (00:00):
What's up everyone? And welcome to the weekly edition of ESG now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host Mike Disabato, and this week we tried to answer the age old question for you in 10 minutes. Is governance a useful factor to focus on when investing? So thanks as always for joining us. Stay tuned.
(00:27):
A company's governance structure is ostensibly a look into how it makes its long-term decisions, and it's an important aspect for all of us in this capitalist system to pay attention to because these companies have an impact on our daily lives. And if you're an investor, it is definitely important to understand because those structures can help demonstrate where the company may be headed. Boeing is an easy example here to demonstrate the importance of governance. Boeing's leadership seem to prioritize production over safety and it's reflected in the pay package awarded to Boeing's CEO in 2022, where only 0.7% of the 22 million US dollars the board awarded him was tied to product safety. One could make the argument that Boeing's board failed in its job of helping the company make long-term profitable decisions by using its pay package in an incorrect way, and thus could not compete as favorably with a competitor like Airbus over the long run.
(01:26):
But you can see the governance issues with Boeing miles away these days. The CEO is set to step down at the end of the year. The head of commercial aviation already stepped down due to the various issues with the 7 37 max. The question is, can you use governance factors to avoid the next governance Rian in your portfolio if you're an investor and you care about that kind of thing? Of course, in order to figure that out, you'd have to run some sort of study to see if governance ratings, basically the score we give a company based on the structure of its governance correlate with profits, risk reduction, and returns. While my colleague and guest today, Harlan Tougher did just that, he completed the surprisingly difficult but simple task of assessing how the potential benefits of good governance translated into market performance. He and our colleague, hin Wang, who will actually also be in this episode, published a blog on their findings recently as well. If you're so inclined, don't worry. I'll leave a link in the podcast description. And in the beginning of the study, what Harlan did is he wanted to better define our view of what someone might call good governance in order to show how it might perform the company itself over the long run.

Harlan Tufford (02:40):
The governance is about how organizations make decisions, and that's true whether we're talking about some giant company or a small mop and pop shop or my local curling club where I sat through a four hour AGM a few weeks ago. Whatever the organization, the key questions are always the same, right? It's who makes decisions and how. So when we at M-S-C-I-E-S-G research talk about good governance, we're talking about what's good for investors and particularly minority investors who hold some equity or debt, but not a controlling stake in the company. And for those investors, the big problems follow along the principal agent risk spectrum, and I won't get into the nerdy jargon, but the core ideas that managers and owners might not always want to act in the best interests of other investors. They might want to act in their own best interests, but if you have things like a well-structured board, an independent auditor, effective pay practices, meaningful shareholder rights, all of these things collectively can help those insiders to put investor interests first. And that's why we think

governance is universally relevant because this problem will happen to a greater lesser degree at every organization that has to make decisions.

Michael Disabato (03:52):
Also, because every organization can theoretically have bad governance, that's when a company is buying company cars from the owner's car company at an elevated price, or it's giving its government clients a product at a favorable rate. So its leadership can one day get a cabinet appointment in the next administration. What I mean is bad governance is when the interest of the leadership structure ignores the interest of the shareholder, and that is a problem. Okay? So then the solution is easy. Underweight the bad governance companies and overweight the good governance companies when you invest bang bang, I asked Harlan if that actually works.

Harlan Tufford (04:29):
Hell yes, brother. When you look at the financial performance of constituents of the MSCI aqui and index over the nine years from 2015 to 2023, you or rather, we found that companies with better overall governance practices had higher profitability and particularly in developed markets, lower risk. And we found that these were statistically significant differences. So yeah, a short answer, yes, our findings support the conclusion that well-governed companies do a better job of rewarding investors. If you have stronger governance practices that generally meant you were more profitable, you had lower risk, and you were giving your investors better risk adjusted returns over the long term. And that's in line with what we would expect our model to do, right? Because it's a situation where the whole decision-making apparatus is geared toward making decisions that are better aligned with the interest of investors.

Michael Disabato (05:28):
So that seems validating for us, especially proper governance structures lead to profitability for companies that were in Harlan's study. So the G pillar can take the weight on a company by company basis, and in many circles, that is what you should be paying attention to when investing in companies its ability to keep those cash flows coming over the long term at a low risk, which is the intrinsic value of the company in and of itself. But the complication here is just because a company is profitable doesn't mean obviously it performs well in the market. And I say obviously in case you're all listening and you're much better investors than I am, and I don't want to sound like I know more than I'm talking about because the market is its own beast serving emotional masters that make irrational decisions such as myself. What Harlan needed to do was take those lists of bad and good governance companies and look at whether he could invest in the good and not invest in the bad and maybe just maybe make a bit of money. So to do this, Harlan turned to our colleague Chin Hin Wang, who is an expert on building hypothetical portfolios that could make hypothetical money and analyzing why they performed how they performed, and she took Harlan's universe of companies and built some portfolios with them. And here's what she found.

Xinxin Wang (06:42):
So basically to show whether good governance characteristics can translate into performance or not. What we've done is that we look at the past and we did that by constructing portfolios that has good governance characteristics in contrast to the ones that have bad governance characteristics. And then we compare the two portfolios and we see if there's any performance differentiation. That's essentially what we did and the empirical results that we found is that yes, there is companies with better governance characteristics, outperform companies that have worse governance characteristics. But of course when we construct a portfolio, there are other consideration because one of the criticism of ESG or sustainability in general is that companies with good ESG characteristics may happen to be correlated with sectors size, for example, like big companies tend to have more money to throw at these type of issues, and as a result, they may have better characteristics.
(07:58):

So in order to have more of a pure comparison, if Mike could use that word, we try to control for the other characteristics that could introduce bias into our analysis essentially. So what we did is that we do regional justice adjustments, for example, EM versus dm or even within dm, we do North America amea in order to take out regional biases, we did adjustment for sector. So information technology for example, would not somehow overweight or introduce bias for other potential sectors out there. We also adjust for size. So we take out the size element of the companies and we adjust for all of those characteristics, and then we look at the portfolio after for those characteristics and see if we still see better governance companies outperform. And the result is yes.

Michael Disabato (09:02):
So if you look at past returns, good governance companies outperform the broader market on a global level, and that's useful for us to know. Running a company with good governance practices is both profitable and can be useful as an investment practice. If you look at past returns, past returns are not indicative of future returns, et cetera, et cetera, et cetera. Now there are some wonky details to that statement. If you build a portfolio with just using governance, you're going to be overweight some countries in underweight some other countries. And that is because governance, as Harlan alluded to, is a local creation To demonstrate this Chin hin built not only a global portfolio, but one that separated out the developed and emerging market companies. And what was interesting was while the developed market portfolio outperformed the broader market, the emerging market portfolio did not, and the reason for that was we found due to country exposures, for example, in the emerging market portfolio, South Africa punched above its weight because a majority of companies in South Africa have good governance, which is a reflection of the country's local governance achievements such as the King Fourth Corporate Governance code, which was released in 2016 and further strengthened what was already content leading governance practices.
(10:17):
But the problem is, is the overall market in South Africa didn't do that well over the period that Chin hin looked at from 2015 to 2023. Okay, so what does this all mean? What are the takeaways that I should just build a portfolio with good governance companies and have it be global and then I'm good? Well, yes and no. If you could somehow in a magical world build a portfolio that could erase all the other factors that control the market, like how people buy companies that are doing well, making them do even better and sell companies that are doing poorly, making them do even worse, something we call momentum. If you could get rid of all that noise, then yes, you could use governance alone to build a portfolio. But since you cannot do that, you have to operate in the real world. You have to use other factors than just governance. When you're building a portfolio, governance can be one part of a useful signal. Yes, we tried to prove that with this study, but one factor cannot guide you. You cannot figure out the market alone. Governance needs to be paired with some other considerations, and if you could do that well, then you're golden.
(11:27):
And that's it for the week. I want to thank Harlan and HIN for talking to me about the news with a sustainability twist. I want to thank you so much for listening. If you like what you heard, don't forget to rate and review us and subscribe wherever you get your podcasts. It really helps. Thanks again and talk to you soon.

Speaker 4 (11:52):
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