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# In Stock-Picking, Governance Ratings May Be Like Darts

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WASHINGTON -- Investor concern about corporate governance has spurred the creation of a growing assortment of ratings systems, but experts aren't sure they can predict good shareholder returns any better than throwing darts at a board.

From GovernanceMetrics International's 10-point scale to Institutional Shareholder Services' Corporate Governance Quotient, or CGQ, these tools seek to measure whether boards and management have their shareholders' best interests in mind.

The premise assumes that a company following such so-called good governance practices will be a better investment, and those with bad practices may be the next Enron.

Yet, experts say good governance is a slippery thing to measure, and that companies that do all the right things on paper may be no better aligned with shareholders' interests than those that rank lower. Researchers can't even agree on just what practices deserve the governance seal of approval, let alone what changes might lead to enhanced corporate performance or shareholder returns.

"Right now, there seems to be no unanimity in the field on two things," said **Anup Agrawal** , a finance professor at the University of Alabama's business school. "One is what is good governance and the other is the effect of corporate governance on corporate performance."

Ratings reflect a number of factors, including the number of independent directors, the presence of anti-takeover measures and whether the same person holds the chairman and chief executive jobs.

But a bewildering array of studies haven't all led to the same conclusions about governance standards, at least in the U.S. That's in part because researchers don't measure various pratices the same way. Additionally, a well-run company carrying out its business strategy on all cylinders may also have exemplary governance practices, so isolating governance as a driver of value is a challenge.

"People are still skeptical about whether corporate governance can be distilled into a rating," said Keith Johnson, chief counsel for the State of Wisconsin Investment Board, which uses ISS's CGQ product. "I would say it's probably going to take years of experience to make an accurate judgment."

Also, others think that just "checking the box" on governance attributes doesn't get investors very far.

"We think that box-checking is too easy and misses too many of the important, contextual subtleties," said Gregory P. Taxin, CEO of Glass Lewis & Co., a new proxy advisory firm, which plans to offer research in September focused on "corporate integrity," free of numerical scores, rankings or ratings. "Life is more complex than just a number."

Conflicting Studies

One of the biggest attention-getters among governance experts was a research paper published this year, which found that shareholder-friendly companies performed better than corporate "dictatorships," based on two dozen governance criteria, including a number of anti-takeover mechanisms limiting shareholder rights.

A few years back, however, a mid-1990s study by Agrawal and a fellow academic found no relationship between market value and seven other governance mechanisms, including board independence.

Outside the ivory tower, meanwhile, some experts worry that such traditional governance measures can be cosmetic.

"There's something that says to us very intuitively and very seductively that independent directors are better than non-independent directors. But that doesn't take into account the problem of resume independence, where a director appears to be independent" on paper but is really the CEO's longtime golfing buddy, said Nell Minow, a shareholder activist and editor of The Corporate Library, a Portland, Maine, governance research group.

Minow, whose firm launched its own board assessment tool, said she prefers to screen based on company actions rather than their professed beliefs in good governance. To that end, the Web-based firm evaluates pay policies, how transparent financial reporting is and overall business strategy.

"I want to know if it's real or if it's window dressing," Minow said.

Poor Governance, Blowups

While the jury is still out on the link between high governance rankings and performance, there at least seems to be anecdotal evidence that poor governance can be linked to greater risk of blowups.

To analysts at Moody's Investors Service, which plans to start issuing governance reports on a select universe of companies later this year in conjunction with its core credit ratings, governance risk resonates strongly.

"There is a strong view that the events of the last few years do relate to corporate governance. There were a large volume of investment grade defaults in 2001 and 2002, and relatively few corporations accounted for it - Enron, WorldCom and Adelphia are the biggies," said Kenneth Bertsch, director of corporate governance for Moody's. "The largest ones all appeared to us to have been large corporate governance failures."

Marc Zenner, a director in Citigroup Global Markets' financial strategy group, probed whether ISS' CGQ correlated with measures of value such as price-earnings ratios or stock prices, but he came up empty.

But he did find evidence that companies in the bottom quarter of ISS' rankings underperformed the market when measured three and six months after they were first released last June. "The one thing we could say was having a low CGQ was not a good thing," Zenner said.

One skeptic about the existence of a direct cause-and-effect relationship is ISS senior vice president Patrick McGurn, who thinks investors should use CGQ as just one factor in determining, say, risk of investing in a particular stock.

"If there was some silver bullet out there, every money manager would be touting their stock-picking based on some particular governance attribute," he said. "The notion that there's something magical about corporate governance as far as predicting superior long-term performance is something that at this point in time is dubious at best."

For those who still want to believe, GovernanceMetrics has done its own study - and found that those that ranked in its own top tier outperformed the market on several measures.

GMI CEO Gavin Anderson acknowledges that the study is by no means scientific. Still, he thinks it says something about a trait the firm is trying to capture in its ratings: accountability.

"Companies with good accountability see that accountability reflected in the way the business is run, not just in terms of how it's run for shareholders," he said. Measuring 600 plus variables "helps us find patterns of accountability or lack thereof."

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