



Sustainable Investing Quarterly Insights

January 2019: *Data Driven Corporate Governance*

Friends & Clients:

Last quarter we wrote about corporate governance and how specific internal processes can maximize the efficient use of existing resources, avoid short term incentive structures that increase risk without growth, and ensure enough diverse and independent input among the board and management to avoid “group think”. While we absolutely believe in these generalizations, we equally believe in the importance of a data driven approach to any investment decision. As such, this quarter we will look at the nuts and bolts of corporate governance: What specific metrics should we look at? What is the actual impact on our return?

Long considered one of the top index providers, MSCI has identified 96 separate data points that they consider part of corporate governance, which fall under the following broad categories:

- 1) The Board – Are there independent, diverse, qualified, and engaged board members? If so, are they empowered and on the proper committees? How and when are they elected?
- 2) Compensation – Are manager’s compensation and bonuses tied to long-term performance? Are they tied to metrics that fit in with the company’s strategic plan? Are stock options sufficiently illiquid to ensure executives share the same financial risks and rewards as shareholders?
- 3) Ownership – Can all shareholders vote or are their restrictions? What issues can shareholders vote on? Is ownership concentrated or diverse?
- 4) Accounting – Is the company measuring, reporting, and disclosing information that is relevant to investors and to the company’s long-term risks and opportunities?

Of the 96 metrics within these four categories, not all are equal. There is healthy debate among investors about which specific data points are most important, and it is certain that some metrics are more relevant than others depending on a company’s industry, region, size, etc. However, there is little debate about the importance of these governance metrics as a whole. MSCI has a famous index called MSCI World that tracks the majority of the global stock universe. They also have a smaller index that tracks the companies within MSCI World that have the highest aggregate corporate governance scores based on their metrics. Comparing the two over time is a good indication of how corporate governance translates to investment returns.

CUMULATIVE INDEX PERFORMANCE - GROSS RETURNS (USD) (NOV 2009 – DEC 2018)



ANNUAL PERFORMANCE (%)

Year	MSCI World Governance-Quality	MSCI World
2018	-4.59	-8.20
2017	26.57	23.07
2016	6.97	8.15
2015	0.90	-0.32
2014	9.78	5.50
2013	28.04	27.37
2012	12.89	16.54
2011	4.26	-5.02
2010	11.59	12.34

As you can see above, the results are astounding. Companies that score better on their corporate governance practices, without considering additional financial metrics, outperformed the overall market by 2% annualized over a ten-year period. Of all the components of sustainable investing, this is perhaps the least surprising. Of course companies that are well governed will perform better than their poorly governed peers. What is surprising is how little importance investment managers have historically placed on corporate governance.

Investment managers will and should continue to debate the relevant importance of various corporate governance metrics – it is their job to do so. And no doubt new corporate governance measures will be discovered, studied, & tracked. At North Woods, we savor getting into the weeds on those debates. But whatever our opinion on the relevant importance of metric #37 vs. metric #93, what is clear is that the aggregate of all 96 of these data points tells a story about a company and how well it is governed. And the data proves what our intuition suspects, that well-governed companies should outperform over time.

As always, please do not hesitate to reach out to anyone on our team – we look forward to speaking with you soon!

Sincerely,

Barrett Wadsworth
President
Barrett@north-woods.com

Jeremy Wadsworth, CFA
Chief Investment Officer
Jeremy@north-woods.com