Sustainable Investing Quarterly Insights
October 2018: *Why Does Corporate Governance Matter?*

Friends & Clients:

Pick your favorite company. Start explaining to yourself why that company is successful or is exceptionally well poised to thrive. Is it a new product line? Terrific margins? A well-established brand? A new patent? Now ask yourself, does that company have a sound internal corporate governance system in place? Most likely, you do not know the answer to that question, but don't fret – you are not alone. Corporate governance is typically overlooked and highly undervalued when analyzing a company.

Corporate governance is an all-encompassing description for a company's internal processes that exist to provide structure for associated stakeholders: employees, shareholders, board members, and management. Poor corporate governance can lead to: 1) inefficient use of resources, 2) poor incentive structures that increase risk without growth, and 3) lack of diverse and independent thinking.

1) **Inefficient Use of Resources** – Most large companies consist of thousands of employees, numerous product lines, and hundreds of suppliers, all with their own policies, procedures, regulations, and contractual obligations. Like an aircraft carrier, they are powerful forces that are difficult to stop, but not very adept at making sudden turns. As with Newton's first law of physics, companies will often continue along their existing trajectory until that course is changed by an outside force. For example, as times change, companies may require less human capital for certain functions that can be automated or have become irrelevant but may benefit by investing in human capital in new areas of research & development or digital marketing.

   Ensuring that companies are responsive to these outside forces and do not remain complacent or become uncompetitive is a critical part of corporate governance. Strong corporate governance requires having objective, accountable systems in place to both evaluate and challenge all aspects of a company's operations. Starting with the board and its various committees, strong corporate governance extends to external advisors & consultants, internal committees & working groups, and sometimes industry peer review or best practices organizations.

2) **Incentives** –If you own shares of stock in a company, chances are you believe in the most basic principle of free market capitalism: in the economic sphere of their lives, individuals will by and large pursue their own self-interest. This means that a company's compensation structure; the primary tool companies have to drive the behavior of their employees from the C-Suite to the mailroom, has enormous ramifications on corporate earnings. Companies with bonus structures based on short-term metrics (i.e. quarterly or semi-annually) are incentivizing their labor force to boost short term numbers, which typically comes with a sacrifice to long-term earnings growth. On top of hurting long-term profitability, this also has the effect of building hidden risks within a company. Employees get rewarded

in the short-term if a risky action works out but can then simply move on to the next quarterly bonus period to try again if the risky action fails, leaving shareholders with the financial consequences. Strong corporate governance means carefully constructing compensation policies and packages to incentivize and reward behavior that is in line with the long-term objectives of the company, its stakeholders, and most importantly from our perspective, its shareholders.

3) **Lack of Diverse and Independent Thinking** – "Group Think" is one of the biggest issues that the boards of many publicly traded companies face. Group think occurs when a committee consists of similar individuals with respect to career path, socioeconomic background, gender, race, and education. With no challenging opinions or different perspectives, a board can easily fall into a pattern of unanimous decision making that is setting the company along a narrow path, whereas there may be alternative, and potentially more profitable, options available that are not even being discussed. A diverse board with varying ideas has been shown to have superior decision-making abilities that lead to higher long-term growth. Additionally, it is essential to have an independent board chair; the CEO of a shocking 52% of S&P 500 companies is also the chairman of the board.[1] This is an obvious conflict of interest; the board's primary role is to independently monitor the operations of the company. This cannot be accomplished successfully when the leader of the board is the same individual who is supposedly being supervised.

Corporate governance is the cornerstone of Sustainable Investing because it is the way in which we evaluate whether a company has the infrastructure and systems in place to position it for long-term earnings growth.

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

[1] Larcker, D., & Tayan, B. (2016). Chairman and CEO: The Controversy over Board Leadership Structure. *Stanford Closer Look Series*. Retrieved September 13, 2018, from https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-58-independent-chair.pdf.

1231 Delaware Ave Suite 201, Buffalo, NY 14209 • 716-322-5221 • Info@north-woods.com • www.north-woods.com