MACRO FACTORS IN CORPORATE GOVERNANCE

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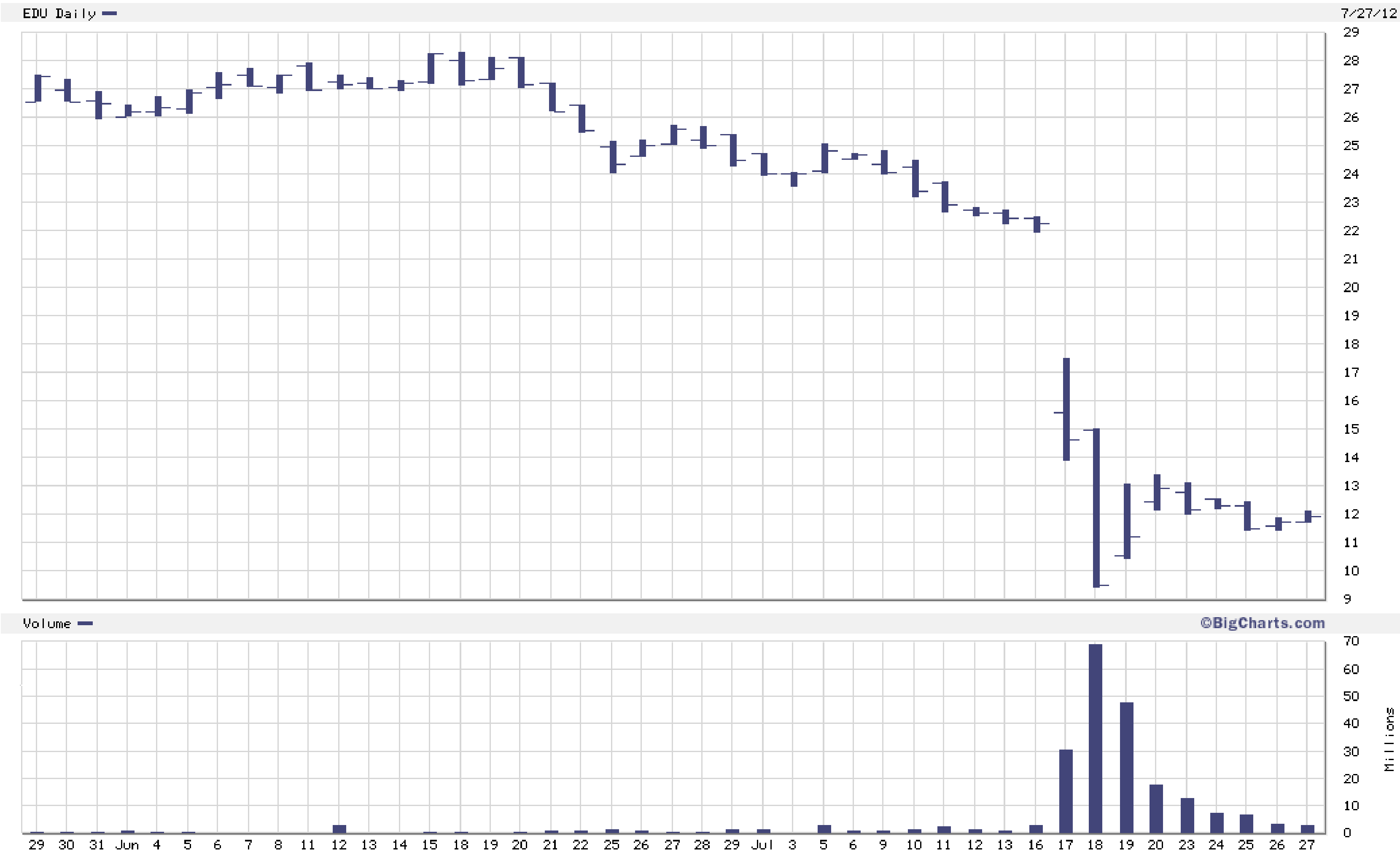
Topics

- Issues
- Control
- Agency
- Context

Issues

A Stock-Specific Issue

New Oriental Education & Technology Group - NYSE



Systemic Issues (late 90s – early 00s)

- Healthsouth
- Tyco International
- Columbia/HCA
- Computer Associates
- Cendant
- Imclone
- Informix
- Worldcom
- McKesson/HBOC
- Enron

In the late 1990s and early 2000s, governance issues seemed to be driven primarily by management teams stretching to perform in a pressurized environment. Insider trading and earnings manipulation were key themes.

Systemic Issues (continued)

- Lehman

  Lehman's Global Financial Controller confirmed that "the only purpose or motive [for Repo 105] was reduction in the balance sheet" and that "there was no substance to the transactions."

  Lehman did not disclose its use – or the significant magnitude of its use – to the rating agencies, to its investors, or to its own Board of Directors.

  - Examiner's Report

- Fannie Mae / Freddie Mac

  "[T]wo of the greatest accounting misstatements in history..."

  - Warren Buffett

Avoid Bad Governance Firms?

- Yes, entrenched managers underperform
  - Gompers, Ishii, and Metrick (2003)
- No, the effect reversed in the 2000s
  - Goldstein (2006)

Control

The 10 Largest U.S. Tech Companies

by market capitalization

- Apple - $362 bn
- IBM - $224 bn
- Microsoft - $212 bn
- Google - $201 bn
- Oracle - $158 bn
- Intel - $126 bn
- Cisco - $100 bn
- Qualcomm - $91 bn
- Hewlett-Packard - $55 bn
- EMC - $47 bn

Total market value: $1.35 trillion

Value of next 119 technology stocks: $1.16 trillion

Source: Empirical Research Partners. As of 5 December 2011

10 Largest U.S. Tech Companies

by degree of shareholder influence

<u>Normal relationship</u>

- ✓ IBM
- ✓ Hewlett-Packard - Subpar board performance, however
- ✓ Intel
- ✓ EMC

<u>Some shareholder influence</u>

- ✓ Microsoft – Ballmer maintains control, but diminishing
- ✓ Cisco – Chambers has a high degree of influence, but poor performance has diminished this

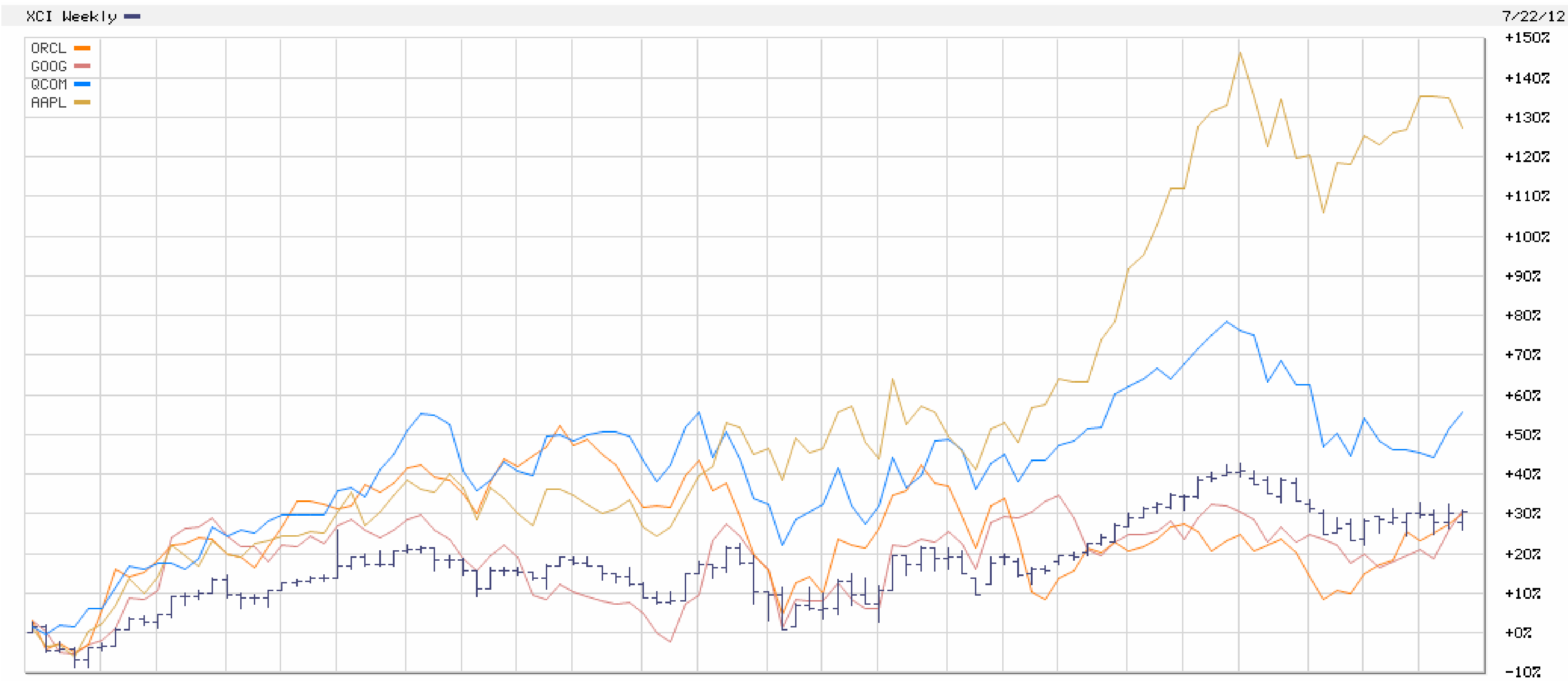
<u>Low or no shareholder influence</u>

- ✓ Apple – Significant positive movement following death of Steve Jobs
- ✓ Oracle – Board capture, Ellison effectively controls the company
- ✓ Qualcomm – CEO is founder's son
- ✓ Google – Shareholders are formally excluded (non-voting)

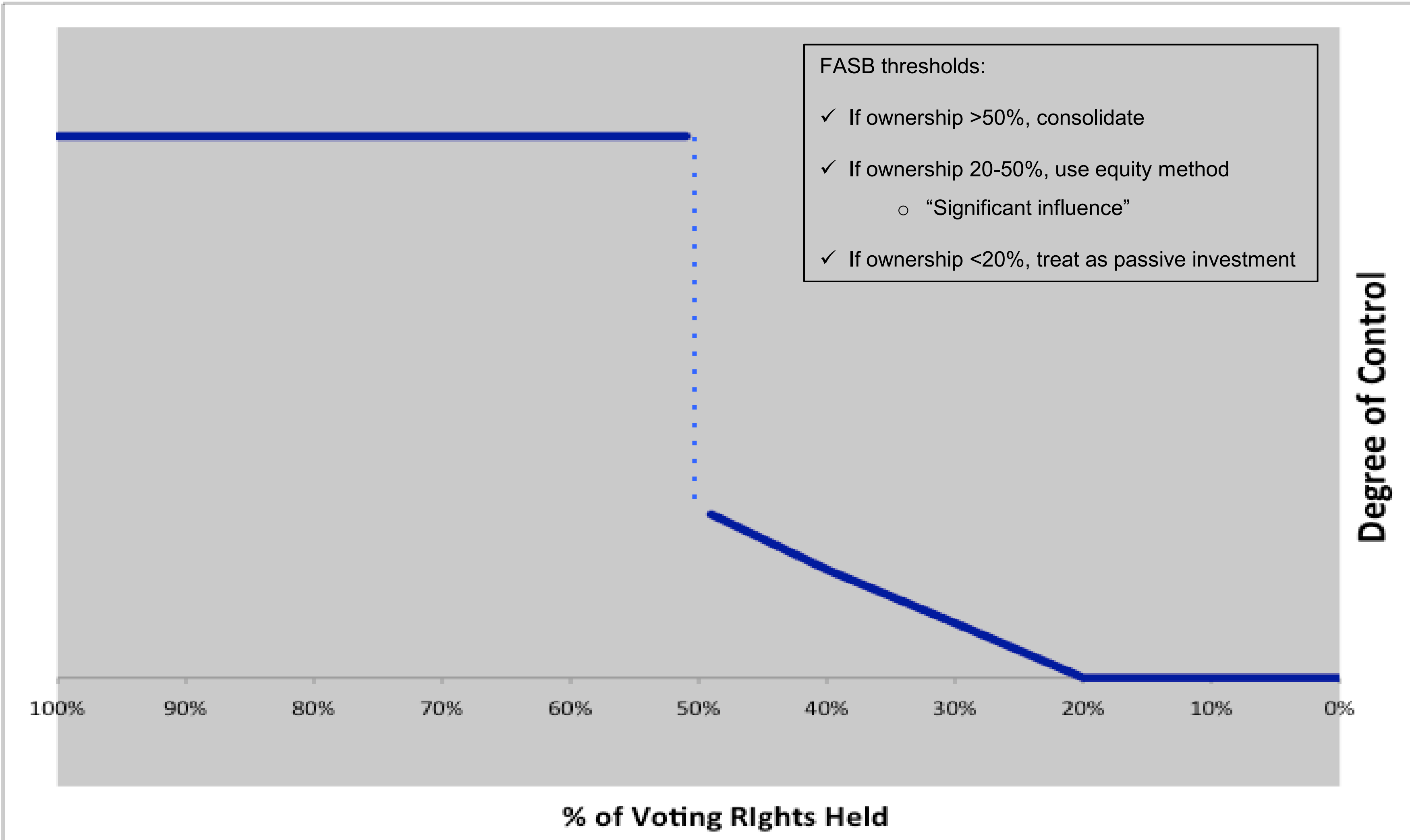
Source: Kurtz judgmental classification

When Bad Governance is Good

Four Governance Laggards vs. The Amex Computer Technology Index (Last 2 Years)



Concentration: Power is Non-Linear



Who's the Boss?

- [B]ecause they shoulder most of the risk, shareholders have every right—within the law—to exclusively enjoy, benefit from, and dispose of the entity they created.

  - Page (2005)

- [T]oday shares are held, on average, less than 10 months. Should managers really regard such investors, whose investment horizons are shorter than the most nearsighted of managers, as stakeholders whose value they ought to maximize? Perhaps it is time for companies to adjust the paradigm...

  - Christensen and Anthony (2007)

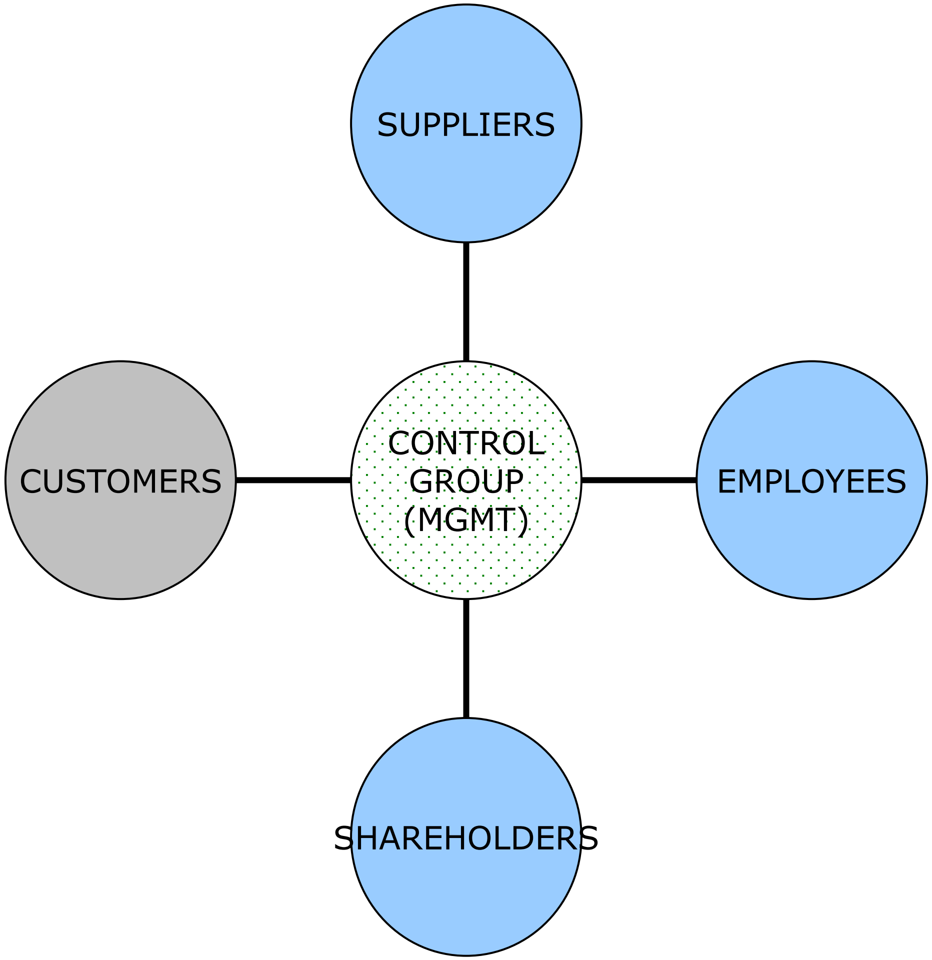
Ways to Have Control

- Own 51% of the stock
- Control 51% of the voting rights
- Capture the board
- Have inattentive owners

Agency

Commercial Stakeholders

This constellation of economic relationships is similar to the widely-used Input-Output Model, but we argue these relationships are dynamic, continuously negotiated, and heavily influenced by loyalty/voice dynamics.



Source: Kurtz (2012)

Two Points on Agency

- Managers will take what they can
  - ✓ "[S]lightly less than 30 percent of public companies that used stock options for executive compensation manipulated at least one grant between 1996 and 2005." - Heron et al (2007)
- Monitoring Helps
  - ✓ "Opportunistic timing, we find, is correlated with three variables associated with greater influence of the CEO on pay-setting. In particular, CEO grant events and director grant events are both more likely to be lucky when the company lacks a majority of independent directors on the board, does not have an independent compensation committee with an outside blockholder on it, or has a long-serving CEO." - Bebchuk et al (2010)

Agency: Cost/Benefit of Monitoring

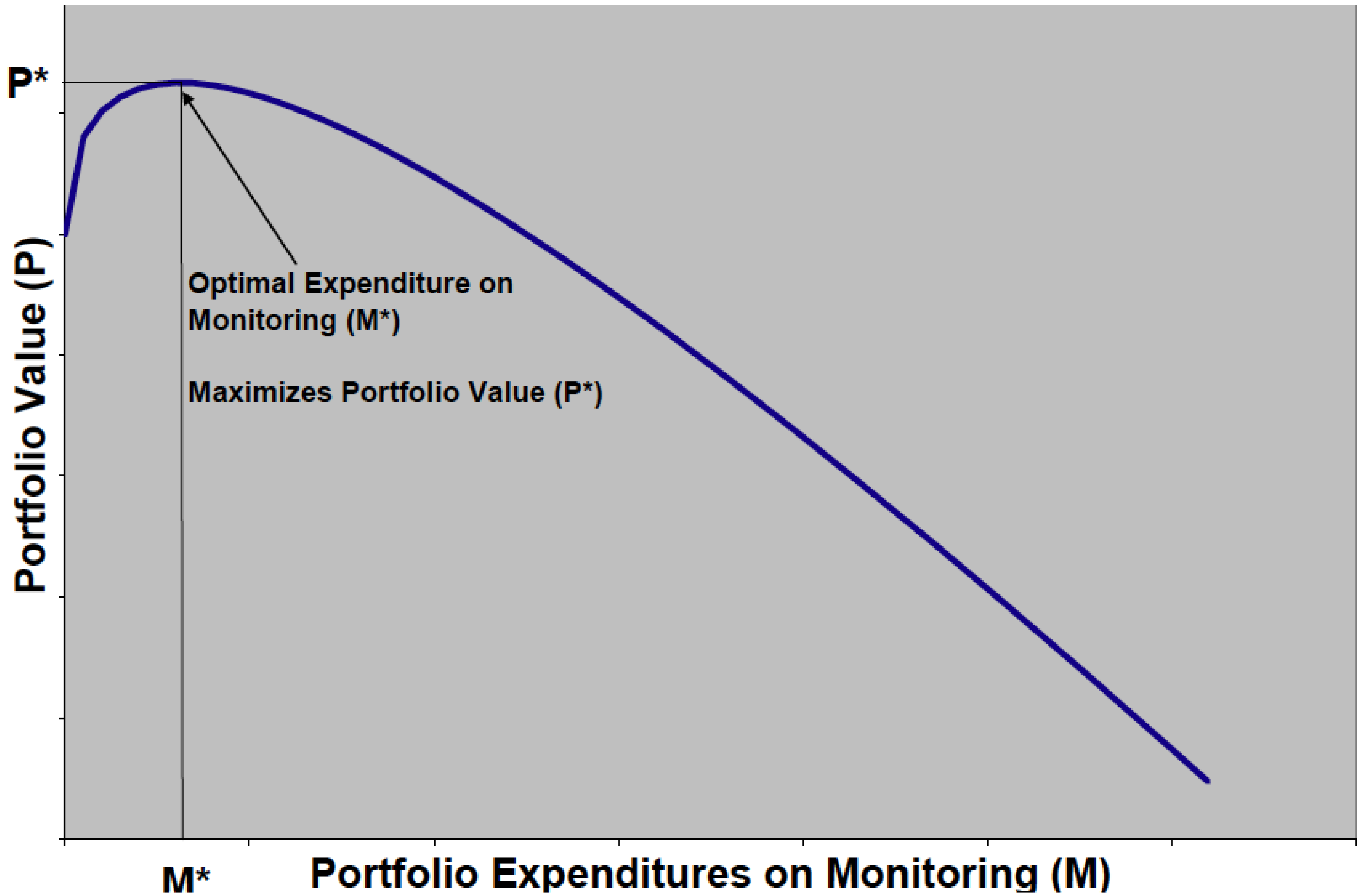


Diagram from Barber (2006)

The Uniqueness of Managers

“[M]anagers are unique...because of their position at the nexus of contracts. Managers are the only group of stakeholders who enter into a contractual relationship with all other stakeholders. Managers are also the only group of stakeholders with *direct* control over the decision-making apparatus of the firm (although some stakeholders, and particularly the suppliers of capital, have indirect control).”

Hill and Jones (1992)

Problems with Monitoring

- No objective way to know where you are on the line
  - ✓Was Lehman over-monitored or under-monitored?
- Agency costs appear to be time-varying
  - ✓Why?
- Appear to vary by sector and industry
  - ✓Why?
- Appear to vary by national/cultural context
  - ✓Why?

Bases for negotiation

- Absentee Owners
  - ✓ Seeking to maximize their wealth
  - ✓ Minimize disruptive impact on the business
  - ✓ Avoid manager misbehavior
    - Expropriation
    - Overinvestment
    - Overreach
  - ✓ Optimize monitoring costs

- Managers
  - ✓ Seeking to maximize their wealth
  - ✓ But also maintain their reputation
  - ✓ Do what's right for the other stakeholders

Open Question

Do contextual factors, *e.g.*, the sensitivity of firm value to changes macroeconomic factors, influence this negotiation?

Context

Corporate Library/GMI Ratings

- Independent corporate governance research group, now part of Governance Metrics International (GMI)
  - ✓Founded by Robert Monks and Nell Minnow in 1999
- S&P 500 ratings from 2003-2011
- Focus on investors and shareholders

Areas Evaluated

- Board Composition
- CEO Compensation
- Shareholder Responsiveness
- Accounting
- Strategic Decision-Making
- Litigation and Regulatory Filings
- Takeover Defense
- Problem Directors

Northfield Macroeconomic Model

$$R_{it} = Int_i + \beta_{1i}\,IN_t + \beta_{2i}\,IP_t + \beta_{3i}\,HS_t + \beta_{4i}\,OP_t + \beta_{5i}\,EX_t + \beta_{6i}\,RP_t + \beta_{7i}\,SL_t + \varepsilon_{it}$$

Model factor loadings are estimated using a time series regression of monthly stock returns against monthly changes in our seven factors. We use 60 months of history when available.

Independent Variables

First Stage

- Unanticipated inflation
- Credit risk premium
- Industrial production
- Slope of the yield curve

Second Stage

- Housing starts
- U.S. dollar exchange rate (trade-weighted)
- Oil prices

Null Hypothesis (example #1)

	Unexpected Inflation	Industrial Production	Housing Starts	Oil Price	Exchange Value of $	Credit Risk Premium	Slope of the Yield Curve
A-B	0.60	0.02	0.82	0.40	0.14	0.25	0.17
A-C	0.16	0.39	0.86	0.28	0.83	0.64	0.98
A-Cminus	0.21	0.22	0.80	0.53	0.66	0.92	0.11
A-D	0.43	0.38	0.32	0.76	0.41	0.34	0.93
A-F	0.98	0.09	0.02	0.33	0.46	0.94	0.02
B-C	0.00	0.28	0.40	0.28	0.87	0.28	0.80
B-Cminus	0.79	0.73	0.49	0.19	0.62	0.88	0.88
B-D	0.14	0.42	0.82	0.46	0.05	0.17	0.10
B-F	0.21	0.54	0.63	0.49	0.66	0.90	0.58
C-Cminus	0.01	0.78	0.69	0.07	0.90	0.56	0.44
C-D	0.51	0.45	0.65	0.28	0.74	0.88	0.04
C-F	0.79	0.61	0.09	0.71	0.02	0.62	0.87
Cminus-D	0.58	0.43	0.55	0.15	0.42	0.58	0.86
Cminus-F	0.60	0.38	0.72	0.70	0.91	0.40	0.42
D-F	0.04	0.81	0.61	0.59	0.60	0.75	0.99

Null Hypothesis (example #2)

	Unexpected Inflation	Industrial Production	Housing Starts	Oil Price	Exchange Value of $	Credit Risk Premium	Slope of the Yield Curve
A-B	0.80	0.47	0.73	0.02	0.57	0.54	0.90
A-C	0.26	0.93	0.89	0.31	0.92	0.55	0.03
A-Cminus	0.58	0.63	0.88	0.15	0.79	0.20	0.14
A-D	0.84	0.12	0.82	0.89	0.15	0.01	0.41
A-F	0.29	0.15	0.53	0.18	0.93	0.74	0.45
B-C	0.79	0.04	0.51	0.89	0.14	0.58	0.06
B-Cminus	0.17	0.63	0.98	0.72	0.15	0.77	0.26
B-D	0.96	0.72	0.57	0.93	0.72	0.93	0.02
B-F	0.91	0.39	0.36	0.83	0.39	0.84	0.50
C-Cminus	0.76	0.77	0.77	0.68	0.42	0.94	0.61
C-D	0.04	0.75	0.98	0.63	0.39	0.84	0.90
C-F	0.39	0.17	0.59	0.19	0.21	0.03	0.50
Cminus-D	0.79	0.22	0.88	0.89	0.79	0.16	0.11
Cminus-F	0.03	0.21	0.26	0.48	0.43	0.26	0.75
D-F	0.91	0.77	0.99	0.46	0.55	0.69	0.72

Results

	Unexpected Inflation	Industrial Production	Housing Starts	Oil Price	Exchange Value of $	Credit Risk Premium	Slope of the Yield Curve
A-B	0.64	1.00	1.00	0.99	0.95	1.00	0.99
A-C	0.69	1.00	1.00	1.00	1.00	1.00	0.90
A-Cminus	0.54	1.00	0.98	1.00	1.00	1.00	0.96
A-D	0.71	1.00	1.00	1.00	1.00	1.00	0.97
A-F	0.65	1.00	1.00	1.00	1.00	1.00	0.64
B-C	0.57	0.63	0.73	0.90	0.96	0.98	1.00
B-Cminus	1.00	0.87	0.98	0.94	1.00	1.00	0.88
B-D	0.94	0.94	0.86	0.92	1.00	1.00	0.68
B-F	0.91	0.72	0.71	1.00	1.00	1.00	0.99
C-Cminus	1.00	0.80	1.00	0.53	0.98	0.99	0.92
C-D	0.81	0.96	0.72	0.63	1.00	0.97	1.00
C-F	0.93	0.66	0.81	1.00	0.95	1.00	0.88
Cminus-D	1.00	0.84	1.00	0.63	1.00	1.00	0.68
Cminus-F	0.99	0.58	0.84	1.00	0.74	0.77	0.98
D-F	0.82	0.79	0.84	1.00	0.67	0.66	0.99

The yellow cells represent cases where the difference in exposure appears statistically significant at the 90% level. While we might expect 10% of the cells to be in light yellow spuriously, substantially more than half the cells appear significant. Many have significance levels approaching 1.

Findings

- Corporate governance practices vary according to the economic context of the firm.

- Simplistic accounts of governance from the perspective of control, management self-interest, or ethical theories are therefore incomplete.

- Assessing the economic context of the firm is critical to accurately assessing the appropriateness of governance practices.

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