

Governance matters

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Conventional wisdom is that investors talk a lot about wanting good governance but rarely act on that basis. The punchy valuations of some stocks in exotic developing economies would appear to support this. Yet a Pace University study suggests emerging market investors should not be too forgiving. It looked at six years of Alliance Bernstein data. Analysts rated companies monthly on issues such as accounting, disclosure quality and management accessibility. Some of the governance tests appear pretty cosmetic: companies get points for an English language website. But other categories, which carry more weight, involve more pertinent factors such as board structure, accounting rigour and whether capital is managed for the benefit of minority shareholders.

After controlling for sector and geography as well as changes in earnings and debt, the study found a clear link between a company's governance changes and its valuation in the following three months. That does not prove causality - indeed, the raters may have been influenced, consciously or not, by valuation changes or by other factors. Still, the study suggests that, all else being equal, good governance can boost shareholder value.

An intriguing question is whether governance is more important when the emerging markets cycle is unfavourable. Research by academic Kee-Hong Bae and colleagues, focused on the 1997 South Korean financial crisis, found that the share prices of companies perceived to have good governance fell less in response to bad economic news than those where governance was thought to be weaker. The message is clear. When markets are shaky, why take on unnecessary risk?

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