

THE GOOD GOVERNANCE CRASH TEST: COVID 19



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Well governed organizations have vastly overperformed poorly governed ones during the Covid-19 pandemic. Despite the vast difference in context, this is an exact repeat of the 2008 crisis. So why has governance become such a key differentiator?

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Defining good governance

Governance is the art of decision making at the very top of an organization. It is a complex matter, involving different parties and organizational structures (the board, executive committee, owners, stakeholders) as well as leveraging many fields (law, economics, behavioral psychology, moral philosophy, control, regulatory policy, leadership, etc.). If this decision-making works well, with a good balance of power among all involved parties, it will result in clear strategy development and execution and good management of both internal human capital and external stakeholder relations. This will benefit the company and, thus, result in overperformance in the long term.

In addition to covering the effective functioning of a company, governance is the keystone of solid and growing company results. When it is inefficient or simply broken, it becomes very evident (think Boeing, Volkswagen or FIFA). Good governance is rarely publicly rewarded as scandals and negative governance get the most visibility. However, governance is increasingly being priced by the markets. Poor governance often triggers a penalty when companies are faced with large issues, such as the 2008 or Covid-19 crises, because it becomes more visible during these times. This penalty is measurable and can last beyond the crisis because governance issues are not usually resolved immediately. As Warren Buffett once said to Berkshire Hathaway investors, "You only find out who is swimming naked when the tide goes out."



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Therefore, a key objective of all stakeholders is to try to detect and identify indicators of good governance. Modern advances have given us new views of what truly creates good governance. One of the authors, who has worked with many different organizations around the world, has developed a practical model of governance based on four pillars:¹

1. *People quality, diversity and dedication*, which translates into board members presenting rich, differentiated perspectives, being strategic, focused on the most important topics, knowledgeable and dedicated.
2. *Information architecture*, which combines internal and external information and formal and informal information coming from a broad range of sources.
3. *Structures and processes*, which ensure the disciplined and effective management of governance (strong processes for audit, risk, strategy, performance review, nominations, culture, etc.).
4. *Culture and values*, which drive group dynamics, allowing members to provide inputs in a collegial manner to ensure a rich and constructive dialogue among all members and parties.

This practical model helps organizations achieve better governance. It requires granular work on several dimensions as well as discipline. Similar to the multiple dimensions for improving one's health, the model for improving governance has many dimensions. Nonetheless, when trying to diagnose or assess governance, there are fundamental tenets. At the very base is character and values. A sense of accountability and responsibility combined with integrity and moral authority are marks of the character required for good governance. This leads to other drivers such as a long-term view balanced with short-term efficiency, an ability to build resilience, a combination of financial conservatism and innovation, stability and agility, passion, purpose and compassion – so essential to true success – and, of course, open mindedness and constructive dissent based on a diversity of views. This forms the basis for handing something off to the next generation that is better than what the previous generation received. Positive environmental and social impacts, in brief, stewardship, are also hallmarks of good governance.

From a shareholder perspective, applying the above to investments, will result in identifying companies that have strategies involving long-term, resilience, conservatism, innovation, stability, agility and other fundamental dimensions of a successful, robust business. In so doing, shareholders will take hold of better-governed companies despite market volatility. In other terms, governance theoretically becomes a key differentiator (in generating returns) for shareholders, and well-governed companies should become a core consideration for investors' portfolio allocations. We demonstrate how this works in practice.

How can one quantify good governance?

Many economic and financial theories find their roots in psychology. This is similar to how the study of the language individuals use gives us an indication of their personality traits. A company can simply be viewed as another individual and studying its communication provides rich information. Recent advances in computer processing and artificial intelligence have made this possible. We used content

analysis to measure the personality of organizations, i.e. how well they are governed. Natural language processing (NLP) uses a word dictionary that reflects the values expressed above to identify companies that are materially different across a number of dimensions. The process itself is a subfield of deep learning or machine learning techniques. We started by identifying forward-looking messages embedded in company reports. We analyzed each report, sentence by sentence, computationally to reveal elements that related to corporate culture, behaviors and actions. We levered our direct experience with boards for the word selections. We used both implied and explicit lists and adapted to changes in business language by regularly updating the word lists.

In this framework, the key is how to cluster the words and combination of words to extract the fundamental elements of good governance. This language analysis leads to identifying the personality of an organization in the same way psychologists can map individual personalities. We looked at numerous components such as time orientation, people and stakeholder management (see **Figure 1**) as part of a broader review involving numerous clusters. This broad analysis is composed of a dictionary of more than 7,000 distinct words, which constitutes the body of our governance scores from reading companies' annual reports. This review allows us to diagnose the governance quality of every company, which allows us to rank and compare them.

Figure 1: Language code to diagnose a company's corporate governance

This table highlights some words used by well-governed vs. poorly governed companies. The appearance and associated frequency of these words is obtained statistically from two groups of companies and is a good indicator of governance quality.

	Typical language of well-governed companies	Typical language of poorly governed companies
Timeframe language as an indication of long-term strategy	century coming constant continually continue continuous decade decades era future long-term moment old ongoing onward perpetual tomorrow year	contemporaneous currently daily dates immediate month monthly months overnight promptly quarterly quarters recently
Human-capital language as an indication of collegiality and corporate culture	career colleagues commitment compensation diversity employee empower engaged expertise grooming individual people performance promote recognize recruitment reward safety spirit staff talent team	appraisal assigned compensatory dismiss evaluated hire job nonqualified payroll postretirement qualifying replaced replacement retention uncommitted unemployment wage
Language to stakeholders as an indication of the corporation's commitment to its environment	carbon child children climate collaboration communities cooperation CSR culture dialogue ecological economical environment families science stakeholder transparency wellbeing	appeal arbitration attorney claims court defendant delinquencies discharged enforceability jurisdiction lawsuits legislative litigation petition petitions plaintiff punitive rulings settlement suit theft

Source: Cossin, Didier, and Boon Hwee Ong. Inspiring Stewardship. Hoboken: Wiley, 2016. Please note that the methodology used in the model comprises more than 6,000 words and combination of words.

Are well governed companies materially different?

Our methodology uncovers important differences between well-governed companies and their peers. Based on the words they use, we find that well-governed companies are financially more conservative (controlling for size and industry), have less debt and higher liquidity, invest more in innovation and are less prone to mass layoffs (see **Figure 2**).

Figure 2: Well-governed companies are led by vision, run conservatively and focus on investment and innovation

This table provides an analysis of 236 companies of the S&P 500 (April 2009 – March 2014, sales over \$10B) divided into four quartiles (1st quartile being the 84 best-governed companies of the sample).

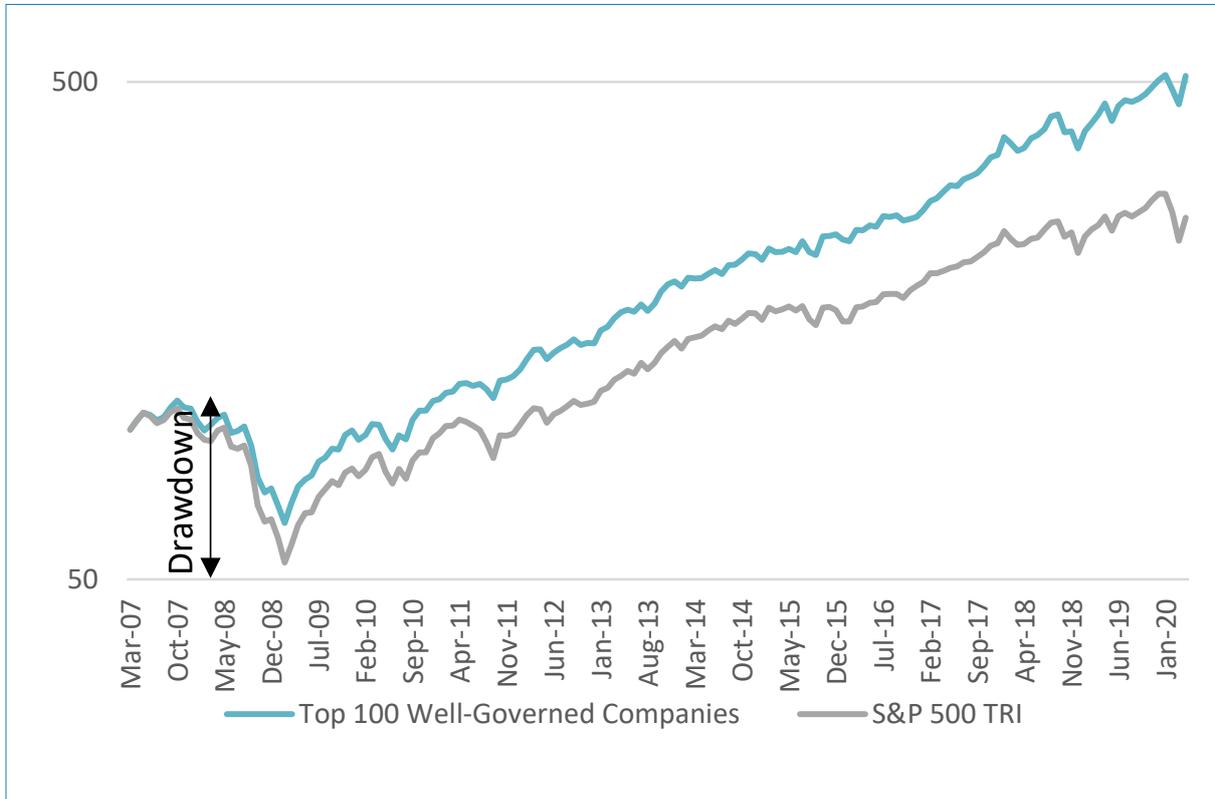
	1st Quartile	2nd Quartile	3rd Quartile	4th Quartile
Employee firing	-4.00%	-5.50%	-5.80%	-9.10%
Total Debt / Assets	20.50%	23.20%	28.90%	29.80%
Liquidity (5-year average Quick ratio)	1.14	1.04	0.92	0.87
R&D as % of sales	4.80%	4.10%	3.50%	1.00%
5-year average return on equity	24.90%	15.80%	10.80%	10.10%

Source : Inspiring Stewardship, Didier Cossin and Ong Boon Hwee (2016)

A crisis like 2008 demonstrated that well-governed companies are rewarded by the market. We observed that the share price of well-governed companies dropped less during the correction and then, thanks to their agility and better positioning, rebounded better and for the long term (see **Figures 3 and 4**). It seems that the performance premium accumulated during the crisis expanded in the rebound.

Figure 3: Performance (logarithmic scale) of the 100 best-governed companies of the S&P 500 (April 2007 – April 2020)

This chart highlights the lower drawdown of well-governed companies in the 2008 crisis followed by a higher performance of these well-governed companies the following years. It suggests a permanent penalty to the shareholder value of the companies that are less well-governed.



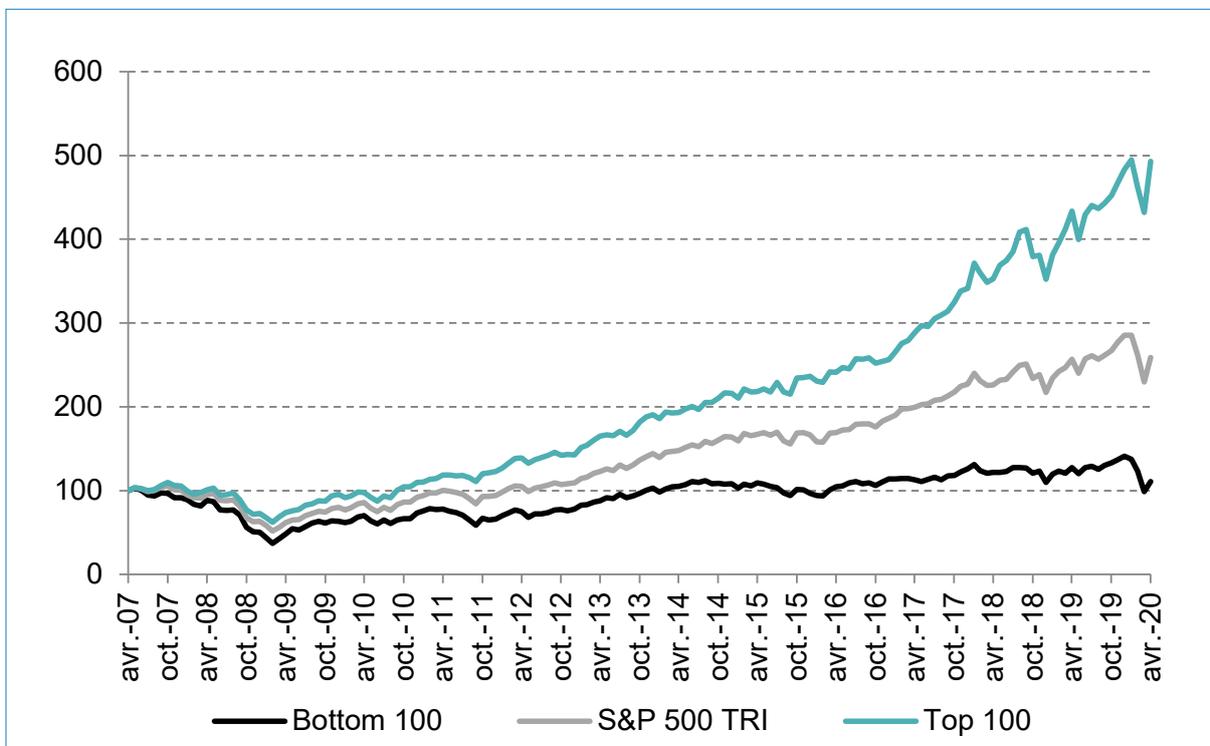
Legend: Analysis of S&P 500 companies selected on an annual basis based on their 10-k reports language review. The portfolio of the 100 better-governed companies is invested on May 1st each year. The weightings of the 100 companies in the portfolios are based on their market capitalization following the same construction methodology of the S&P 500 TRI. The portfolio allocation bears concentration limits that are readjusted every three month. Years 2007 to 2015 have been backtested on the basis of the dictionary established in 2015. The following years follow the same dictionary that is completed with additional words that appeared in the 10-k reports every year.

So what about governance during the pandemic?

In well-governed organizations, the board will be better prepared for crises, adopt long-term strategies and incorporate risk management. Good governance drives agility with the view that the organization will adapt to both growth, recession and unexpected shocks. Also, the stability of board members and employees ensures a transmission of knowledge to the human capital, which prepares the company for non-predictable future shocks. And indeed, as illustrated below, during 2020, well-governed companies, according to our methodology, decreased 10% less than the market.

Figure 4: Analysis of the 100 better-governed companies of the S&P 500 and the 100 less-well-governed companies for the period April 2007 – April 2020.

This chart highlights the continuing challenge of poorly-governed companies to recover. It suggests the 2008 penalty to shareholder value of the companies that were not well-governed is still present after 12 years.



	July 31, 2007- February 28, 2009	Dec 31, 2019 - March 31, 2020
Top 100	-37.78%	-10.52%
S&P 500 TRI	-47.53%	-19.60%
Bottom 100	-60.91%	-30.04%

Legend: Analysis of S&P 500 companies selected on an annual basis based on a language review of their 10-k reports. The portfolio of the 100 better-governed companies is invested on May 1 each year. The weightings of the 100 companies in the portfolios are based on their market capitalization following the same construction methodology of the S&P 500 TRI. The portfolio allocation bears concentration limits that are readjusted every three months. Years 2007 to 2015 have been back tested on the basis of the dictionary established in 2015. The following years use the same dictionary with additional words that appeared in the 10-k reports every year.

Interestingly, it is similar to what happened in 2008 as seen below. The companies with lower governance scores suffered the most. The companies with better governance seemed to have:

1. Better shock absorption in down markets as these companies were more agile and better prepared for crises.
2. Faster recovery in terms of rebuilding the business thanks to better processes and policies, stronger balance sheets and ultimately stronger acquisition and sales power.
3. Higher long-term performance potential concentrated on growth, while less-well-governed companies tended to be more short-term oriented.

Figure 5: Recovery performance numbers for the 100 better-governed companies of S&P 500 and the 100 less-well-governed

This chart highlights the governance premia evolution during and after the 2008 crisis

	July 31, 2007 – February 28, 2009	Return to July 31, 2007 mark	Total performance March 31, 2009 – March 31, 2013
Top 100	-37.78%	38 months	134.74%
S&P 500 TRI	-47.53%	45 months	114.17%
Bottom 100	-60.91%	60 months	101.71%

Legend: Analysis of S&P 500 companies selected on an annual basis based on a language review of their 10-k reports. The portfolio of the 100 better-governed companies is invested on May 1 each year. The weightings of the 100 companies in the portfolios are based on their market capitalization following the same construction methodology of the S&P 500 TRI. The portfolio allocation bears concentration limits that are readjusted every three months. Years 2007 to 2015 have been back tested on the basis of the dictionary established in 2015. The following years use the same dictionary with additional words that appeared in the 10-k reports every year.

Remaining two questions: How come and what next?

How come? It is quite clear that good governance creates the type of agility and sense of responsibility that help an organization efficiently handle whatever disturbance or chaos happens. It also drives grounded decisions when difficult choices need to be made. And well-governed companies have more engaged employees protected by a more caring perspective from the hierarchy.

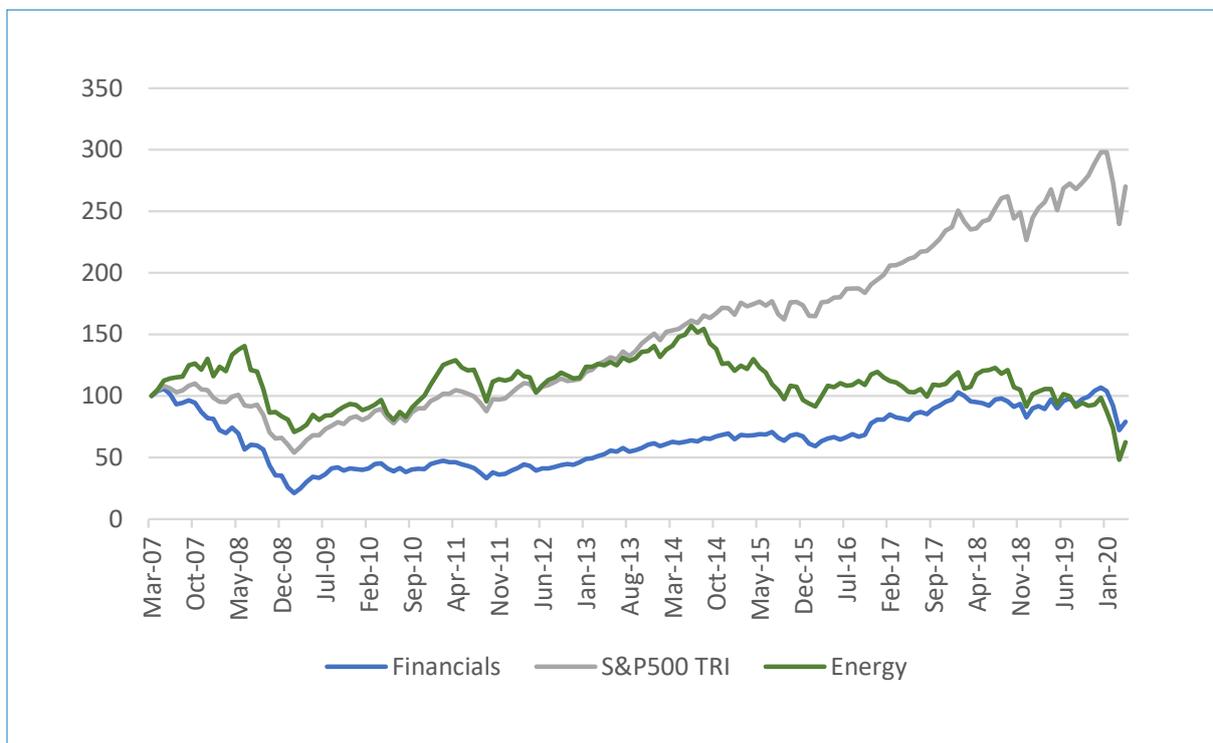
What next? Won't these overperformers in the downturn suffer in the upturn? It looks to be quite the contrary. Better governance positions the company for a faster rebound. It will result in:

- Faster recovery of its sales process
- Faster decision-making overall
- Ability to gain market share vs. weakened competition
- Faster strategic hiring from weakened competitors
- Potential for cheap strategic acquisitions.

The case was proven in 2008. Therefore, those that are not considering governance quality when investing during the pandemic are taking an unnecessary risk. Of course, short term, governments will be able to distort the picture by intervening against the natural selection process of the markets. They are already doing this with specific companies that are showing poor governance (Boeing) and with industries (oil and gas). Nonetheless, the markets will overcome governments in the long term.

Figure 6: Comparison of the financial and oil & gas sectors vs. the S&P 500 TR for the period April 2007 – April 2020.

This chart highlights the evolution of weaker sectors in terms of overall governance quality in the sector during and after the 2008 crisis



Source : S&P Dow Jones Indices.

Short-term investors beware: Governance goes long term. Most of the better governed companies in 2008 are still in the sample in 2020, and they weathered the storm better! This analysis expands not only at the company level but also at the sector level. Not surprisingly, our model shows that the sectors with relatively poor governance (e.g. banks – see *Figure 6*). In addition, it is interesting to see that these industries are among the most regulated ones, which confirms the need for better governance in these industries.

And what about environmental, social and governmental (ESG) factors at large?

Climate and environmental issues are looming large in the current crisis. Both on the positive (improvements in environmental conditions due to lesser pollution) and the negative sides (what will happen with a drop in oil prices?). So do social sustainability issues as the crisis has affected social classes differently, and inequality has proven to be a health driver, with all the associated moral consequences. The key principle, however, is this: Governance drives environmental and social choices. Good governance will drive the long-term orientation, values and quality of an organization’s resilience and agility in environmental matters as well as in social matters. In ESG, G drives E and S.

Indeed, our analysis shows that well-governed companies are better at environmental and social issues as well (see *Figure 7*). The catalyst for a good ESG policy starts with the G which, in addition to triggering stock outperformance, enhances impactful E and S policies at the corporate level.

Figure 7: Average E and S ratings for the 100 better-governed companies of S&P 500 and the 100 less well-governed of the 2019 sample

This table shows that well-governed companies have superior environmental and social ratings according to Sustainalytics and RobecoSAM

	Sustainalytics		RobecoSAM	
	Social percentile	Environmental percentile	Environmental dimension rank	Social dimension rank
Top 100	57.38	57.72	49.36	44.95
S&P 500 TRI	50.92	50.80	45.62	40.96
Bottom 100	48.16	50.26	43.97	34.15

Source: Bloomberg

Conclusions

In times of regime shifts, governance is central to success. Thanks to governance, corporations are both more resilient and more agile and adapt faster and better to exogenous shocks. This has a positive impact on their results, their employees, their stakeholders and, thus, their shareholder value.

At the corporate level, while a certain level of conservatism generates resilience, legacy structures and processes are challenged and more agile companies rebound better; hence, they make healthier investments both for the short and long term. This is materialized in a long-term overperformance of the stock price that comes in three steps: first, outperformance during a market shock corresponds to the fact that well-governed companies live through crises better; second, a faster recovery corresponds to the fact that capital markets differentiate companies that will have a long-term gain vs. the weaker ones that will have to cope with a longer reconstruction due to failing governance; and third, faster expansion corresponds to stronger growth capacity coming from the relatively quicker reconstruction of the sales process or cheap acquisition opportunities.

In this context, governance is becoming even more central to the world of ESG. A company with good G will also approach S and E better, which we can verify statistically. This combination not only adds ethics but also contributes to superior performance for its shareholders in both positive and negative markets.

The current Covid-19 crisis is rich in lessons for both companies and their shareholders, just as the 2008 crisis was in the past. It is promising to see the acceleration of ESG criteria adoption at board levels, where we see the growing involvement of their members, with some of them even now paying attention to their individual carbon footprints for example.

The results observed will not leave investors and shareholders indifferent both in terms of their investment decisions or their involvement and commitment. We expect higher allocations to well-governed companies giving rise to a good-governance premium. This premium has become both an indicator of higher responsibility and of outperformance.

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