TOUGH CLIMATE MARKS VALUE IN GOVERNANCE

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Investors are scouring the world searching for ways to eke out a few more basis points in returns in an environment characterised by low prospective performance. Generally, they are having to push out along the risk spectrum to do this, so success is far from guaranteed.

For many investors, a more promising path to improving returns lies right at their doorstep. It's not an easy route to travel but it is one they have a high degree of control over. This journey involves strengthening the governance arrangements they employ.

Let's start with a definition. The Chartered Institute of Public Finance and Accountancy states that governance comprises the arrangements put in place to ensure that the investor's mission is both defined and achieved.

There is now general acknowledgement that effective governance plays an important role in the success of organisations. But does improving the quality of an organisation's governance improve the chances of it meeting its mission? In a recent paper, *The Investment Case for Better Asset Owner Governance*, Willis Towers Watson set out to determine how much better governance is worth to institutional funds.

The short answer is that it's hard to be definitive about the answer. Measurement is difficult. If we had an objective score for governance recorded over many years, then we might, in conjunction with empirical data, be able to answer the question definitively. But we don't.

Building on studies first initiated in 1994, Canadian pension governance expert Keith Ambachtsheer has argued that an improvement from poor to good governance is worth 100-200 basis points a year. Moving from good to great may be worth another 100 basis points or more.

CEM Benchmarking has developed a database of net value add (a like for like measure) of contributing pension funds with more than 20 years of continuous history. Over the last decade, the difference between a first decile and 10th decile fund is about 140 basis points a year.

None of this work is conclusive about the value of better governance but it gives a broad estimate to which an investor might apply both their belief in the strength of the evidence and arguments supporting such value and the gap between their current and target governance state.

Because the link between governance and performance is not conclusive, the degree to which better governance leads to better performance is best expressed as a matter of belief. Many leading funds have an explicit belief about the importance of good governance. For example:

CalPERS	*CalPERS will be best positioned for success if it has strong governance*
NZ Super Fund	*Clear governance and decision-making structures that promote decisiveness, efficiency and accountability are effective and add value to the fund*
Railpen	*We value effective governance, leadership and strong culture as essential for a world-class investor*

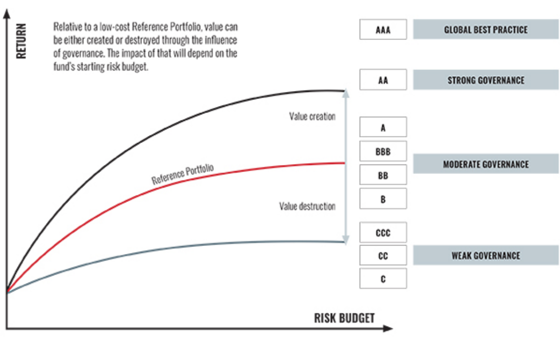
How strongly an organisation holds a belief about the value of governance will be a matter of some introspection. In addition, organisations will have their own inherent view of the quality of their governance. The danger with self-assessment in this area is the human tendency to be over-confident in one's own abilities. Few funds will be willing to admit they have below-average governance, even though half must, by definition.

A common feature of better-governed funds is that they have organised themselves to counter inherent human tendencies that can contribute to value destruction through behavioural biases affecting how they invest, such as over-confidence and representativeness. Various studies looking at average investor performance in share-markets point to a drag of 100 basis points or more from behavioural biases.

Successful investors start by being clear about their mission, their organisational strengths and their beliefs about what drives investment markets and returns. They have a highly competent board and executive; the latter builds clear frameworks to guide their investment decision-making and applies them under clearly delegated authorities. They make decisions in real time, able to respond to opportunities as they arise. Finally, they never assume they have investing fully worked out; they are always learning. In short, they tend to score well across 12 factors highlighted in the landmark work on best-practice governance undertaken by Oxford University's Gordon Clark and Willis Towers Watson's Roger Urwin. These 12 factors can be attributed to the four broad areas where we believe asset owners can either create or destroy value.

A governance rating framework, developed at Willis Towers Watson, allows us to rank organisations' governance from C (very weak) to AAA (global best practice) across these factors. Using this framework, we can help funds make a realistic assessment of how much governance improvement is within their grasp.

FIGURE 1 Willis Towers Watson's governance rating framework



The attractive aspect of focusing on better governance is that it is a relatively inexpensive exercise – at least in dollar terms. An assumed $25 billion fund aiming for a lift from moderate to strong governance might expect to spend no more than 1-2 basis points up front to re-engineer itself to a stronger governance platform. This initial investment triggers the potential for a multi-year delivery of superior returns. Discounting reasonable expectations about what the future payoff might be demonstrates attractive returns on the initial investment.

If the investment case for better governance is so strong, why doesn't everyone do it? It's surely not a cost issue. As we have seen, financial costs to transform governance are relatively small in the context of other decisions funds routinely make.

The reasons are diverse. Some funds are constrained by legislatively enshrined poor institutional structures or are burdened by competing multiple objectives. Some lack the awareness to recognise that there are better governance models available and some that are aware simply might not know where to start. While the financial cost is relatively low (especially when viewed against other investing costs), the psychic costs of change can be high. Boards and their staff have to commit to a transformation program that will shake up the ways things have been done.

In our view, the case for continually improving how funds are managed holds through any environment. However, at a time when investors are faced with historically low expected returns, the case seems overwhelming. By combining how strongly they believe in the proposition that improved governance adds value with an objective assessment of where they currently sit in terms of best practice, funds can develop a strong business case to strengthen their governance.

Tags: Future Fund, governance, Railpen, Tim Mitchell, Willis Towers Watson