with Anthony Hilton

Invest in the best

Governance alone is not a sufficient guide to share price performance

In recent years it has become commonplace to describe the reputation of a business as one of its most valuable assets – even if this insight does not always appear to guide the behaviour of some senior executives. It is only relatively recently that people have sought to put an actual value on reputation and to describe, in money terms, just how much of a company's market capitalisation can be attributed to it.

The way these numbers are calculated is open to challenge because it is necessarily subjective – in the same way that calculating the value of a consumer brand like KitKat can never be an absolute science. It is also the case that if the profits in a business stay the same but the price of the shares goes up, then at least part of that change is because investors think more favourably about the business. The Reputation Dividend study is now in its seventh year and gives a strong indication of trends and direction of travel, even when the absolute numbers might still be argued over.

Helpfully, the study lists what the compilers consider to be some of the key reputation drivers – though not the weightings attributed to these. These include the ability to attract talent; the way the company uses its assets; whether it invests for the long term; its record of innovation; the quality of its marketing; the quality of its goods and services; its overall financial soundness; and of course its community and environmental responsibility. Thus the reputation of Astra Zeneca suffered not just because of the allegations of bribery in China, but also because its new product pipeline is unimpressive, which in turn will make it harder for the business to attract the best of the current crop of graduates. Other companies have taken a hit over their 'exotic' tax planning because of the risk that the public's negative perception of this kind of behaviour can lead to a customer backlash.

These results contrast, although are not at odds with, a study on the effects of corporate governance on share prices, conducted by Hermes, the fund management group. The report, provocatively titled: 'ESG investing – does it make you feel good, or is it actually good for your portfolio?' found that it was rather the case that bad governance caused damage to share prices rather than that good governance delivered measurable gains. 'Overall we found a strong link between underperforming companies and poor corporate governance. Yet we did not see a statistically significant relationship between shareholder return and environmental or social metrics', said Geir Hode, Head of Hermes Quantitative Equities.

The study raised two further issues of complexity; first that the effects of good or bad governance were more marked in Asian and less developed European markets, than they were in the UK or the US; and second that there were some sectors which appeared to ignore the rules. In particular, in the technology sector, companies like Facebook and Apple have enjoyed stellar returns but have flouted convention in terms of boardroom structures and the voting rights attached to shares – so much so that the correlation between governance and returns is negative.

Therefore the message is that governance alone is not a sufficient guide to share price performance but it does matter as a part of a wider group of metrics, all of which contribute to reputation. Apple may score badly on governance but its reputation for innovation attracting talent and product quality make up for it. Meanwhile, the Hermes study, which covered the five years 2009-2013, did find that on average, companies in the top decile of governance outperformed those rated in the bottom decile, by over 30 basis points a month.

This leaves us with the encouraging message that it does make sense to invest in well-governed companies.

» About the author

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