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Learning and the disappearing association between governance and returns ☆

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ABSTRACT

The correlation between governance indices and abnormal returns documented for 1990–1999 subsequently disappeared. The correlation and its disappearance are both due to market participants' gradually learning to appreciate the difference between good-governance and poor-governance firms. Consistent with learning, the correlation's disappearance was associated with increases in market participants' attention to governance; market participants and security analysts were, until the beginning of the 2000s but not subsequently, more positively surprised by the earning announcements of good-governance firms; and, although governance indices no longer generated abnormal returns during the 2000s, their negative association with firm value and operating performance persisted.

1. Introduction

In an influential paper, Gompers, Ishii, and Metrick (2003) (hereinafter GIM) identified a governance-based trading strategy that would have produced abnormal profits during the period 1990–1999. This strategy was based on a G-Index that GIM constructed on the basis of 24 governance provisions that weaken shareholder rights.

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Bebchuk, Cohen, and Ferrell (2009) (hereinafter BCF) subsequently showed that these results were driven by 6 out of the 24 provisions and constructed an E-Index based on these 6 provisions. The intriguing correlation between governance and returns has attracted a great deal of attention ever since it was first reported, and the G-Index and E-Index have been extensively used.

In this paper, we contribute to understanding GIM's and BCF's results concerning the association between governance and abnormal returns. We show that the G-Index and E-Index were no longer associated with abnormal returns during the period of 2000–2008 (or any subperiods within it), and we then investigate what explains both the existence of the governance–returns correlation during the 1990s and its subsequent disappearance. We identify several systematic differences between the 1990s and subsequent years and relate them to the disappearance of the governance–returns correlation. We provide evidence that is consistent with the hypothesis that both the existence and disappearance of the correlation were due to market participants' learning to appreciate the difference between well-governed and poorly governed firms.

GIM and BCF found that governance provisions—or the characteristics of firms' governance and culture that they reflect—are associated with lower industry-adjusted *Q*. Subsequent work found additional links between the G and E indices and firm performance. For example, Masulis, Wang, and Xie (2007) find that worse G-Index and E-Index scores are correlated with worse acquisition decisions (as measured by the stock market returns accompanying acquisition announcements), and Dittmar and Mahrt-Smith (2007) find that worse scores are correlated with a less valuable use of cash holdings.

That the G-Index and E-Index are associated with lower firm value and worse firm performance, however, does not imply that these indices should be associated with abnormal stock returns, as GIM and BCF found for the period 1990–1999. To the extent that market prices already reflect fully the differences between well-governed and poorly governed firms, trading on the basis of the governance indices should not be expected to yield abnormal profits.

We conduct in this paper a series of tests for one possible explanation of the abnormal returns during the 1990s. According to this "learning" explanation, which was noted by GIM, investors in 1990 did not fully appreciate the differences between firms with good and poor governance scores. The legal developments that shaped the significance of the G-Index and E-Index provisions took place largely during the 1980s, which was also when many of these provisions were adopted. In 1990, investors might not yet have had sufficient experience to be able to forecast the expected difference in performance between well-governed and poorly governed firms. Under the "learning" hypothesis, the association between governance indices and returns during the 1990s was expected to continue only up to the point at which a sufficient number of market participants would learn to fully appreciate the differences between well-governed and poorly governed firms. Noting the empirical evidence that lengthy intervals are sometimes necessary even for information that is relatively tangible to be incorporated in prices,[1] GIM suggested that it was not possible at the time of their article to forecast when such a process of price adjustment would be completed.

We begin by showing that, consistent with the learning hypothesis, the association between the governance indices did not persist. Using the exact methods employed by GIM (and subsequently BCF) for 1990–1999, we find that this association did not exist during the subsequent period of 2000–2008. Core, Guay, and Rusticus (2006) note that the GIM strategy did not produce abnormal returns during the four-year period 2000–2003, but were naturally cautious about drawing inferences from the relatively short period they examined, and did not focus on the change or seek to explain it. Our robust findings for a period of similar length to the one studied by GIM enable concluding that the documented governance–returns association did not persist after the 1990s.

Note that, to the extent that the disappearance of abnormal returns was due to learning, such learning did not necessarily have to involve learning about the significance of the provisions in the governance indices. While some market participants might have learned to appreciate that certain governance provisions are associated with worse expected performance, other market participants might have directly identified the differences in future performance between the firms that score well and poorly on the governance indices. For our purposes, the learning hypothesis involves market participants, in the aggregate, coming to appreciate the difference between firms that score well and poorly on the governance indices regardless of whether all or some of these participants made use of all the components of the indices themselves.

To investigate further the learning hypothesis, we study how the existence of abnormal returns to governance strategies was associated with changes in the attention paid to governance by market participants. We identify proxies for the attention to governance by the media, institutional investors, and academic researchers, as well as construct an aggregate attention index. We find that the decrease in the returns to the governance strategies was associated with an increase in levels of attention to governance. Furthermore, analyzing potential structural breaking points in the pattern of returns, we find that their location corresponds to the period in which attention to governance rose sharply.

The number of media articles about governance, and the number of resolutions about corporate governance submitted by institutional investors (many of which focused on key provisions of the governance indices), jumped sharply in the beginning of the 2000s to historically high levels and remained there. Academic research,

[1] GIM cited in this connection the evidence that earnings surprises (Bernard and Thomas, 1989), dividend omissions (Michaely, Thaler, and Womack, 1995), and stock repurchases (Ikenberry, Lakonishok, and Vermaelen, 1995) have long-term drift following the event, and noted that all seem to be relatively simple pieces of information compared with governance structures.