Morgan Stanley

INVESTMENT MANAGEMENT

November 2017 Outlook

The Third Arrow: Governance

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Investors have always prized companies with good governance: It is generally understood that well-managed companies tend to grow faster and survive longer than poorly managed ones. What has changed is that, due to increasing attention being given to ESG factors, governance (the "G" factor) is coming into sharper focus. With better ESG reporting, we are now able to put quantifiable metrics around governance.

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At an aggregate level, we are seeing that companies with better corporate governance have higher return on equity (RoE) and better share price performance.[1] To better understand this trend, we studied corporate governance across developed markets over time. Analysing the components of the S&P 500, MSCI Europe and MSCI Japan indices, we observed an improvement in governance scores in recent years. Interestingly, we found that in Japan—where governance scores have risen the most—RoE has also risen sharply *(Display 1)*.

Japan: Most improved player

Prime Minister Shinzo Abe was originally elected in 2011 with a promise of "three arrows": loose monetary policy, stimulative fiscal policy and regulatory reform. Monetary policy has been widely considered successful, while fiscal policy has received mixed reviews—mainly due to stimulating the economy yet offsetting it somewhat with a sales tax hike. Many observers say the third arrow, structural

[1] ESG is an acronym covering three pillars of sustainability: environmental, social and governance factors.

reform—which has a close relationship with governance—has been slow in coming.

In our study, the governance scores reveal there has been more going on behind the scenes than most realise. Japan seems to have made concerted policy efforts to improve governance and return on equity. Abe has reformed agricultural cooperatives, which previously had tremendous political power in Japan. He has liberalised Japan's electricity market, cut corporate taxes and strongly supported female employment with a new gender equality law.

Most notably, he has pushed through corporate governance and stewardship codes that have started to change Japanese corporate culture. Progress is strikingly evident across a number of corporate governance metrics *(Display 2)*.

Companies now have more independent directors on their boards, more performance-based compensation packages, fewer takeover defence measures and easier online proxy voting. The number of companies in the TOPIX with women on boards has increased from 52 in 2011, to 206 in 2016,[2] and general female labour participation in the 15-64 age bracket is higher than the U.S. or the OECD average.

There is also a trend toward performance-based pay and transparency. More companies are linking pay to performance, disclosing board members' pay and publishing their policies on governance.

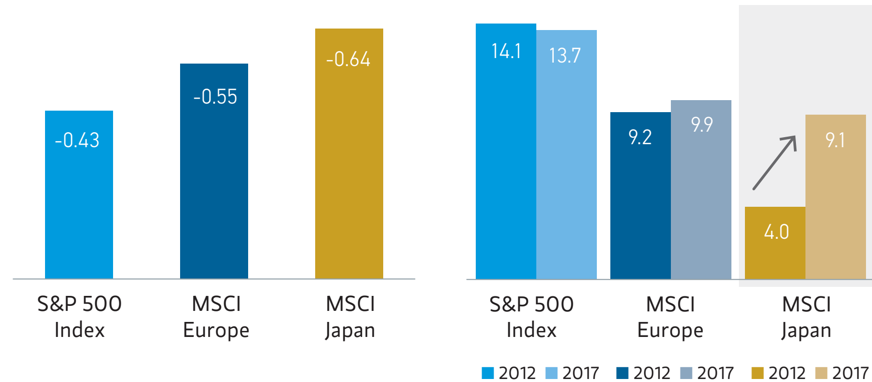
Annual general meeting materials are now often available online, and a simple change in the deadline for filing tax returns now allows the meetings to be more conveniently scheduled. In the past, clustering of meetings at the same time made it difficult for any investor to attend more than one meeting.

DISPLAY 1

Governance scores have improved, especially in Japan . . .

G Score change years, cap-weighted across sectors; 2013-2017 (smaller nos. are better scores)

. . . where rising RoE has coincided with better governance



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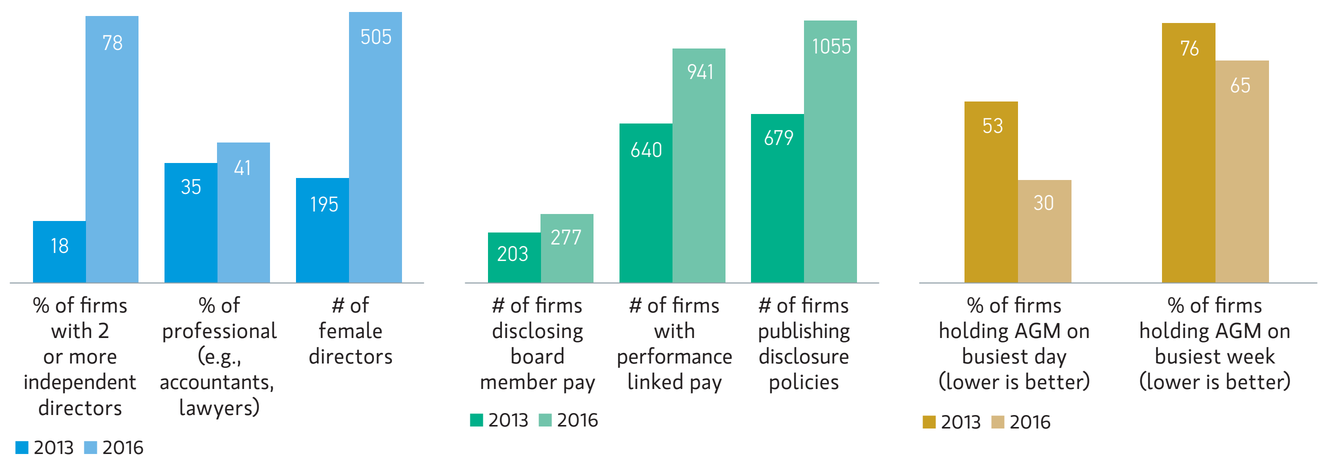
DISPLAY 2

Board composition: More diversity

Compensation: More transparent

Annual meetings: Easier to attend



Source: Japan Exchange Group. Data as of 31 December 2016.

[2] Source: Bloomberg, 31 December 2016.

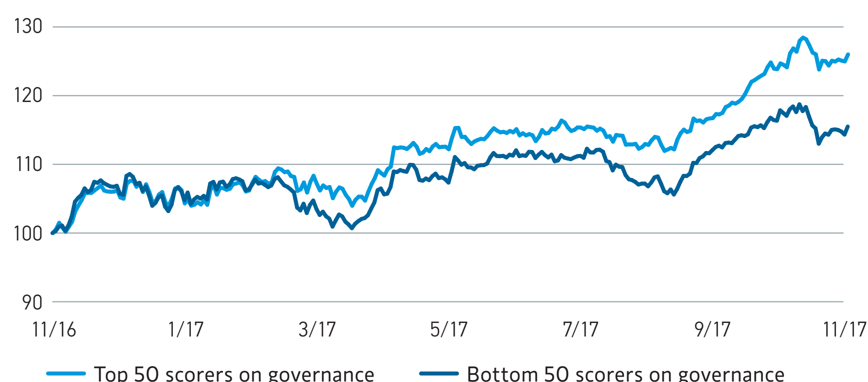
Better governance is a reassuring sign for global investors, who are starting to see that Abe's third arrow of reform is making a difference. As a result, Japan is starting to attract more foreign investors who—after an extended era of disappointing equity returns—now find it easier to justify investing in Japan.

Since mid-2016, stock prices in Japan have risen sharply, recently hitting an all-time peak and surpassing their 1990s high. This improvement in performance is a function of all three of Abe's initiatives, as well as improvement in the global environment. Interestingly, companies with better governance have outpaced those with weak governance, which suggests that could be a link between governance as one of the factors, which has helped performance *(Display 3)*. We believe better corporate governance has played a vital role in attracting investment and driving stock prices higher.

DISPLAY 3

Good governance may be rewarded

Top and bottom scorers of companies in the MSCI Japan Index.



Source: Sustainalytics, Bloomberg, as of 29 November 2017. Sustainalytics is an independent ESG and corporate governance research, ratings and analysis firm supporting investors around the world with the development and implementation of responsible investment strategies. With 13 offices globally, Sustainalytics partners with institutional investors who integrate environmental, social and governance information and assessments into their investment processes. Today, the firm has more than 350 staff members, including 170 analysts with varied multidisciplinary expertise of more than 40 sectors. For more information, visit www.sustainalytics.com. This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

Europe: A concerted effort across sectors

Europe's governance scores have also improved. In fact, excluding the UK would have put Europe's improvement during the 2013-2017 period at 0.76, ahead of Japan's. To be fair, the UK undertook significant governance changes at the beginning of the century; these are not reflected in changes tracked since 2013.

What is remarkable about Europe's path to stronger governance is the consistency of improvement across sectors *(Display 4)*. Comparing Europe with Japan by sector, Europe has had a very even improvement over the past five years, with all sectors except health care improving their governance score (if you exclude the UK, all sectors have improved, including health care). In Japan and the U.S., most sectors improved but several others deteriorated.

And the EU is set to keep improving. The European Commission recently passed a new shareholder rights directive to be implemented by each of the member states over the next two years. The new directive increases transparency requirements, encourages consideration of ESG issues and has a number of provisions related to governance. It requires institutional investors to disclose how they take the long-term interest of their beneficiaries into account and how they incentivise their asset managers to do the same.

"Say on pay" provisions, requiring a shareholder vote on remuneration both ex ante and ex post to ensure companies don't pay CEOs more than shareholders had initially agreed, are also part of the directive. A provision aimed at facilitating voting will give companies the right to identify their shareholders, which facilitates shareholder engagement.

The United States: Driven by technology companies . . .

Whereas Japan and Europe showed generally steady improvement in G-scores during the 2013-2017 period, governance scores in the U.S. bounced around. After deteriorating between 2013 and 2015, they rebounded through 2017. The end result has been an overall improvement, but less than the other two regions *(Display 5)*.

U.S. governance scores also seem to be driven largely by the information technology sector, which accounts for nearly one quarter of the S&P 500's market capitalisation. The sector traced the same pattern of deterioration followed by improvement. This may reflect the fact that many of these technology companies are operating with new business models that are, at least initially, subject to less regulatory scrutiny.

. . . including some with poor governance scores

The steady march of poor corporate governance scores among the four most prominent "online superstar" companies—three of which have the worst score possible on the Institutional Shareholder Services[3] scale—reinforces the notion that these newer business models may be somewhat lax in the

[3] Institutional Investor Services is a proxy advisory firm that advises investment firms as to how to vote their shares.

realm of governance. These companies, which have experienced explosive growth as a result of the boom in internet-based services, are going against the general trend of improving governance.

If the general conclusion that "good governance pays" is valid, these four behemoths have proven themselves exceptions to the rule, which raises a logical question: Could they be potentially vulnerable to a setback? There are far too many considerations that go into any individual company's performance to portend a selloff, but the low G-scores do indicate potential risk factors.

This tension is also playing out in the recent debate over dual-class shares in the technology sector. These structures, criticised for being undemocratic, give company founders a large amount of control over their companies even if their actual holdings amount to only are a tiny sliver of ownership. A recent study[4] found that dual-class companies remain a minority, with just 13 of 128 technology companies examined having dual-class structures. These 13, however, include some of the biggest names.

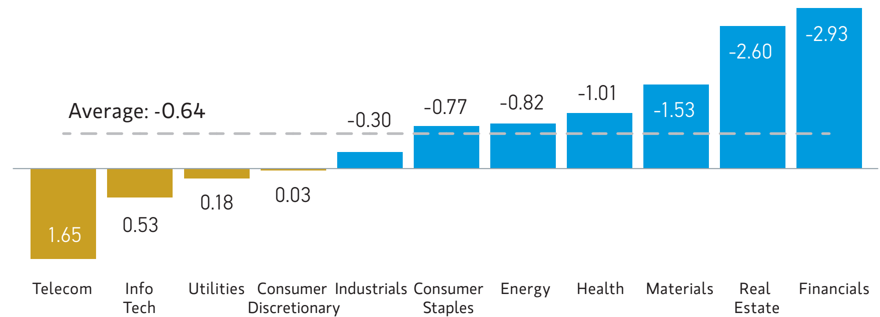
Many institutional investors that own sizeable interests in some of these titans oppose the structures, but nevertheless buy stakes. But the tide may be turning, as notable companies have scrapped plans to create new share classes following legal action by shareholders, and indices including the S&P, Dow Jones and FTSE Russell have decided to exclude some dual-class shares going forward.

This can have a meaningful influence on the demand for a stock. Being ineligible for the S&P 500, for example, means passive funds are not obliged to buy that stock. At the same time, however,

DISPLAY 4

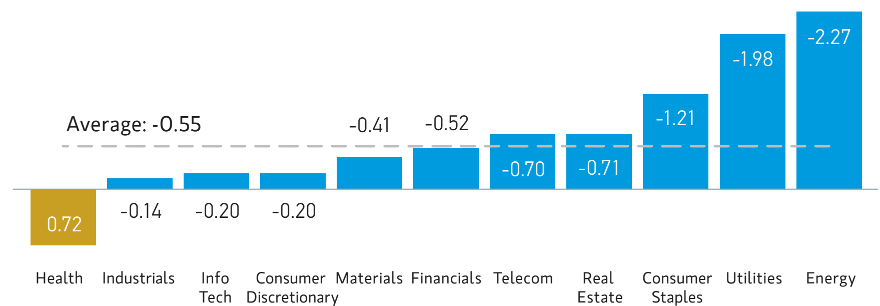
Japan: Most improved overall

G scores



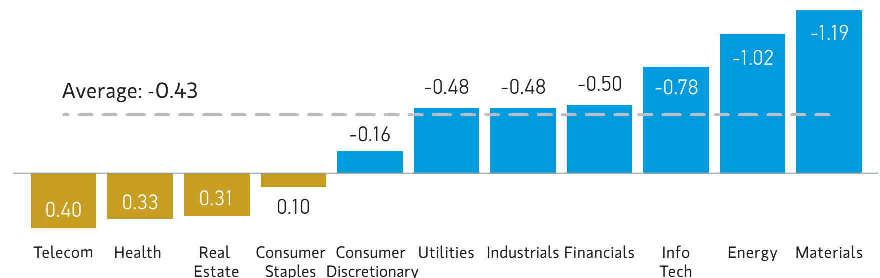
Europe: Consistent progress across sectors

G scores



United States: Less dramatic pickup

G scores



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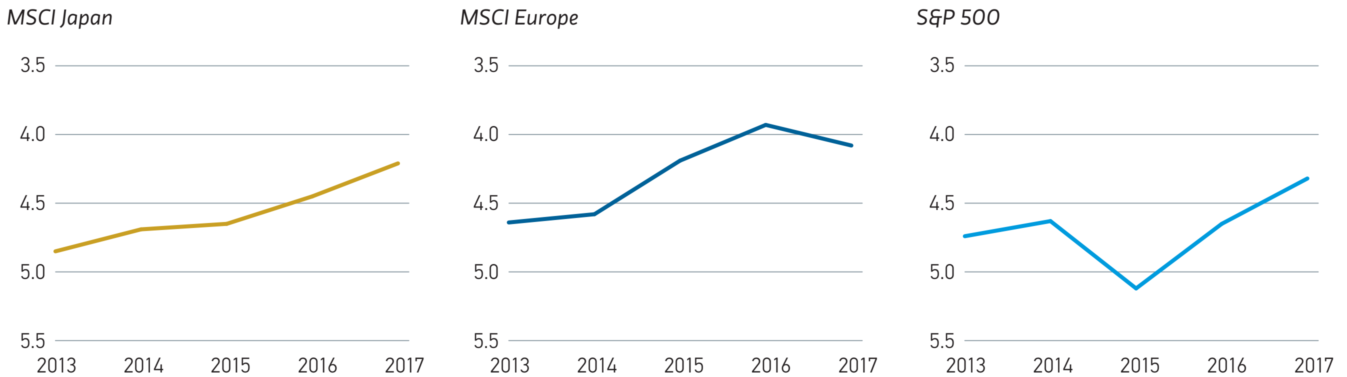
[4] https://www.orrick.com/Insights/2017/06/Orrick-Unveils-Major-Study-on-Corporate-Governance-of-Nations-Tech-Sector

DISPLAY 5

Different paths to good governance



Source: Bloomberg, Institutional Shareholder Services as of 30 September 2017. The above data shows the cap weighted G scores.

some exchanges are going in the other direction, considering loosening restrictions in order to protect their status as financial hubs. These include Hong Kong, Singapore, and the UK.

Conclusion: Hitting the mark—mostly

Corporate governance is improving almost everywhere, and it has generally coincided with strong performance in the Japanese, European and U.S. stock markets. Japan has been the poster country, where improving governance has gone hand in hand with heightened investor interest and growth in assets.

The energy sector in the U.S. and the financial sector in Japan have improved noticeably *(Display 4)*. It appears that the sectors that were formerly underperformers have scrambled the most to strengthen their corporate governance. G-scores have improved as market caps have come down, and our analysis shows that this is not due to survivorship bias but rather a result of active steps being taken.

Governance may be a factor that comes into play, not in periods of exuberance—such as the case of the tech superstars that rate poorly in governance—but more in times of adversity. Japan as a market has gone through a very long period of adversity, and that has been the driver for a lot of this regulatory change. Investors seem to be waking up to the realisation that, at least in the realm of corporate governance, Prime Minister Shinzo Abe's third arrow has been hitting the mark.

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