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# Pricing Corporate Governance

By Lucian Bebchuk

Do markets appreciate and correctly price the corporate-governance provisions of companies? In new empirical research, Alma Cohen, Charles C.Y. Wang, and I show how stock markets have learned to price anti-takeover provisions. This learning by markets has important implications for both managements of publicly traded companies and their investors.

In 2001, three financial economists – Paul Gompers, Joy Ishii, and Andrew Metrick – identified a governance-based investment strategy that would have yielded superior stock-market returns during the 1990's. The strategy was based on the presence of “entrenching” governance provisions, such as a classified board or a poison pill, which insulate managements from the discipline of the market for corporate control.

During the 1990's, holding shares of firms with no or few entrenching provisions, and shorting shares of firms with many such provisions, would have outperformed the market. These findings have intrigued firms, investors, and corporate-governance experts ever since they were made public, and have led shareholder advisers to develop governance-based investment products.

Even if anti-takeover provisions hurt firms' performance, however, investors may be unable to make trading profits if prices come to reflect the effects of these publicly-known provisions. Indeed, in our study, Cohen, Wang, and I show that the association between governance and returns documented for the 1990's subsequently disappeared. No such association existed during the 2000's or any sub-period within this decade. After out-performing the market during the 1990's, the governance-based strategy subsequently performed on par with it.

How can one make sense of the association between governance and returns during the 1990's and its subsequent disappearance? We find that this pattern is due to markets' learning over time to appreciate the difference in expected future profitability between firms that have good and bad governance (in terms of their levels of anti-takeover protection).

Consistent with such learning, the attention to governance by the media, institutional investors, and researchers jumped sharply at the beginning of the 2000's, and has remained at historically high levels. For example, the number of governance-related articles in US newspapers tripled from 2000 to 2002, and the number of governance-related resolutions brought to a vote by institutional investors (many focusing on anti-takeover provisions) more than doubled, with both figures remaining at elevated levels ever since.

Market prices seem to have been affected by the increase in attention to governance. We found evidence that, by 2001, markets learned to appreciate the difference between good-governance and bad-governance firms in terms of their expected future profitability.

We examined the extent to which firms' earning announcements surprised markets (as reflected in stock-price reactions to these announcements) and stock analysts (as measured by the gap between announced and forecast earnings). We found that, during the 1990-2001 period, but not afterwards, the earning announcements of good-governance firms were more likely to surprise both markets and analysts than the earning announcements of bad-governance firms.

It should be emphasized that, while trading on anti-takeover provisions could no longer be used to out-perform the market during the 2000's, such provisions remain quite consequential for firms' valuation. Throughout the 2000's, firms with higher entrenchment levels have had lower market capitalization (relative to their book value). Indeed, the incorporation of entrenchment levels into market prices is what made it impossible to trade profitably using information on such levels.

Overall, our findings support the view that markets might be unable to price new governance provisions and practices accurately right away, but that they can be expected to learn over time to do so. Such learning can take considerable time, but it does happen.

Both managements and investors should take market learning into account, paying close attention to the potential increase in market capitalization that eliminating anti-takeover provisions could produce. Many firms have already eliminated anti-takeover provisions in recent years, removing staggered boards and supermajority requirements for mergers. Lowering entrenchment levels, rather than trading on them, continues to offer opportunities for substantial returns to firms' shareholders.

Furthermore, while markets now price anti-takeover provisions, our findings raise the possibility that markets do not (yet) price other governance features whose emergence is relatively more recent. The introduction of new governance arrangements and their subsequent incorporation into prices is a gradual process, a work constantly in progress.

Thus, while investors can no longer profit by basing their trading decisions on standard anti-takeover provisions, our findings leave open the possibility that an investment strategy based on other features of corporate governance might be worthwhile. Thus, managements should not dismiss governance reforms that are potentially valuable, but that investors are not yet focused on, and that markets do not yet price.

Investors eventually do learn. And, when they do, they appropriately reward or penalize firms for their governance choices.

*Lucian Bebchuk is Professor of Law, Economics, and Finance and Director of the Corporate Governance Program at Harvard Law School. This article draws on his study with Alma Cohen and Charles C.Y. Wang, "Learning and the Disappearing Association between Governance and Returns."*