Corporate governance gets place with indexes

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Institutional Shareholder Services Inc. and Glass, Lewis & Co. LLC plan to launch rival corporate governance indexes, expecting they will outperform conventional equity indexes, or at least dampen the risk.

ISS, Rockville, Md., teamed with FTSE Group, London, to create the FTSE ISS Corporate Governance index series, covering 4,000 stocks from global developed markets. The firms plan to launch their index between late November and year's end.

Glass Lewis, San Francisco, collaborated with a group of Harvard professors to produce the Shareholder Rights index, comprising all the companies in the Standard & Poor's 500 index. Glass Lewis plans to launch the index Dec. 1.

Each firm plans to license its new index for investible index funds and for performance benchmark uses.

Less volatile

Jerry Moskowitz, managing director, FTSE Americas, New York, said there might not be a difference in performance between the FTSE ISS index series and FTSE's conventional indexes, which cover the global developed markets, but the new index is expected to be less volatile.

"We looked at the better companies" in terms of corporate governance, and "they don't outperform," Mr. Moskowitz said. Companies with poorer records in corporate governance don't underperform either, but "they are more volatile."

FTSE is still developing how it will weight the stocks in the index, Mr. Moskowitz said. ISS is providing the corporate governance rating, modifying its Corporate Governance Quotient scale from 1 to 100 to produce a scale from 1 to 5 for the FTSE global index series, he added.

FTSE and ISS would like to license the index for index funds. "It's too early" to market to investment managers," Mr. Moskowitz said. "They want to see what kind of demand there is" for it.

FTSE and ISS formed a 12-member advisory committee for the new index; it will be chaired by William Crist, professor of economics at California State University, Stanislaus, and former chairman of the California Public Employees' Retirement System, Sacramento.

Glass Lewis expects its index to outperform the S&P 500 by 40 to 60 basis points a year, said Gregory P. Taxin, CEO. The firm plans to market the index to plan sponsors and other institutional investors, hoping to build interest for its use before approaching index fund managers, Mr. Taxin said.

The Glass Lewis Shareholder Rights index will consist of all the companies in the S&P 500 index, whose weighting will be adjusted using an algorithm designed by Lucian Bebchuk, professor of law, economics and finance at Harvard Law School. The new index will overweight companies with good governance and underweight companies with poor governance, according to a statement from Glass Lewis. The Shareholder Rights index will be rebalanced whenever the S&P 500 is changed; Glass Lewis contracted with Standard & Poor's to maintain and calculate its new index.

Harvard research

The Glass Lewis index is based on research by Mr. Bebchuk and two Harvard Law School colleagues, Alma Cohen and Allen Ferrell, who analyzed data from 1990-2003 and identified six key governance provisions that were negatively correlated with shareholder value. They regard the six provisions as entrenchment factors, or policies and procedures that make change by shareholders difficult.

Four of the six provisions prevent a majority of shareholders from having their way: staggered boards, limits to shareholder bylaw amendments, supermajority requirements for mergers, and supermajority requirements for charter amendments. Two provisions involve measures that boards put in place to deal with hostile takeovers: poison pills and golden parachutes.

Companies with poor governance produced returns that were "substantially worse, on a risk-adjusted basis and in a statistically significant way, than firms with lower entrenchment scores," according to the company's statement.