



The Impact of Good Governance on International Investing: The 'Home Bias' Effect and Other Issues

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Following accounting and governance scandals at Enron and other U.S. companies, policymakers in the United States and elsewhere responded by establishing new corporate governance rules, including the Sarbanes-Oxley Act. Now, after complaints from the business community that regulations are hurting profits, some countries are taking a second look at post-Enron reforms.

The Securities and Exchange Commission has already made it easier for foreign firms to deregister, reduced audit requirements for smaller firms and is weighing a proposal to accept statements from foreign firms based on international accounting standards rather than U.S. rules known as GAAP (generally accepted accounting principles).

Countries should, however, think carefully about loosening governance regulations, according to research presented during a recent conference on international corporate governance sponsored by the Weiss Center for International Financial Research at Wharton.

Wharton finance professor [Richard Marston](#), who is also director of the Weiss Center, told the conference that listings on foreign exchanges have increased compared to U.S. exchanges, but the evidence is mixed on whether that is because the new rules are a burden, or because of new opportunities to list in other countries.

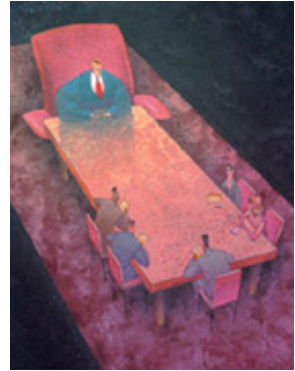
Good governance remains an important national asset, Marston said. "Investors have a variety of national markets to choose from. Good corporate governance can enhance the attractiveness of one country's financial markets relative to another's. It can also enhance the attractiveness of one company's stock relative to another's within the same market."

Research by conference co-host George Andrew Karolyi, a finance professor at Ohio State University, challenges the idea that the latest regulatory hurdles are driving more companies to list in London and elsewhere at the expense of U.S. exchanges. In a paper titled, "Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices," Karolyi and co-authors Craig Doidge, a professor at the University of Toronto's Joseph L. Rotman School of Management, and Rene M. Stulz, a finance professor at Ohio State University, argue that U.S. exchanges are actually holding their own.

The authors examined the decisions of thousands of companies to list -- or not list -- on U.S. and London stock markets from 1990 to 2005, and found that once key characteristics of the companies are factored in, the gap disappears.

According to the paper, the bulk of the difference is due to a rise in foreign firms listing on the London Stock Exchange's Alternative Investment Market (AIM). When AIM launched in 1995, there were two listings; by the end of 2005, there were 220. Karolyi noted that the average AIM firm has only \$11 million in total assets and would be too small to qualify for listing on any of the U.S. exchanges. "Before you jump to the conclusion that this is evidence of New York losing market share, remember most of those firms wouldn't qualify for the listing in New York," said Karolyi. "It's apples and oranges."

Meanwhile, he points out that investors still seem willing to pay a premium for companies that are listed in the United States. The authors built on earlier research showing that from 1990 to 2001, foreign shares that were listed on the NYSE, Nasdaq or the American Stock Exchange traded at a premium of 17.5%



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above companies that were listed on both a U.S. and a foreign exchange, or 15.4% when the unusually high figure for 1999 is excluded. In their paper, the authors state that from 2002 to 2005, the premium was 14.3%, a decline they said is not statistically significant.

Individual Attributes of Governance

At the conference, Stulz, who is also director of the Dice Center for Research in Financial Economics at Ohio State, presented a paper echoing the findings that good governance pays. For example, in a comparison of governance between similar U.S. and foreign firms, only 8% of non-U.S. companies had better governance than their comparable U.S. firms, mostly companies in the United Kingdom and Canada.

The gap between a foreign company's governance and a comparable U.S. firm is rewarded with higher valuations, according to the paper, "Do U.S. Firms Have the Best Corporate Governance? A Cross-Country Examination of the Relations between Corporate Governance and Shareholder Wealth." In addition to Stulz, the paper's authors are Reena Aggarwal and Rohan Williamson, both professors of finance at the McDonough School of Business at Georgetown University, and Isil Erel, professor of finance at Ohio State's Fisher College of Business.

"The difference in governance from the U.S. firm is strongly related to the valuation," said Stulz. "You gain a lot more from being better than you lose from being worse."

To conduct their study, the researchers examined Institutional Shareholder Services (ISS) data, regulatory filings and annual reports from more than 5,296 U.S. companies and 2,234 foreign firms in 22 developed countries since 2005. The authors then constructed a metric for good governance. Overall, U.S. companies scored 61 on the index of good governance attributes while corresponding non-U.S. firms averaged 49.

The authors also examined individual attributes of governance to determine which made more of a difference in valuations. They focused on seven characteristics: board independence, board size, separation between the chairman's position and chief executive officer, board structure, audit committee independence, auditor ratification and classes of stock.

They determined that audit committee independence was highly valued, while other attributes -- including the separation of the chairman of the board and chief executive, stock classes and board size -- had little impact on increasing shareholder value.

In a discussion following the presentation, Wharton accounting professor [Wayne Guay](#) made the point that some countries place more emphasis on creating value for all stakeholders. "The role of governance is to unlock value and get rid of the problems, but that's a different way of thinking than assuring that investors get a fair rate of return." Even if value is diverted to minority shareholders, or insiders, it is still value, he argued. "It might be that the governance gap is the degree to which certain firms do not maximize shareholder value. This is a different view of governance in foreign firms, but it is not necessarily bad governance."

According to Marc Zenner, global head of Citigroup's Financial Strategy Group, the paper's findings reflect what he sees in the private sector. The impression he gets from talking to clients is "that, indeed, the results make sense," he said. "U.S. firms seem to be more concerned about governance than European firms." He also noted that governance may come into play in different ways across long and short time horizons. An intense focus on short-term earnings in the U.S. may be driving some of the research results. Another factor is family ownership, which may depress governance rankings and share price because the family has other goals. "Typically, these are the firms that are violators of good governance because they don't care."

Zenner suggested that tougher laws and regulation may be what's behind better governance scores in the United States. "Firms will do what they have to do and never go beyond. It's not that U.S. firms care more about (governance) per se."

Zenner said he often meets executives who may not be driven to improve governance, but wind up taking steps to do so because they want to do what's right for their shareholders. "We have this approach in

academia that unless there is a mechanism to control [executives, some] will take money away. But a lot of executives are not like that." He also noted that peer pressure, or the fear of being singled out for governance problems on the front page of a newspaper, is another incentive to establish good governance.

In addition, the rise of activist hedge funds is changing the nature of good governance campaigns, he suggested. Unlike pension funds and other activists, hedge funds are less interested in governance issues, such as whether the company has a poison pill, nor are they interested in getting representatives appointed to the board. Hedge funds are looking at the asset mix and capital structure, and the potential break-up value of the firm.

Zenner also said there may be factors beyond the ISS attributes that could be having a more powerful impact on corporations than governance. "In terms of value creation, there are so many other factors that matter beyond good governance. In some situations where you have really good opportunities, it may be that you don't need to focus on governance."

For example, his clients with high growth opportunities don't want to be distracted by worrying about governance, he said. "They want to do all they can to really create value. Once the company is mature, they can focus on other things to create value." Governance received a lot of attention from executives in 2002 and 2003 as post-Enron reforms were taking hold, Zenner added. "Now, the focus is on activist investors."

The "Home Bias" Effect

Another paper presented at the conference examined the role of governance in the so-called "home bias," or the tendency for investors to buy shares in companies based in their own countries despite the globalization of financial markets. "We have had a lot of barriers to international investment come down over a decade ago. It's a good time to take a step back and understand what is driving this evolution," said Frank Warnock, professor of business administration at the University of Virginia's Darden Business School.

Warnock presented a paper titled, "Financial Globalization, Governance, and the Evolution of the Home Bias," co-authored with Stulz and Bong-Chan Kho, a professor in the College of Business Administration at Seoul National University.

In their paper, the authors show that despite the disappearance of many barriers to international investment, the home bias of U.S. investors toward the 46 countries with the largest stock markets did not fall from 1994 to 2004.

According to Warnock, there are a number of reasons for a home bias, including barriers to investment, hedging motives, access to information and behavioral biases. He said lifting the explicit barriers to investment and better access to information alone would suggest a sharp decline in home bias over the past 10 to 15 years. "The traditional reasons are fine and they're helpful, but they will not explain why home bias is so prevalent and why it is being eroded only slowly," Warnock told the conference.

The authors suggest this is due to what they call the "optimal insider ownership" theory of home bias. The theory is that since foreign investors can only own shares not held by insiders, there will be a home bias toward countries in which insiders --including local investors and management -- own a large stake in corporations.

The authors took a closer look at Korea, which experienced the largest reduction in home bias from U.S. investors of any country during the study period. The proportion of the Korean stock market capitalization held by foreign investors tripled from 13.5% in 1996 to 41.3% in 2004. Foreign ownership was concentrated in a few large firms with fairly dispersed ownership, two attributes that other research shows tend to lead to good governance.

Warnock said the paper takes into account foreign direct investment and weighted various firm characteristics, including governance attributes, and found that at the firm level in Korea, foreign investors take more equity in firms with lower insider ownership and better governance.

"Foreign investment in a country depends crucially on the extent to which the institutions of that country

support diffuse ownership of corporations," the paper states. "If the institutions of a country are extremely poor, a country has no public traded equity and there will be no foreign portfolio equity investment."

The University of Toronto's Doidge suggested that the slow rate of change in insider ownership could be due to current insiders' reluctance to give up control. "Even when better governance is the rule, it's going to take time for markets to sufficiently develop to allow insiders to sell stakes." He also pointed out that in some countries, the state still plays an important role, crowding out new investors. "The only way home bias will disappear is if the government decides to privatize a lot of firms."

According to James E. Shapiro, CEO of Galileo Global Securities in New York, it is difficult to disentangle the factors behind home bias. He recalled that in his prior job as an executive in the international division of the New York Stock Exchange, he tried to convince Samsung Electronics to sign on. He said the company's foreign ownership was already growing to the point where Korean investors and management were nervous about losing control and didn't want to list on the exchange or encourage foreign ownership. "They were afraid that [listing] would make them vulnerable to a hostile takeover."

He also said much of the persistence of home bias may be due to foreign direct investment and state participation in corporations, particularly in rapidly growing economies such as China and India. In addition, foreign investors may be participating in global equity markets indirectly. "We know people are getting exposure to countries like China by investing in international firms, such as Wal-Mart or Coke."

Whatever reasons lie behind home bias, Shapiro said it is worth understanding in order to make better investments. "Is there going to be a world with no home bias? Probably not in my lifetime. But if you can understand what affects the trajectory over time and what factors are important, you can anticipate foreign investment -- and probably valuations -- and you can make money."

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