Corporate Governance and Valuable Innovation: Short Summary

This report summarizes the major results, findings, and policy implications for the six sub–projects carried out under the NFR/KUNI project Corporate Governance and Valuable Innovation.

1 The data base

All the other subprojects depended critically on the availability of an extremely detailed database on facts about the Norwegian equity market and corporate governance of Norwegian companies. The database and the software built up for this project is a considerable resource for future research on Norwegian financial markets. It is a goal of the project leader that this resource can be continued into the future and made as widely available as possible. In particular, the resources is hoped to be channeled directly into the proposed Financial Markets Data Center, which is a proposal of a joint center between the Norwegian School of Management (BI) and the Norwegian School of Economics and Business Administration (NHH). The purpose of the center is to collect and organize data from financial markets for use by academic researchers. While the sharing of software is unproblematic from this perspective, and in fact some of the software has already been released under an open licence, the challenge is the data itself. The data has been bought from data providers who have imposed strong restrictions on their use. Currently most of the data cannot be transferred to other researchers. To allow as much as possible of the data to be transferred to a future data center, it will be necessary to negotiate with the different data providers to clarify whether and under what conditions this may be done.

2 Owner patience and value creation

To date little is known about how long equity ownership lasts, what determines its length, and whether ownership duration matters for firm performance. Using a unique time series of equity holdings over eleven years in Norwegian listed firms, we find that the firm's largest owner stays on average less than three years and stays longer than owners with smaller stakes. The holding period of financial institutions and foreigners is shorter than that of individual owners and industrial firms. We also find clear evidence of time dependence: How long you have been an owner so far matters for whether you maintain your stake in the next period. There is a negative relationship between duration and performance in general, but the sign and strength of this relationship differs across owner types. Long duration by financial institutions and industrial corporations is negatively related to performance, whereas the opposite is true for individuals. This suggests that long term ownership may improve firm performance if the monitoring is direct as opposed to delegated. Our findings refute the conventional regulatory assumption and popular opinion that short-term investors are bad owners, that long-term ones are good, and that economic welfare suffers because ownership duration is too short. The unconditional praise of the long-term owner is simply wrong.

3 Board composition and corporate performance

This project explores empirically how board composition influences the conflict of interest between principals and agents, the production of information for monitoring and support, and the board's effectiveness as a decision-maker. We find that the average board of a Norwegian listed firm has only six members, gender diversity is low, roughly half the firms have employee directors, and that most CEOs are neither directors in their firm nor elsewhere. Using a wide set of such board characteristics and new measures of board independence and director networking, we show that value-creating boards are aligned with their shareholders, but dependent on the CEO. Multiple directorships create valuable information networks, whereas increased diversity in terms of better gender mix, larger board size, and more employee directors reduces value.

Some of these conclusions are politically incorrect, run counter to many countries' corporate governance codes, and pull board design into opposite directions than where conventional wisdom currently makes it to move. We believe practical board design has been shaped too long and too strongly by practitioners and regulators based on their limited personal experience, political agendas, and recently by their concern with scandal prevention rather than firm value maximization.

4 Corporate governance, investment and growth

Existing corporate governance research shows that a firm's governance mechanisms are systematically related to the firm's economic performance. However, the channel through which governance affects performance remains underexplored, as the governance literature does not tell clearly why well-governed firms produce superior returns. Within a broad sample of US manufacturing firms, we find that increased governance quality is associated with higher investments, better responsiveness of investments to growth opportunities, and lower sensitivity to financial constraints. Governance quality influences investment quality independently of financial constraints, but does not reduce overinvestment. We find no indication that the firm's governance quality is driven by its growth opportunities. These results suggest good governance improves the firm's economic performance by improving the quality of its real investment decisions, and that lax governance produces underinvestment rather than overinvestment.

Thus, better governance drives the firm's market value by way of better efficiency and not just by increased rent extraction. Policywise, this suggests that regulatory measures encouraging good governance is a socially useful endeavor.

5 Ownership breadth and value creation

This project revisits US results which show that the breadth of ownership, operationalized as the number of mutual fund owners of a firm, is important for the crossection of asset returns. The American results are justified theoretically as implications of short sales constraints. Our Norwegian setting allows us to revisit this result using a better suited data set, since our database on the ownership of Norwegian equities covers monthly observations of the complete ownership structure over the period 1989 to 2003, a period of 14 years. This also allows us to investigate alternative breadth measures, not just the mutual fund holdings used in the US study. Our results show that the American results are really about mutual funds trading. Quarterly mutual funds trades predict next quarter's returns. However, broader breadth measures, such as the change in holdings by individual (private) owners, do not share this property. We show evidence that the channel through which this returns effect happens is by the mutual funds selling to individual investors, and not by an increase in ownership concentration. We find that the quarterly effect is not observed on a monthly horizon. We hypothesize that this may be due to short term effects from the mutual fund's actual trading, since we observe a strong contemporaneous link between asset returns and mutual fund trading.

6 Liquid ownership and the cost of capital

This project studies the relationship between company ownership and market liquidity using a panel regression approach. The sample contains detailed transactions data from a limit order driven stock market, and a full breakdown of company ownership into five distinct owner types as well as outside owner concentration and insider holdings. In line with theoretical predictions, we find ownership concentration to matter for liquidity, both measured by the spread and the adverse selection component of the spread measured by Kyle's lambda. A somewhat weaker relation is found between spreads and insider holdings. No strong relationship can be documented between liquidity and institutional ownership. Ownership variables which affect spreads do not in general jointly affect depth in the predicted way, suggesting that spread and depth measure different dimensions of liquidity. Finally, a one-way Granger causality relation from ownership structure to liquidity is hard to document.