N° 7 | October 2017

Swiss Finance Institute Practitioner Roundups

s:fi
KNOWLEDGE

Prof. Rajna Gibson Brandon
Swiss Finance Institute Full Professor of Finance at the University of Geneva and Deputy Director of the Geneva Finance Research Institute. Her research areas include asset pricing, risk management, experimental finance, and corporate governance.

Prof. Alexander F. Wagner
Swiss Finance Institute Associate Professor of Finance at the University of Zurich, independent counsel for PwC, and Chairman of the board of trustees of SWIPRA. His main research interests are executive compensation, corporate governance, and behavioral economics.

Do Investors Value Managerial Honesty?

From the Enron scandal to the subprime crisis to the Bernie Madoff scam, corporate fraud and managerial misconduct have rattled shareholder value and investors' trust over recent decades. Initiatives to eradicate such behavior have been numerous. They have included changes to the structure of managerial compensation, strengthening board members' skill sets and auditors' independence, and an increase in regulation throughout the corporate world. Yet little is known about whether investors influence managers by making investment decisions based on perceived managerial honesty. So, is further regulation required to improve ethical management and promote honest corporate cultures?

SFI professors Rajna Gibson Brandon of the University of Geneva and Alexander F. Wagner of the University of Zurich, Dr. Matthias Sohn of Zeppelin University, and Prof. Carmen Tanner of the University of Zurich employ experimental research techniques to determine the role of perceived managerial honesty in investment decisions. Their paper *Investing in Managerial Honesty* argues that investors form views about CEOs' honesty based on the CEOs' previous decisions regarding whether to earn a higher bonus by managing upward the firm's earnings. Although only legally acceptable practices of earnings management are considered, results show that investors view a CEO who has resisted the temptation as substantially more honest.

Do investors' perceptions of managerial honesty impact their investment decisions?

In total, 60 percent of the participants in the experiment chose to invest with CEOs who did not engage in upwards earnings management and thus passed on the opportunity to earn a significantly higher bonus. Participants favored CEOs they perceived to be more committed to honesty, even if this implied lower financial returns. Further, the more a CEO is perceived to treat honesty as a protected value, the less investors tend to be sensitive to the relatively higher future returns claimed by CEOs perceived to be less honest.

Does managerial honesty carry the same meaning for all investors equally? And if not, in which sense do they differ?

Investors are classified as «pro-self» or «pro-social». The results show that both types of investors seek the same goal—managerial honesty—but for different motivations. Specifically, the pro-self investors assign greater credibility to future financial returns announcements when such statements are issued by CEOs perceived to be more committed to honesty. The rationale at work here is that such CEOs are expected to announce more reliable information regarding financial returns and thus lower the odds of investors being deceived.

Pro-social investors seem to base their investment decisions directly on moral values and are largely insensitive to financial returns. They appear to favor perceived managerial honesty simply because they themselves value honesty, and are willing to accept lower returns in order to invest with a similarly minded CEO.

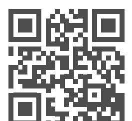
What do the results mean for the financial sector?

The learning points from this research have implications not only for investors, but also for banks, corporations, and regulators. Investors seem willing to avoid firms they perceive as being run by dishonest managers. Instead, they favor investments in firms run by managers seen as being more honest. This is irrespective of any given investor's pro-self or pro-social orientation.

Banks should acknowledge the importance and role of managerial honesty when selecting financial assets and creating suitable portfolios for their clients. They should not focus exclusively on financial expectations. Corporations should recognize that managerial honesty may impact a firm's value. Essentially, the results suggest that firms with CEOs perceived as more honest may enjoy better access to funds and, therefore, a lower cost of capital. The research therefore supports ongoing efforts to make managerial integrity a key consideration when recruiting top management.

Finally, transparent information regarding managerial characteristics is required to enable investors to channel funds to firms they consider more honest. This is where policy makers and regulators have a key role to play in setting the right disclosure requirements.

This insights draw on the academic paper by Prof. Rajna Gibson Brandon, Dr. Matthias Sohn, Prof. Carmen Tanner, and Prof. Alexander F. Wagner. The full academic paper can be accessed at: http://bit.ly/2vwLhUK



N°7 | October 2017

Swiss Finance Institute
Practitioner Roundups

s:fi
KNOWLEDGE

Christine Schmid
Christine Schmid serves as Head Investment Solutions in the Swiss Universal Bank of Credit Suisse. She leads the Private Placement Committee for Switzerland and is a Member of the Private Equity Business Board of Credit Suisse. Previously, she was Head of Global Equity and Credit Research, herself specialized as an analyst for global financials. She holds a Master's Degree in Economics from the University of Zurich and is a CFA charterholder.

The Growing Use of ESG Criteria in Investment Decisions

Analyzing a company's corporate governance including factors such as board independence, transparency, corporate controls, and shareholders rights are effective ways for investors to assess the quality of a company, and in particular its long-term managerial alignment with their own interests.

Looking beyond remuneration systems

For quoted companies, variable compensation is becoming increasingly regulated, with the aim of fully aligning management incentives with investors' interests. At times of financial success, multipliers have been lowered. And when losses are incurred, clawbacks have been installed for top management and key decision takers. Risk management has therefore become even more important for managers of large, quoted companies. Taking in business/operational, legal, and reputational risk, the focus has moved beyond remuneration or salary systems. The question is, how do investors incorporate these factors into their decisions in the context of a systematic investment approach? The answer is, by applying corporate governance criteria.

Using ESG data to help identify aligned companies

Analyzing a company's corporate governance is an effective way for investors to assess the quality of a company, and in particular its long-term managerial alignment with their own interests. Environmental, social, and governance (ESG) criteria can provide insights in this regard. This may in part explain why the market for so-called ESG investments grew to CHF 266 billion in Switzerland as of 2016, representing an increase of 39 percent since 2014, according to data provided by FNG (Forum Nachhaltige Geldanlagen Schweiz, 2017).

This forms part of the outward spread of the corporate governance approach adopted in the UK—notably to member states of the OECD. The OECD now produces the *Principles of Corporate Governance*, which have also been adopted by the G20. According to a CFA Institute study (CFA Institute, October 2015), 64 percent of investment professionals focus on corporate governance criteria such as management accountability and executive compensation. One of the most common data sources used by investors is the MSCI ESG criteria.

A sectoral approach by investors is warranted when using corporate governance criteria

The growing importance of corporate governance prompted Credit Suisse to publish an in-depth Research Institute Study in 2016. The study presents a detailed analysis of how investors should handle corporate governance data in order to achieve performance (CSRI, How corporate governance matters, 2016; http://bit.ly/2hCCuvH). Although corporate governance is important to all sectors, it does seem to matter more to some. An investment strategy may outperform when it focuses on well-governed companies in sectors where governance is particularly important. Sectors with high governance weightings in the overall ESG framework include telecommunications, financials, and oil and gas. As one might expect, well-governed companies in these sectors are more likely to outperform well-governed companies from sectors with lower governance weightings. Especially if long–short pairs are selected.

Investors might invest in long–short portfolios based on going long on the top 10 percent of companies versus shortening the bottom 10 percent when looking at the governance score within each sector. Applying this strategy to historical MSCI ESG data, financials and telecommunications outperformed clearly. Overall across sectors there is a positive correlation between performance and the importance of governance. The higher the governance weighting within the ESG criteria, the more likely it is that the long–short strategy within the sector will produce a positive outcome.

Although it does not seem possible to generate outperforming investment strategies by focusing simply on governance metrics in the overall market, governance-based strategies still have the potential to outperform. Investors should focus on well-governed companies in sectors where governance has moved from being relatively unimportant to being in sharper focus, perhaps due to regulatory changes or similar pressures. As indicated by specific shifts that occur from time to time—e.g., at Volkswagen in 2015—a shift in governance can be an early warning sign. Such cases serve to reinforce the necessity—and the benefits—of investors considering aspects of corporate governance in their investment strategies.