



How analysis of companies' corporate governance can enhance investment analysis

Insight has long believed that good corporate governance is a critical determinant of the success of companies and, hence, of investment performance, both over the short- and long-term. High-profile collapses such as Enron, Worldcom and Parmalat have demonstrated how important it is for investors to look closely at the governance practices of the companies in which they invest and to intervene early when they sense that boards are not managing the company in the interest of shareholders.

Insight's approach to corporate governance

We incorporate assessment of governance practices into our investment decision-making process in three ways:

- Through the formal consideration of corporate governance issues in our standard investment process;
- By building links between our corporate governance specialists and our analysts/fund managers, and;
- By aligning our engagement and voting activities with our investment decisions.

Incorporating corporate governance issues into standard investment analysis

While corporate governance has been incorporated into our investment analysis for many years, in 2006, we decided to formalise our approach. We established an internal working group whose objective was to help equity and credit analysts and fund managers to identify companies where corporate governance is, or may be, problematic.

The working group developed a series of risk indicators (see Box 1), with each indicator weighted based on our assessment of its overall importance to successful corporate governance. Companies are classed into one of three groups:

- **Category A:** companies where the governance risks are considered to be very high and further detailed research and discussion are required.
- **Category B:** companies where some governance risks have been identified and some further research and discussion are required.
- **Category C:** companies where no governance risks have been identified.

For each company that falls into Category A or B, we write a note setting out our views on its governance. The company scores and notes are available to all analysts and fund managers in Insight's central research database. Analysts are required to explicitly consider (and discuss with our head of corporate governance) corporate governance issues when they are considering investments in companies in Category A or B.

Box 1: Corporate Governance Indicators

Board risk indicators:

- Chairman not independent upon appointment.
- Less than half of the board are non-executives.
- Board turnover has been greater than 25% over the previous year or more than three new people (excluding internal promotions) have joined the board in the same period.
- Fewer than three executive directors.
- No senior independent director on the board.
- Chairman of the company is chair of the audit committee.
- Executives on the audit committee.

Remuneration risk indicators:

- Any Insight votes against or abstentions on the company's remuneration report in the past three years.
- Any Insight votes against or abstentions on the company's share schemes in the past three years.

Corporate governance and shareholder value

We have looked closely at many of the quantitative studies that have sought to demonstrate a positive correlation between corporate governance and corporate financial performance and have concluded that none provides a satisfactory method for calculating the value premium associated with good governance. However, we are clear that poor corporate governance can destroy shareholder value. Therefore, when we ask our analysts to consider corporate governance, we are not dictating that they should never consider investing in companies with poor governance, but rather that they should ensure that they are fully aware of the risks associated with investing in such companies.

Strengthening internal communication and collaboration

We recognise that developing indicators is only part of the process; it is equally important that analysts, fund managers and corporate governance specialists interact and share information with each other.

We do this through actively encouraging communication and collaboration. This seems obvious, but even when

an asset manager has its entire research staff in one location, it is not uncommon for different research teams to work in isolation from one another. To facilitate open and regular communication, we have placed our corporate governance team within our equities department, reporting directly to our head of equities, and members of the corporate governance team, analysts and fund managers routinely hold joint meetings with companies.

For example, in our rolling programme of meetings with company chairmen, we discuss issues such as succession planning, business strategy and financing, as well as incentives and rewards. We ensure that these meetings are attended by our corporate governance specialists and by the relevant analysts and/or fund managers. Similarly, our corporate governance analysts participate in meetings with company executives along with our research analysts. We ensure that meeting notes and other relevant information – for example, our views on broader corporate governance issues – are made available through our central research database.

Joint working groups

We have also established working groups to analyse specific questions or to develop specific analytic tools drawing members from our equity, credit and investor responsibility teams. This has added real value to our investment process and has helped to reinforce greater communication between these teams. Over the past two years, we have established working groups on issues such as corporate pensions, corporate governance (as discussed above), climate change and narrative reporting.

For example, in relation to pensions deficits (a major issue for many UK and European companies), the working group comprised Insight's head of equity research, a credit analyst, an equity analyst (with extensive knowledge of actuarial and valuation issues) and an investor responsibility analyst. The group developed a series of indicators (e.g. total gross liability versus market capitalisation, the assumptions being used about the investment returns from different asset classes, the manner in which pension fund liabilities are accounted for) and then used these indicators to generate a list of companies about which we had the greatest concerns. This research was then presented to our equity and credit research analysts and fund managers, is available in our central research database and is discussed in specific situations, e.g. takeovers, where pensions are an important part of the investment decision.

Engagement and voting

The third way we have enhanced our investment process is to take action in situations where we feel that companies are not acting in the best interests of their shareholders. While our preference – and our standard approach – is to use our informal influence to encourage companies to take action, there are cases where we need to consider voting against management in order to effect change. In these situations, the issue is discussed with relevant members of our investment team to agree our strategy, e.g. to continue to engage with the company, to abstain or vote against management, and/or to work with other investors or through the ABI or a similar institution. In high-profile or particularly contentious cases, our head of equities or chief investment officer is consulted before a final decision is made.

One area of corporate governance integration from which we have derived particular value is the analysis of executive remuneration schemes. Ensuring that executive rewards are aligned with the interests of shareholders entails scrutinising how appropriate the performance measures are that are being used to trigger executives' bonuses, determining whether these performance measures are the same as those that investors are using to evaluate the overall success of the business, as well as understanding

how challenging and realistic the targets are.

This type of analysis requires in-depth knowledge of remuneration (i.e. what does an appropriate remuneration proposal look like), as well as specific knowledge of the company and its sector (e.g. are the peer group comparators appropriate), to assess whether the particular remuneration arrangements being proposed for a company are, indeed, the most appropriate.

Conclusions

In addition to the investment benefits that we derive from focusing on corporate governance, we believe that there are broader benefits from focusing on the investment implications of governance issues. In the current environment where box-ticking and compliance seem to dominate, (rather than a true commitment to the principle of 'comply or explain'), it is essential that we – and other investors – do not lose sight of what we are seeking to achieve through our governance activism, namely well-run companies that create sustainable value for their investors. We believe that our approach helps us – and, we hope, the investment industry as a whole – to avoid falling into the trap of seeking slavish adherence by companies to corporate governance codes rather than of creating real value for investors.

July 2007

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05042-07-07