INALYTICS

ASSET OWNERS

MEASURE OF SKILL

Locating skill, identifying good governance

Combining the Expertise of Inalytics and PIRC

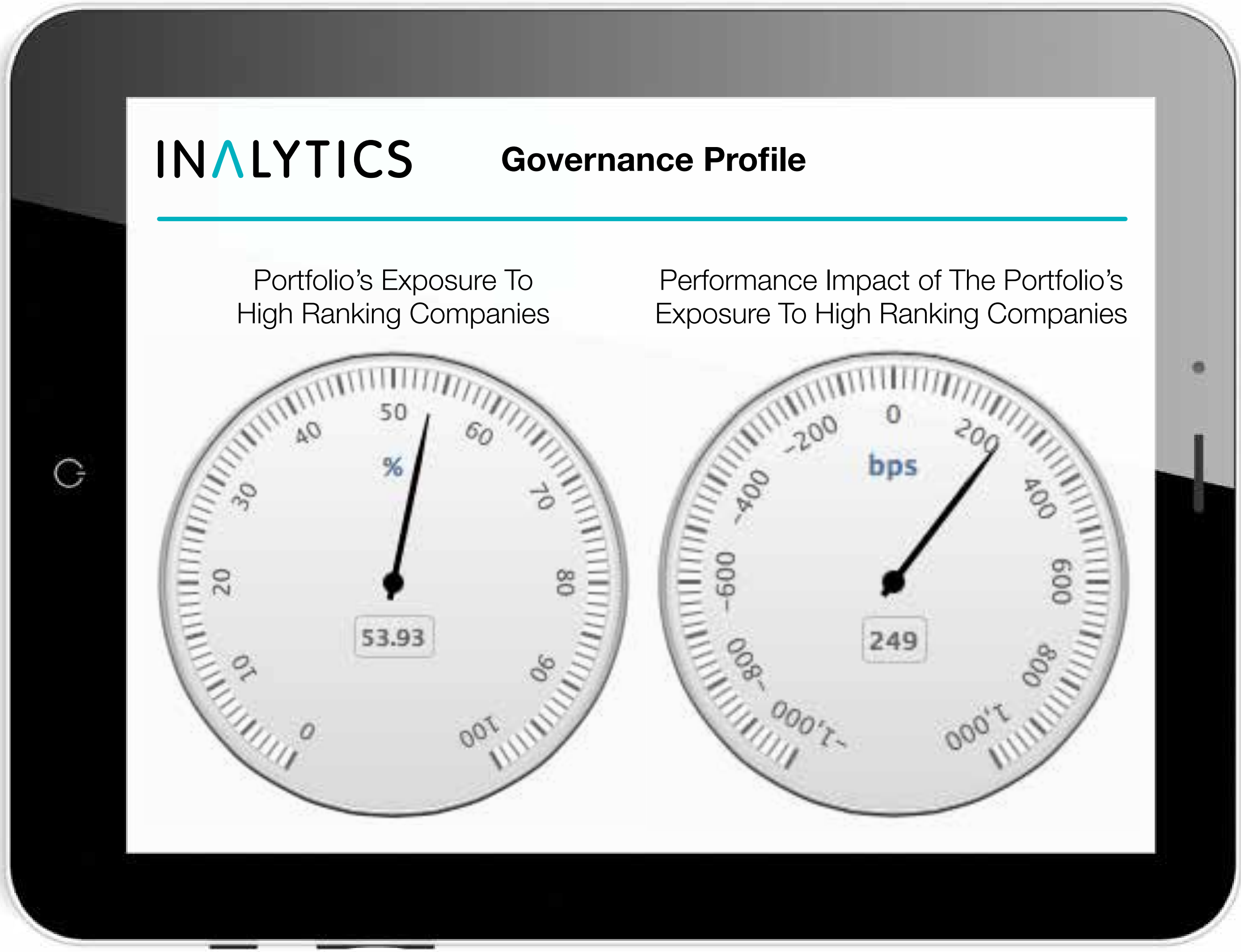
This combined service provides you with two powerful filters for assessing the decisions your Managers are taking. It allows you to evaluate:

- The governance profile; our research shows that this translates directly into performance.
- Whether the Portfolio Manager has the investment skills to meet your performance objectives.

This combination helps you appoint Managers who can meet your objectives while doing the right thing.

Inalytics and PIRC are combining to bring together the best of benchmarking investment skill and assessing the governance profile of equity portfolios.

PIRC - Understanding Governance's Impact on Performance



How it helps you

It allows you to assess the risks presented by the governance profile of companies your Portfolio Managers are investing in.

How it is done

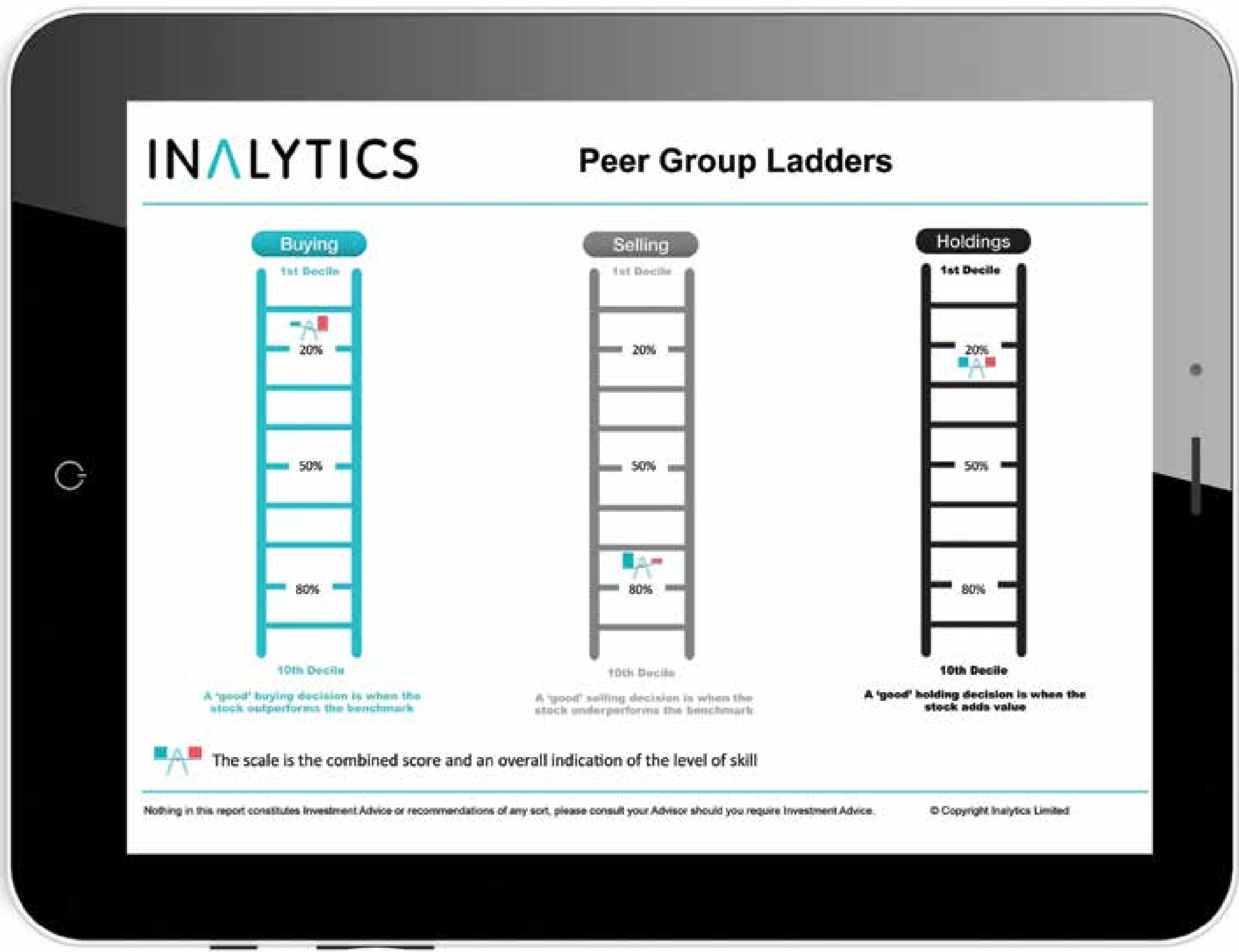
We use PIRC's Governance Risk Ratings which assess companies based on a range of different governance criteria (the details of which are shown in Inalytics Research Paper 08).

How we convey the rankings

Speedometer – A greater weight of stocks with a superior governance rating moves the dial to the right, while stocks with an inferior ranking moves the dial to the left.

Volt Meter - The dial moves to the right when positive to the benchmark; and to the left when it is negative.

Inalytics - Benchmarking Manager Skill



What are the ladders?

The ladders show, at a glance, how a Manager's skill in the three key areas compares against the Inalytics peer group.

How these help you

You can clearly see if a Manager has the skills to rise above the pack, and to meet your objectives.

What we rank

We rank Fund Managers on their ability to find winners, to have the conviction to run them, and then know when to sell.

What the Peer Group is made of

Over 800 portfolios from around the world, measured against a variety of benchmarks.

INALYTICS

RESEARCH PAPER
SUMMER 2013

PIRC

08

Does It Pay To Own Companies That Do The Right Thing?

Or is it as St. Augustine famously said, “Lord, make me pure, but not yet”. This paper puts the moral question to one side, and addresses it from a more prosaic or secular perspective by analysing whether the share prices of companies with good governance outperform the market, and by extension if poor governance is associated with underperforming share prices.

We have analysed a comprehensive set of Governance Risk Ratings from PIRC, the specialist Corporate Governance Advisors, to show that it pays to do the right thing. We have found that during the past two years the share prices of companies with high governance risk ratings perform poorly, whereas companies with good governance and low risk ratings perform well over time. This is just as well, as many of us had believed it to be the case, rather than just wishful thinking.

Having established that the overall relationship was strong, and for small companies in particular, the next question is whether Fund Managers actually hold companies with low levels of governance risks, or disregard it as unimportant when deciding what to put into client portfolios.

For those Managers in the latter camp, maybe these results will go some way to change their minds, as there appears to be a market anomaly that warrants attention.

THE PIRC GOVERNANCE RISK RATINGS

PIRC provide Governance ratings for companies in most of the major markets, although this research focuses on the UK.

They rate 423 companies in the FTSE All-Share Index, accounting for 96% of the market. Each company is rated according to the following criteria:

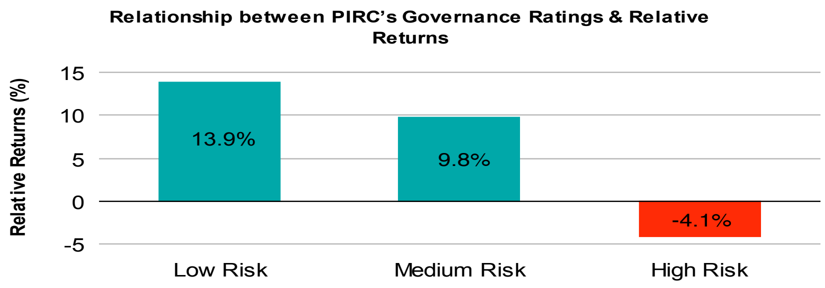
	Rating Categories			
	Audit & Reporting Rating	Board Rating	Compensation Rating	Shareholders & Capital Rating
Sub Issues & Indicators Covered	Independence of Audit Process	Board Composition	Disclosure	Dividend
	Committee Membership	Board Structure	Balance	Voting System
	Internal Controls	Committees	Contracts	Shareholder Structures
	Accountability Oversight	Nomination Process	Pensions	Board Responsiveness

Companies are given a rating for each category and a total score, then ranked into percentiles. For the purpose of this research we classify companies as high, medium and low risk, although PIRC is able to provide much more granular classifications. The data is just for the past two years, although it will grow through time.

WHAT THE DATA SAYS

We tested the proposition that the share prices of the companies with low levels of governance risk, outperform those with high levels.

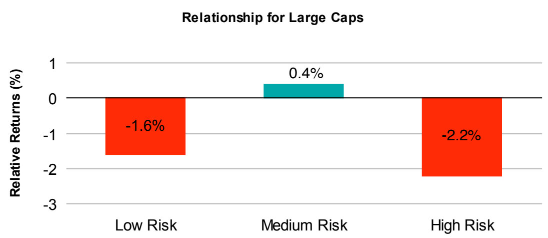
The results are indicated by the following chart:

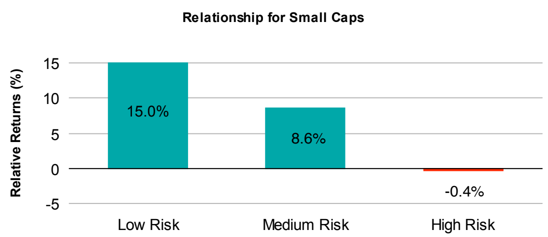


The results are remarkably strong, as the average relative performance of the companies with low risk is some 18.0% above the high risk companies. Even on a weighted basis to allow for the fact that there are a large number of Small Cap companies, the difference is still 3.4%. Possibly one of the very few instances where mammon *(money - not the demon, for those reaching out to Google!)* might be on the side of the angels.

SMALL IS BEAUTIFUL

If we look at the data in terms of the differences between large and small companies the results are even starker:





Any explanation is merely conjecture, but maybe large companies in general feel able to weather any storms that brew up over governance issues, whereas smaller companies possibly see governance as more important. I suspect these results will spark some very fruitful and interesting Research Papers in the future.

SOME MANAGERS ARE MORE EQUAL THAN OTHERS WHEN ASSESSING GOVERNANCE RISK

We took the UK equity portfolios of one of our clients, Merseyside Pension Scheme, and found that two Managers carried a low level of governance risk, while two carried an average level. Although it is fair to say that these Managers are unlikely to have focused on this in the past, given the strength of the results this could easily change.

CONCLUSION

This analysis has established the relationship between good governance, share price returns and portfolio exposures. This has come about through our working relationship with PIRC which combines the benchmarking of the investment skills that produce the returns, with the governance risk carried in the portfolios.

The three main conclusions from the data are that:

- the share prices of companies with low levels of governance risk performed well
- but this applied exclusively to small companies
- some Managers carried a low level of risk and some high.

We look forward to working with PIRC and clients to explore these issues further.

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Summary

This new service enhances your due diligence process.
You can:

- Critically evaluate Managers' performance so you can be confident when appointing and retaining Managers.
- Understand the impact that governance profile is having on your investments.

Please contact Inalytics if you would like any further information on the service.

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