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Good corporate governance: Does it pay in Peru?☆

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ABSTRACT

This paper aims to discover whether or not good corporate governance practices generate positive returns on the Lima Stock Exchange (LSE). The study examines two questions. First, does the announcement that a firm is in the good corporate governance index (GCGI) increase its stock price and offer a positive abnormal return? Second, from the point of view of socially responsible investing does an investment portfolio of Peruvian firms with good corporate governance practices offer better performance than a portfolio of firms with bad corporate governance? The findings from an event study show that the announcement of a firm's inclusion in the GCGI yields a positive abnormal return in a range of 0.95% to1.11% on the day of the announcement. Furthermore, firms with good corporate governance practices that are in a democratic portfolio outperform firms with bad corporate governance practices in an autocratic portfolio with an average monthly return of 3 % during the period of January 2004 to December 2008.

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1. Introduction

Currently, the common practice among investors seeking higher profitability in developed countries is to pay close attention to corporate governance issues and the environmental and social performances of firms. Investors use these factors to build their international equity portfolios. However, the emerging markets in Latin America do not necessarily follow this strategy because surprisingly few initiatives exist that create environmental, social, and governance indicators. Therefore, institutional investors, who are by far the most important investors in Latin America, do not have these indicators to guide them in their investment decisions. Despite this fact, socially responsible investing (SRI) continues to gain popularity. According to the Mercer Investment Consulting Report (2010) report on 157 investment managers worldwide, 38% of the managers believe that over the next three years customers will demand that SRI management be integrated into their investments.

Socially responsible investing refers to investments that are ethically responsible to stakeholders, which includes firms with good corporate governance practices. The main advantage of these types of investments is that they demand transparency and credibility for both corporate policies and the company's relation with the stakeholders and financial markets. This practice, in turn, provides business analysts with more qualitative and quantitative information for corporate risk assessment and portfolio formation.

Friedman (1970) argues that the sole responsibility of the company is to maximize the profitability of its shareholders. By late 2005, half of the 500 largest firms in the United States had published a social responsibility report (without being obliged to do so). Today, four out of five employers around the world think that their company has a social responsibility in addition to the responsibility to produce profits. In fact, Mr. Friedman is not wrong in his assertion. On the contrary, his statement holds true in the current global context. The point is that nowadays the possibility of maximizing the wealth of the company's shareholders in the long-term without also paying attention to environmental, social, and governance issues no longer exists.

According to the European Central Bank's (2005, pp 219) definition:

> Corporate Governance is the system by which corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the various members of the company, such as the board of directors, management, shareholders and other economic agents who have an interest or stake in the company. Corporate governance also provides the structure through which company objectives are established, the means to achieve these objectives, and how to monitor their performance. Good corporate governance practices seek to attract capital, to ensure proper company management and administration (mainly for those that issue securities on stock exchanges), to protect

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investors' and other interest groups' rights, to build confidence in financial markets, and to promote competitiveness.

In Peru, a committee headed by the National Supervisory Commission for Firms and Securities (CONASEV) defines the principles of good corporate governance for firms in Peru. As a result, in July 2002 the commission published the Principles of Good Governance for Peruvian Corporations (PGCG) that adapted the corporate governance principles established by the Organization for Economic Co-operation and Development (OECD) in 1999to the Peruvian market (Lopez & Rios, 2005).

Since the end of 2004, firms have voluntarily submitted a self-assessment survey of corporate governance practices to CONASEV as an appendix to their annual reports CONASEV (2007). Based on these self-assessments, on July 1, 2008, the LSE developed and launched a GCGI that comprised eight securities belonging to firms with the best corporate practices in Peru and that met the minimum liquidity level of the LSE.

While adopting good corporate governance practices is voluntary in Peru, firms with publicly listed securities have to disclose their financial information and also report on the degree of their compliance with the PGCG. Because these principles constitute a guide for businesses, their implementation signals the firm's commitment to good corporate governance practices.

The PGCG has 26 principles that firms must report compliance with. Management and control guidelines comprise the following four categories: shareholder rights and treatment, responsibilities of board directors, information communication and transparency, and the role of stakeholders in corporate governance.

The main objective of this study is to consider the benefits of a firm's adoption of good corporate governance practices for local institutional investors. Does the inclusion of the company in the GCGI produce positive abnormal returns for the firm's stocks? Does an investment portfolio with good corporate governance performance outperform an investment portfolio with worse corporate governance performance important to local institutional investors in Peru?

In order to perform the first task, this study analyzes the stock price behavior of the eight firms in the GCGI around the announcement date of their inclusion in the index by the LSE. In order to perform the second task, the study groups all of the firms listed on the LSE into two categories: the first comprises the firms that show a greater level of compliance with the principles of corporate governance (democratic portfolio), and the second comprises the firms that comply to a lesser extent with the principles of corporate governance (autocratic portfolio). The study examines the performances of the democratic and the autocratic portfolios during the period of 2004 to 2008.

The remainder of this document is as follows. Section 2 discusses the empirical evidence of the effects of good corporate governance on value creation. Section 3 presents the method and the results of testing whether good corporate governance practices payoff for firms. Section 4 explains the method and the results of testing whether a democratic portfolio systematically outperforms an autocratic portfolio. Section 5 is the conclusion.

2. Empirical evidence on the effects of good corporate governance on value creation

Worldwide evidence exists that good corporate governance practices positively affect a firm's performance. Coombes and Watson (2002) show that investors are willing to pay more for shares in firms with good corporate governance. The additional amount investors are willing to pay depends largely on their geographical locations. The percentages are as follows: 12 to 14% in Europe and North America, 20 to 25% in Asia and Latin America, and 30% in Africa and Eastern Europe. In the case of the Americas, the premium percentage that investors pay for firms with good corporate governance is as follows: 24% for Venezuela, 21% for Colombia,19% for Mexico, 24% for Argentina, and 18% for Chile.

Harris (2009) reviews Latin American literature on the link between good corporate governance and market value. He concludes that in general, the studies that focus on Latin America not only are improving in their quality, but also are somehow in agreement with the fact that good corporate governance increases the market value of firms and improves financial performance. However, the literature so far is fragmented into country studies. In this sense, this paper intends to add the Peruvian evidence that has been missing so far in the current Latin American empirical literature.

Table 1 reviews the main empirical evidence related to the positive effects of good corporate governance on the firm's value. Black (2001) uses a sample of only 20 Russian firms to build a corporate governance index ranging from zero to 60 (where zero corresponds to firms with better corporate governance and 60 the worst corporate governance). Black (2001) compares the firms' corporate governance rankings to the ratio of their equity market capitalizations quoted on the Moscow Stock Exchange and their equity market capitalizations as functions of assets. The results disclose a solid inverse correlation between the ranking of corporate governance and this ratio.

Fernandez and Gomez (2002) examine the reforms that 48 firms in Spain implement to adopt corporate governance rules (Olivencia Code). The results show that firms who comply with the reforms have an average positive abnormal return of 0.62% on the day of the announcement, and those firms that fully adopt these rules experience a positive abnormal return of 1.53%, as compared to firms that do not.

Gompers, Ishii, and Metrick (2003) carryout a study in the United States on the benefits of corporate governance. For this study, the authors create a corporate governance index in order to classify U.S. firms according to their corporate governance practices and assign them to a given portfolio. The democratic portfolio comprises firms with better corporate governance and the dictatorial portfolio comprises firms with the worst corporate governance practices. According to these authors, 1 U.S. dollar invested in 1990 in the firms with the worst practices, grew to 3.39 U.S. dollars by 1999. Similarly, 1 U.S. dollar invested in 1990 in well-governed firms grew to 7.07 US dollars in 1999. This increase is equivalent to an annualized return of 14% in the first case and 23.3% in the second, which is a difference in profitability of 9%. Concerning firm valuation, the study finds that a strong correlation exists between the firm's market value and corporate governance: a one point rise in the ranking has an association with an 11.4% increase in Tobin's Q adjusted by the industry effect (i.e., subtracting the firm's Q from the average Q of the firm's industry). Better governed firms have a 56% higher Q than poorly governed firms.

For the case of Europe, Bauer, Guenster, and Otten (2004) use a significant sample of European firms that comprises the firms from the FTSE Eurotop 300 Index that they rank on a scale of one to 100 depending on the quality of corporate governance. Using a portfolio study, the authors compare the returns that both portfolios generated during the period of 1997 to 2002. The authors find that firms with better corporate governance reward investors more than firms with poor corporate governance.

Foerster and Huen (2004) show a positive relation between different measures of corporate governance and stock returns for 270 Canadian firms. These authors verify that Canadian firms with good corporate governance practices get 8.8% more positive abnormal returns than firms without good corporate governance practices. Hence, the authors' findings suggest that investors do care about the corporate governance practices of Canadian firms.

Bebchuk, Cohen, and Ferrell (2004) create an entrenchment index with the following six provisions: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for merger and charter amendments. They find that increases in the index level have a positive correlation with reductions in firms' valuations and with large negative abnormal returns.

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