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**CORPORATE GOVERNANCE
POLICY AND COMPANY
PERFORMANCE:
*The Case of Portugal***

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CORPORATE GOVERNANCE POLICY AND COMPANY PERFORMANCE: THE PORTUGUESE CASE

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SUMÁRIO

Nos anos noventa, uma pluralidade de autoridades de supervisão e de grupos de trabalho de inspiração governamental emitiram recomendações sobre o *corporate governance* de sociedades cotadas. No presente documento, usando uma base de dados única, analisamos a relação existente entre o grau de cumprimento das recomendações emitidas pela Comissão do Mercado de Valores Mobiliários português e os retornos das sociedades visadas. Utilizando um modelo multifactorial, concluímos que existe uma relação positiva entre o cumprimento de algumas das recomendações da CMVM e os retornos anormais apurados. Em particular, merece realce a evidência de efeito positivo entre a performance e a forma de organização e de funcionamento do órgão executivo da sociedade.

ABSTRACT

Several supervisory authorities and governmental working groups issued recommendations on corporate governance for listed companies during the nineties. In this paper, we used a unique database that allowed us to analyse the relationship between the level of compliance of the recommendations issued by the Portuguese Securities Market Commission and the (abnormal) returns of the concerned companies. By using a multifactor model, one can conclude that there is a positive relationship between the compliance of some of these recommendations and the abnormal returns that were determined. The recommendations on the structure and functioning of the executive board deserve a special attention.

Keywords: *Corporate Governance, Performance and Supervision.*

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1. INTRODUCTION

The study of corporate governance experienced an important impulse in the 90's¹. It decanted from the academic realm to the ogle of the institutional debate and brought upon several political measures and standings by governmental areas or linked spheres. Included in this corporate landscape are: *i*) several expert reports (*Cadbury*, *Greenburg* and *Hampel* for the UK, the *Vienot* for France and reports from commissions that were purposely created in Germany, Spain, the Netherlands or in Italy) and recommendations on various subjects of corporate governance issued by *ii*) international bodies such as the OECD and by *iii*) supervisory agencies of securities markets (e.g. Belgium, Greece and Portugal)².

These recommendations aim at adopting mechanisms that will enhance effective investor protection over the despotic power benefited upon by managers of public companies. However, these recommendations rarely take into consideration the effects of recommendation measures on performance. In most cases, these measures aim at easing and making market for corporate control more effective. Such recommendations establish clear-cut information requirements and recommend the adoption of organisational structures that are more transparent and that facilitate effective monitoring. Furthermore, the adoption of manager remuneration mechanisms able to induce closer alignment with the shareholders' interests is recommended. Apparently, aspects related to stimulating company performance do not carry the same attention.

Many of the literature contributions have given rise to reservations, which are usually profiled by supervisory authorities, as to the efficiency of some of the control mechanisms. There is empirical evidence that supports the idea that some of the measures acclaimed by many public powers have an opposite effect on the performance of the companies that adopt them.

The issue of efficiency is two-pronged. Whilst supervisory authorities discourage the adoption of anti-takeover measures, some authors note the controversy of public offers since these are usually refrained by managers of the target company, by employees, and at times by the public administration and political domains (see Jensen (1993) amongst others). Grossman and Hart (1980) show that the functioning of market control mechanisms and in particular takeovers may suffer from free rider problems. On the same note, Shleifer and Vishny (1988 and 1997) forewarn about the possibility of takeovers intensifying agency problems when managers use company resources to launch offers over other companies and overpay for acquisitions that bring them private benefits of control. This would be a way for these managers to gain more power and obtain more private benefits, and would require liquid capital markets (enabling managers to raise substantial amounts of capital in a short period of time). To exemplify this, some political powers are in favour of boards that are controlled or at least composed by independent managers in order to obtaining a more effective monitorisation of the executive managers' action. However, Zahra (1996) argues¹ that the fact that CEOs play an important role in the selection, remuneration and retention of outside directors limits their power and monitoring capacity. Porter (1992) suggests that non-executive directors do possess neither the information nor the time to absorb all the necessary data to understand the functioning of the company. On the other hand, their goals are minimal and that concurs with less commitment in management monitorisation.

¹ For a comprehensive review on the subject, see Shleifer and Vishny (1997), and Keasey et al (1999).

² Several entities from many other countries as well as sundry-typed international organisations have issued recommendation reports on good corporate governance. A more comprehensive reading of these reports is available at the European Corporate Governance Network site (www.ecgn.ulb.ac.be).

As regards the effects on performance, some studies indicate that executive boards of directors controlled by outside directors tend to have less research and development expenses (Baysinger, Kosnik and Turk (1991)). Some have also argued that these boards tend to not follow through on consistent innovation strategies aimed at the creation of new areas of business and venturing (Zahra (1996)). On the other hand, incentive contracts are not immune to criticisms regarding their capacity to align the interests of managers and shareholders, inasmuch as managers carry out their options shortly before the bad news and postpone this exercise after the good news (Yermack (1997)), securing in this way their interests from the impact fluctuations of their management decisions.

In sum, a set of very expressive political standings has recently emerged regarding corporate governance but its impact and relevance are yet to be evaluated. In other words, the aspects related to the evaluation of the effect of different solutions and of the different mechanisms recommended by public powers on performance is an exercise yet to be carried out. This exercise must be done, not only to evaluate the importance and match of the measures that are advised and imposed, but also on the search of indications on the most adequate ways for the necessary readjustments.

This study analyses the relationship between the degree of compliance with the recommendations from *Comissão do Mercado de Valores Mobiliários (CMVM)*³ and the returns of public companies. The purpose of this study is therefore to investigate if companies complying with the corporate governance recommendations of CMVM distinguish themselves from those companies that present lower levels of compliance. In 1999, CMVM issued a total of 15 recommendations aimed at listed companies and another two for institutional investors. These recommendations are intended to induce companies into increased transparency, to ease the exercise of shareholder rights by investors, to avoid the adoption of mechanisms that hamper the control of corporate governance by the market, and lastly to advise on ways of organisation and functioning of the board of directors with a view to ensuring the full representation of a multiplicity of the shareholders' interests as regards the decision-making process.

Soon after these recommendations were issued, CMVM sent out three questionnaires to companies listed on the Official Quotations Market (*Mercado de Cotações Oficiais - MCO*), the main stock market of the Lisbon and Oporto Stock Exchange (BVLP – *Bolsa de Valores de Lisboa e Porto*). These questionnaires aimed at enquiring which companies comply, and those that do not, with each of the recommendations. For the purposes of this study, we've analysed the individual responses to these questionnaires. We did also look at the valuation criteria of the supervisory authority itself on the compliance or non-compliance of each of the recommendations. The database with which we work is therefore unique, not only due to its exclusive informative nature but also the fact that it is an authentic interpretation – i.e. carried out by the supervisory authority itself – on the level of compliance of each of the recommendations.

As far as we know, this study supplies a pioneer contribution for the evaluation of the impact and relevance of different recommendations on governance of listed companies stemming from public power since the last decade. In reality, we will investigate the likely difference in the abnormal performance of companies that comply and those that do not with the different types of recommendations of CMVM. We use the Fama and French (1993) model for shares,

³ Entity responsible for the supervision and regulation of the Portuguese securities market.

expanded to include the ‘momentum’ effect evidenced by Jegadeesh and Titman (1993). We also include one variable intended to capture the potential ‘January-effect’ that was documented, amongst others, by Keim (1983), and Gultekin and Gultekin (1983).

We use econometric analysis in a two-step process. In the first step, we estimate asset returns; in the second we use first-step independent variable coefficient estimates as dependent variables in models in which the explanatory variables include compliance indicators of the corporate governance recommendations. Our results show that there exists a positive relationship between the compliance of some corporate governance recommendations and computed abnormal returns. They also show that, globally, CMVM’s recommendations do not have a systematic effect on returns. In other words, the different groups of recommendations show opposing effects and therefore the total effect of those recommendations is negligible.

This paper is organised as follows. In the next section, we proceed to describe the database used, including CMVM’s recommendations and the questionnaires sent to listed companies. The third section describes the methodology and explains in detail the model of equilibrium used to compute returns. The fourth section contains the main results of the paper. Lastly, we draw some conclusions and outlooks for future studies.

2. DATASET

2.1. CMVM’S RECOMMENDATIONS ON CORPORATE GOVERNANCE

In October 1999, the supervisory authority for the Portuguese stock market issued a set of 17 recommendations on different subjects regarding corporate governance. They were classified by CMVM (1999) into 5 distinct groups: i) recommendations regarding disclosure of information; ii) recommendations regarding voting and shareholder representation; iii) a set of recommendations on the adoption of certain society rules; iv) recommendations on the structure and functioning of the board of directors; and v) recommendations for institutional investors.

There are 7 recommendations included in (i). They focus on the disclosure of information regarding the competences of the various bodies, departments or divisions of the company (R1), including information on the functions carried out by each member of the board and the managers of the company, as well as the job positions that they hold in other companies (R2). Also included in this group are recommendations regarding the director’s board description of the behavior of the company’s shares in the stock market, and the relevant facts that occur (R3), and the recommendation on information disclosure regarding dividend policy (R4). Information on any para-social agreements regarding the transmission of shares, whenever these are relevant to the organisation of the company (R5); the encouragement on the use of new technologies for financial information disclosure and preparation of shareholder meetings (R6), and the recommendation for the establishment of an investor assistance office (R7) are the other recommendations included in this group.

The second group consists of two recommendations only. The first encourages that the exercise of active voting rights be facilitated, either directly (postal voting) or by proxy (R8). The other recommendation encourages an improvement in the procedures on proxy voting in shareholder meetings (R9).

Group iii) on society rules includes two recommendations as well. The first states that it is recommendable that specific rules be set up in order to regulate situation of conflicts of interest among members of the board and the company, as well as the main obligations as to the duties of diligence, loyalty and confidentiality by the board members⁴ (R10). The second recommends that the measures adopted to prevent the success of takeover bids should respect the interests of the company and its shareholders (R11). To this end, it is considered that defensive clauses on poison pills are contrary to the shareholders' interests and hamper in this way the free transmission of shares and the free assessment by the shareholders as to the performance of the board members.

The fourth group integrates four recommendations on the structure and functioning of the board of directors. Advice is given on the composition of the board. Board members must be of a plural nature and the board itself must carry out an effective guidance in the management of the company, their directors and managers (R12). On the other hand, one or more independent members must be included in the board of directors in order to maximise the company's interests (R13). The idea that if an Executive Committee is created, its composition should mirror the balance between independent members and the directors connected to controlling shareholders (R14). The fourth recommendation encourages that the board creates an internal control committee responsible for evaluating potential conflicts of interest, such as the election of directors and managers, the analysis of the remuneration policy and the assessment of the structure and governance of the society (R15).

There are two recommendations that focus on institutional investors. The first notes that this type of investor diligently, efficiently and critically use its rights given the securities that they hold, namely the information and voting rights (R16). The second mentions that the institutional investor should supply information on their practice regarding the exercise of the voting right related to shares which they manage (R17).

2.2. QUESTIONNAIRES SENT TO LISTED COMPANIES

CMVM sent all the listed companies 3 questionnaires on the 31 December 1999, 31 March 2000 and 31 March 2001. These questionnaires aimed at detecting the level of compliance by these companies as to the 15 recommendations and the 4 groups of recommendations. The questionnaires were sent to 82 companies with shares listed on the MCO. Albeit, not all the companies were questioned on the three occasions due to the fact that some had already left the MCO or had been listed after the date of the questionnaires. The number of respondent companies was 60, 44 and 50, respectively, for each questionnaire.

The first questionnaire comprised 20 questions, and the second and third questionnaires included 24 questions. All questions are multiple choice. There are not any questions concerning recommendations R5 and R11; therefore this paper analyses the compliance of 13 recommendations only⁵. Besides this, the 1998 questionnaire does not include questions related to recommendations R2 and R4 – something that did not occur in the following questionnaires.

The answers to each of the questionnaires are of public knowledge, but the responses given by the companies were not disclosed to the public. The criteria used by CMVM to measure the

⁴ Namely regarding the prevention as to the undue use of business opportunities and company's assets.

⁵ This paper is not concerned with the two recommendations that focus on institutional investors (R16 and R17).

level of compliance with the recommendations are also of public knowledge. These criteria were however disclosed after the responses to the questionnaires were received by CMVM.

2.3. SAMPLE AND DATABASE

There are 4 sources as to the information on each of the companies: i) the responses to the questionnaires sent by CMVM to listed companies; ii) the DATHIS database at BVLP; iii) the annual publications issued by the Lisbon Stock Exchange with yearly accounting information on listed companies, and iv) the (daily) quotation bulletins of the Lisbon Stock Exchange.

From Dathis, we extracted the quotation series and the series on quotations adjusted for technical ‘accidents’ (the distribution of dividends, capital increases, and stock split operations) for the shares in our sample. Also from this source, we extracted the number of shares issued by each company as well as the annual and bi-annual account information that was necessary for the calculation of the company’s book value”. The 3-month interbank bid rate series (3M-Lisbor), used as a proxy for the risk-free interest rate, and the stock indexes were also obtained from Dathis.

The annual publications of BVLP and quotation bulletins were used not only to validate the annual accounting information that was extracted from Dathis but also in suppressing existing gaps, namely when information relates to past years. The quotations bulletin played a similar role regarding bi-annual company accounts. From the individual responses to each of the questionnaires we were able to attain the variables on the compliance of the recommendations and sets of recommendations.

Our sample includes 82 companies with shares listed on the MCO, regardless of these being listed or not listed on the markets during the whole period studied⁶. When a company had more than one category of listed shares, the option was always the series that conferred more shareholder rights (e.g. if a company had common shares and preferred shares without voting rights, we opted for the former ones).

2.4. THE DEGREE OF COMPLIANCE OF THE RECOMMENDATIONS

In calculating the degree of compliance of each of the recommendations and sets of recommendations, we defined the following variables: firstly, a dummy variable for each of the 13 recommendations (R_i , $i=1, \dots, 13$). This variable takes on the value 1 if the company complied with the recommendation⁷, and 0 otherwise. We then computed the degree of compliance for each of the 4 sets of recommendations and bestowed each recommendation with equal importance. These variables are identified as G1, G2, G3 and G4. Lastly, we proceeded upon calculating the global level of compliance of the 13 recommendations (G) again using the same weight for each recommendation.

Table 1 shows the degree of compliance for each recommendation and for each set of recommendations. There is a reasonable balance between the complying and non-complying companies except for recommendations R8, R9 and R14 (particularly R8). The number of complying companies for R8 is 2 at most (for the 2001 questionnaire), and 0 for the first questionnaire. Therefore, extra care must be taken with the interpretation of the results for G2 inasmuch as that during certain periods there is a very small number of complying companies. But that is not the case for the other recommendations and sets of recommendations. For

⁶ And thus we avoid any potential survivorship bias.

⁷ Using CMVM’s criteria.

example, in the 2000 questionnaire the percentage of complying companies varies between 27% and 86%, meaning that the number of non-complying companies varies between 14% and 73%.

TABLE 1: DEGREE OF COMPLIANCE OF THE RECOMMENDATIONS

Complying Companies by Recommendation													
Year	R1	R2	R3	R4	R6	R7	R8	R9	R10	R12	R13	R14	R15
1988*	9	na	35	na	17	36	0	4	31	54	42	8	23
	15%		58%		28%	60%	0%	7%	52%	90%	70%	13%	38%
2000*	16	12	31	31	19	33	1	5	24	38	31	3	16
	36%	27%	70%	70%	43%	75%	2%	11%	55%	86%	70%	7%	36%
2001*	25	17	44	36	28	37	2	6	34	42	36	7	22
	50%	34%	88%	72%	56%	74%	4%	12%	68%	84%	72%	14%	44%
Level of Compliance by Set of Recommendations													
Average					Standard Deviation								
	G	G1	G2	G3	G4		G	G1	G2	G3	G4		
1988	0,39	0,40	0,03	0,52	0,53		0,14	0,28	0,13	0,50	0,19		
2000	0,45	0,54	0,07	0,56	0,50		0,16	0,26	0,21	0,50	0,20		
2001	0,52	0,62	0,08	0,68	0,54		0,20	0,30	0,21	0,47	0,27		

* In the first line, we have the number of complying companies, and in the second the percentage number of the respondent companies.

For each company and questionnaire G, G1, G2, G3, and G4 were calculated as follows: (i) $G = \sum_i R_i / n$, where n is the number of used recommendations in each questionnaire (i.e. 11 for the 1998 questionnaire and 13 for the remaining questionnaires); (ii) $G_j = \sum_i R_i / n_j$, where n_j represents the numbers of recommendations of group j (j=1,...,4). Na: not available.

Table 1 also shows that both in absolute (number of companies) and relative terms (percentage of respondent companies), there is an improvement in the compliance of the recommendations during the course of time. On the other hand, on average, companies comply with circa half of the recommendations (with the exception of G2)⁸.

3. METHODOLOGY

3.1 EQUILIBRIUM MODEL

Many of the studies that have analysed the impact on companies of diverse corporate governance solutions, evaluate performance using accountancy variables (Chaganti and Damanpour (1991)) or, when resorting to market returns, do not adjust returns for the specific risk of the firm. When this is the case, the excess return of each stock is established in face of the market return (Kang and Shivdasani (1995) and Bhagat and Black (1998)). As such, these studies choose not to confront the returns of each asset with the equilibrium return of that asset according to its specific features. Hence, this procedure does not allow distinguishing which part of the return surplus is explained by the specific risk of the asset, and which part is explained by corporate governance variables. Bhagat and Black (1998) claim to prefer performance benchmarks not adjusted for the specific risk of each firm as a means to obviate the objections of Barber and Lyon (1997)⁹. We are in favor of using market returns adjusted

⁸ As an example, the average degree of compliance for the 2000 questionnaire and each group varies between 45% and 56%.

⁹ In accordance with these authors, the cumulated returns and the cumulated buy-and-hold returns, with different intensities, are biased indicators due to (i) the absence of the periodic rebalancing of the evaluated portfolio (unlike the reference index), (ii) restrictions to integrating, on the evaluated portfolio, other assets admitted to

for the specific risk of the asset, caring to – as explained later – verify the robustness of the results in face of alternative periodicities of portfolio rebalancing, as well as of alternative calculation methods of such returns and of the explanatory factors of those returns.

On the subject of the returns' evaluation model, we believe that CAPM would not guarantee that the patterns of detected results would not be fully explained by other factors (further to the different level of compliance with the recommendations of the supervisory authority). By way of example, it could be possible that the evidence of return reversion (widely documented in the literature) both in the long term (DeBondt and Thaler (1985, 1987, 1990), and Fama and French (1988)), and in the short term (Zarowin (1989), Chopra et al. (1992), and Conrad and Kaul (1988))¹⁰ or, inversely, the “momentum” effect (Jegadeesh and Titman (1993)¹¹) would fully explain the behavior of the analysed stock returns, meaning that no room is left to deem corporate governance to influence the explanation of the performance of the various stocks. There could be the possibility of the differences in the results achieved being due to the dissimilarity of the companies' size, meaning that return asymmetries would be fully explained by the size effect (documented, amongst others, by Banz (1981), and Fama and French (1992, 1993))¹² and not by diverse approaches of corporate governance. It is equally widely documented – vide, amongst others, Keim (1983), and Gultekin and Gultekin (1983) – the fact of January registering higher returns in comparison with the rest of the year¹³. Therefore, it is important to assess whether differentials in returns persist (between compliant stocks and portfolios of compliant stocks vis-à-vis non-compliant stocks and portfolios of non-compliant stocks), after controlling for this effect.

In short, we use the Fama and French (1993) model for stocks, expanded to include the “momentum” effect and the January-effect:

$$R_{i,t} = \alpha_i + b_i PSI_t + h_i HML_t + s_i SMB_t + g_i WML_t + d_i D_t + \varepsilon_{it}, \quad [1]$$

where R_{it} is the average excess return of the asset or portfolio i (vis-à-vis the return of the *Lisbor 3M* interest rate) on week t ($t=1, \dots, T$); PSI represents the average excess return of the *PSI Geral* index¹⁴ (vis-à-vis the *Lisbor 3M* interest rate return); HML (high minus low) corresponds to the factor intended to quantify the average excess return of high book-to-market-stocks in face of the return of a reduced book-to-market ratio¹⁵; SMB (small minus big) is intended to capture the size effect, and corresponds to the average return of a portfolio which is long in small caps and short in big caps, holding constant the other two attributes (book and momentum); WML (winners minus losers) measures the average excess return of

listing, and (iii) the difference of probability of being found widely positive abnormal returns in the evaluated portfolio and in the benchmark portfolio (*skewness problem*).

¹⁰These studies tend to show that assets registering the worst performance within a period achieve better performance in the following period, and vice-versa. Some studies point up that the phenomenon is asymmetric: low return assets show the higher recovery tendency, and this is frequently combined with the absence of reversion for the winners.

¹¹These authors have shown that short-term (one year) winners tend to remain winners in the following period, and losers tend to remain losers.

¹²These studies tend to show that smaller sized companies exhibit excess return vis-à-vis larger companies, which is not explained by differences in the systematic risk of different assets.

¹³ Particularly for smaller companies.

¹⁴ This index includes all stocks listed on the MCO of BVLP.

¹⁵ HML corresponds to the return of a portfolio that is long in high book-to-market stocks and short in low book-to-market stocks, holding constant the other two attributes (size and momentum).

high cumulative return stocks vis-à-vis low cumulative return stocks¹⁶; D is a dummy variable, taking on the value 1 if the week is January, and 0 otherwise; and ε is a random error term.

When calculating these factors, a similar method to that of Liew and Vassalou (2000)¹⁷ was used. The method consisted of dividing the total number of companies admitted to listing on the MCO¹⁸ in a three-step process. Firstly, the companies were ranked from the higher to the lowest book-to-market, being divided into two groupings (H and L)¹⁹. Secondly, in each grouping, stocks were ranked in accordance with their market value, originating four portfolios (HS, HB, LS and LB). Subsequently, in each of the four established groupings, stocks were divided in accordance with the cumulated return in the previous year, creating winners and losers. A total of eight portfolios were thus obtained (HSW, HSL, HBW, HBL, LSW, LSL, LBW and LBL)²⁰.

Finally, the return series of the various factors were computed considering the continuous daily returns of each portfolio, using:

$$\text{HML} = \frac{1}{4} * [(\text{HSL}-\text{LSL}) + (\text{HSW}-\text{LSW}) + (\text{HBL}-\text{LBL}) + (\text{HBW}-\text{LBW})]; \quad [2]$$

$$\text{SMB} = \frac{1}{4} * [(\text{HSL}-\text{HBL}) + (\text{HSW}-\text{HBW}) + (\text{LSL}-\text{LBL}) + (\text{LSW}-\text{LBW})]; \quad [3]$$

$$\text{WML} = \frac{1}{4} * [(\text{HSW}-\text{HSL}) + (\text{HBW}-\text{HBL}) + (\text{LSW}-\text{LSL}) + (\text{LBW}-\text{LBL})]. \quad [4]$$

The return factors were calculated for quarterly and half-yearly rebalances. Quarterly portfolios were rebalanced at the end of March, June, September and December of each year, and half-yearly portfolios were rebalanced at the end of June and at the end of December. In order to ensure that the market knew the book-to-market ratio of each company, the data were used with at least a six months' time lag. That is, we used the book values obtained at the end of a given year after the 1st of July of the following year. Likewise, the values in the half-yearly accounts were used only as from 1st January of the following year. As for market value, the daily figures are instantly known and were used. The continuous return cumulated during the last 12 months was computed excluding the return of the most recent month in order to eliminate microstructure-associated problems (Asness (1995))²¹.

¹⁶ WML is the return of a portfolio that is long in stock winners and short in recent losers, holding constant the other two attributes (size and book).

¹⁷ The use of Fama and French (1993) method, that is, the independent ranking of stocks to create portfolios long in stocks of specific features and short in stocks of opposite features is not recommendable, if one refers to a small market like the Portuguese, insofar as it is difficult to separate out the effects of the several factors which generate returns.

¹⁸ For each company, when more than one listing line existed only stocks that conferred all the shareholder rights were used. Furthermore, no foreign asset was included in the the factors' assessment. By itself, this foreign asset would represent more than 40% of the MCO market value. In fact, BVLP is not the main market for this asset, and this asset registers reduced liquidity on the said market.

¹⁹ The book-to-market ratio was calculated by dividing the book value of each company by the respective market value. When available, the consolidated book value was used, to which minority interests were deducted; individual accounts were used only when consolidated accounts didn't exist. By turn, market value was always computed considering the total number of shares issued in order to avoid any possible bias due to the different privatisation phases, for example.

²⁰ In each sorting the different stocks were integrated in either grouping, depending on the stocks registering for the relevant variable a value above or below the median.

²¹ For instance, in June of year t returns were calculated for the period 1st June of (t-1) to 31st May of t.

The method used is different to the one used by Liew and Vassalou (2000) in two main aspects. These authors created three portfolios for each ‘sort’ (high, low and average) totalling 27 portfolios. Due to the reduced size of the Portuguese market, in our case, in the sorting process each group was divided into two, making a total of 8 portfolios. On the other hand, since this method has the disadvantage that results may depend on the order of the sorts, we did repeat the portfolio creation process 24 times with the necessary adaptations, changing the order of the sorts. We’ve also allowed different periods of rebalancing (quarterly and half-yearly), and two alternative weighting methods for each asset (“market value weight-MVW” and “equal weight-EW”). In addition, we calculated an overall average (C29) and 4 partial averages (C25, C26, C27 and C28). Table 2 shows these different criteria. Liew and Vassalou (2000) use one criterion only.

TABLE 2: RETURN-BASED FACTORS CRITERIA

	Rebalance Order	Rebalance Period	Wweighting
C1	B/M; MV; CCR	Quarterly	MVW
C2	B/M; MV; CCR	Quarterly	EW
C3	B/M; MV; CCR	Half-yearly	MVW
C4	B/M; MV; CCR	Half-yearly	EW
C5	B/M; CCR; MV	Quarterly	MVW
C6	B/M; CCR; MV	Quarterly	EW
C7	B/M; CCR; MV	Half-yearly	MVW
C8	B/M; CCR; MV	Half-yearly	EW
C9	MV; B/M; CCR	Quarterly	MVW
C10	MV; B/M; CCR	Quarterly	EW
C11	MV; B/M; CCR	Half-yearly	MVW
C12	MV; B/M; CCR	Half-yearly	EW
C13	MV; CCR; B/M	Quarterly	MVW
C14	MV; CCR; B/M	Quarterly	EW
C15	MV; CCR; B/M	Half-yearly	MVW
C16	MV; CCR; B/M	Half-yearly	EW
C17	CCR; B/M; MV	Quarterly	MVW
C18	CCR; B/M; MV	Quarterly	EW
C19	CCR; B/M; MV	Half-yearly	MVW
C20	CCR; B/M; MV	Half-yearly	EW
C21	CCR; MV; B/M	Quarterly	MVW
C22	CCR; MV; B/M	Quarterly	EW
C23	CCR; MV; B/M	Half-yearly	MVW
C24	CCR; MV; B/M	Half-yearly	EW
C25	average of C1, C5, C9, C13, C17 and C21		
C26	average of C2, C6, C10, C14, C18 and C22		
C27	average of C3, C7, C11, C15, C19 and C23		
C28	average of C4, C8, C12, C16, C20 and C24		
C29	average of C1 to 24		

B/M: *Book-to-market*

MV: *Market Value*

CCR: *Continuous cumulative return*

Our results allow us to conclude that there is greater consistency when one uses MVW portfolios²². The C1 criterion that was used by Liew and Vassalou (2000) originated some inconsistent results. Criteria C25 and C27 show an excellent consistency and are both equally capable of minimising the effect of the ordering criteria on the obtained estimates. Results reported in this paper refer to criterion C25, meaning that we opted for the quarterly rebalancing in order to obtain greater proximity with the daily periodicity rebalancing of the General PSI benchmark²³.

²² The MVW criterion determines the weight of each share according to its market value on the date of rebalancing – this weight is frozen until the date following rebalancing regardless of the fluctuation of the market value between two distinct rebalancing dates.

²³ Total return PSI20 Index was also used but results were very similar, and are not reported.

3.2 TWO-STEP REGRESSIONS

We used equation [1] for each of the respondent companies and for each questionnaire. The weekly average of the daily continuous returns was used as independent variable. The estimation period corresponds to the period between the reference date of the questionnaire and the reference date of the next questionnaire. For the 2001 questionnaire we used the reference date of this study (31 July 2001). Overall, we did estimate 154 equations, 60 relating to the first questionnaire, 44 the second and 50 the third.

We thus obtained estimates for the coefficients of equation [1]. In the second step, these estimates were used as dependent variables in other regressions. In this second round, the explanatory variables were the measures of compliance with CMVM's recommendations (G, G1, G2, G3, and G4) for each company and each questionnaire. Other explanatory variables were W, BM, CR12 and P20. W is the average monthly weight of the market value per share relative to the overall market value in the MCO of BVLP. For example, for the first questionnaire and a given share, W is the average market value of that share between 1 January 1999 and 31 March 2000, vis-à-vis the average MCO value for the same time period. This variable controls for the size of the society. BM controls for the book-to-market effect and is the average month-end value of the book-to-market ratio of each share. CR12 is the (12-month) cumulative²⁴ continuous return of the share, and controls for the 'momentum' effect.

Also included is a fourth control variable, P20, that takes on the value 1 if the share belongs to the PSI20 index at the date of the questionnaire in the first step regression, and 0 otherwise. The PSI20 index includes the 20 blue chips of the Portuguese stock market (and they are selected according to size and liquidity criteria)²⁵. This means that there is a high probability that the companies included on the PSI20 also show a high W value. Given the high relevance of a small number of companies in the total market value and the PSI20 market value, W does not, by itself, guarantee the attainment of a probable liquidity effect (or the distortion of the demand due to the asset being on the main Portuguese index)²⁶. Therefore, P20 is intended to capture the liquidity effect.

4. RISK ADJUSTED RETURNS

Equation [1] was estimated²⁷ as stated in section 3.2. From a statistical standpoint, results for questionnaires 1 and 2 are better than those for questionnaire 3. The PSI factor is significant in almost all questionnaire 1 and 2 regressions, and in the majority of the regressions of questionnaire 3. HML is statistically significant in 42% and 43% of the regressions in the first two questionnaires. WML is significant in 28% and 30% of the cases, and SMB in 40% and 34% in the first and second questionnaire, respectively. In the third questionnaire, these percentages decrease to 22%, 14% and 10% respectively for HML, WML and SMB. The 'January' effect is significant in 10% and 5% of the regressions for the first and second

²⁴ 12 months prior to the date of the regression for each share in the first step.

²⁵ From 1 July 2001 onwards, the free-float is the sole relevant selection criterion; the number of transactions and trade frequency are no longer relevant in the selection process.

²⁶ To give an idea of the liquidity concentration on the Portuguese market, as at 31 March 2001 the shares represented in the PSI20 index accounted for 52.5% of the MCO. This figure raises to 89.3% if we consider domestic shares only. By turn, the top-5 shares of PSI20 represent 2/3 of the index market value.

²⁷ Results are not reported.

questionnaire, and is not applicable in the third. Lastly, the estimates of parameter α are significant in 15%, 11% and 10% of the regressions, respectively²⁸.

Results of the second step regressions (with 154 observations) are in Table 3. Our estimates show the relevance of some corporate governance variables (and the corresponding CMVM recommendations) for the explanation of abnormal returns. Here, the fact that G4 has a positive effect on the α estimates is important. Apart from this variable, only CR12 e P20 show the capacity to explain the cross-section estimates of abnormal returns. G3 shows significance at a 15% level on two occasions.

TABLE 3: SECOND STEP REGRESSION RESULTS

Independent Term	Independent Variables										R ²
	G	G1	G2	G3	G4	W	BM	CR12	P20		
0,000375	-0,000521					0,009688	0,0000241	0,516798 *	-0,001047 ***		21,01%
0,000073		-0,000537	0,000972	-0,000569	0,001341 ****	0,008043	-0,0000507	0,510991 *	-0,001059 ***		24,07%
-0,000177		-0,00088	0,001076	-0,000541	0,001355 ****	0,001782	0,000169	0,563381 *			22,24%
0,000032		-0,000497	0,001117	-0,000566	0,001463 ***		-0,0000798	0,522918 *	-0,000740 ***		23,36%
-0,000099		-0,000100	0,001028	-0,00069 ****	0,001538 ****				-0,001162 **		7,69%
-0,000004		-0,00091	0,001064	-0,00056	0,001376 ****			0,556506 *			22,09%
-0,000199				-0,000578 ****	0,001433 ***			0,522854 *	-0,000758 *		22,51%

The dependent variable corresponds to the α coefficient estimates of equation [1], determined in the first-step regressions. The symbols *, **, *** and **** show statistical significance at the 1%, 5%, 10% and 15% level, respectively.

Also worthy of note is that neither the overall level of recommendation compliance (G), nor the level of compliance of group 1 (G1), nor the level of compliance of the second group of recommendations (G2), have any significant statistical effect on the performance of the analysed companies. We can therefore conclude that overall CMVM recommendations are not associated to any effect, be it positive or negative, on the abnormal returns of the different companies. In other words, although G4 reveals statistical significance, the various recommendation groups show opposite signs, evidencing that, on average, the global effect of those recommendations is negligible.

However, the White heteroskedasticity test does not allow us to accept the null hypothesis in table 3 regressions²⁹. Therefore, we shall not give special relevance to the statistical tests performed. The exception is the first regression (with G as overall indicator of governance), which does not exhibit heteroskedasticity.

Looking now at the individual recommendations (R_i), we try to find out which of them is relevant for the explanation of abnormal returns. In other words, (i) we did estimate 4 equations³⁰ in which we include W, BM, CR12 and P20 as control variables, as well as that group's individual R_i variables. We then selected the relevant explanatory variables in each equation: R4 and R7 in the first, R10 in the third, and R14 in the fourth equation. Moreover, (ii) we run another regression with all 13 individual R's and the four control variables. R4, R10, R12 and R14 revealed to be significant. Finally, (iii) we estimated 13 equations, each

²⁸ The 90% confidence level was used.

²⁹ Upon realising this, a finer analysis of our results allows us to conclude that the real problem is the definition of the G's more than true heteroskedasticity. In fact, the problem seems to rest on the equal weight attributed to each recommendation within each group.

³⁰ One for each group.

one of them including one corporate governance variable only. R4, R7, R10, R12 and R14 turned out significant³¹.

Results of our final estimations are in table 4. The explanatory variables were those selected in (i), (ii) and (iii), and the control variables W, BM, CR12 and P20. The White test did show no sign of heteroskedasticity. Our results confirm the statistical relevance of G3³². They also show that the positive effect of G4 is due to recommendation R14. Finally, recommendation R4 included in group G1 shows a negative effect on the abnormal return estimates.

TABLE 4: SECOND STEP REGRESSIONS WITH INDIVIDUAL RECOMMENDATIONS

Constant	Independent variables										R ²
	R4	R7	R10	R12	R14	W	BM	R12	P20		
0,00319 ***	-0,00256 **	-0,00157	-0,00175 ***	0,00140	0,00272 **	0,00992	0,00052	0,52426 ***	-0,00161		46,76%
0,00292 ***	-0,00252 **		-0,00204 **	0,00095	0,00281 **	0,00878	0,00044	0,46766 ****	-0,00232 ****		43,87%
0,00443 *	-0,00273 **	-0,00127	-0,00172 ***		0,00278 **	0,01129	0,00028	0,49925 ***	-0,00180		49,73%
0,00056			-0,00086 ***		0,00121 ***	0,00925	0,00011	0,54348 *	-0,00143 ***		25,82%
0,00061			0,00061 ***		0,00135 **		0,00007	0,55595 *	-0,00103 ***		25,09%

The dependent variable corresponds to the α coefficient estimates of equation [1], determined in the first-step regressions. The symbols *, **, *** and **** show statistical significance at the 1%, 5%, 10% and 15% level, respectively. The fourth and fifth regressions exclude R4; in fact, the first questionnaire did not include any question aimed at evaluating compliance with this recommendation. Excluding R4 thus increases the number of usable observations.

Group 2 results are not unexpected: neither recommendation exhibits any significant effect on firm performance. As shown in Table 1, only one company in the 2000 questionnaire and two companies in the 2001 questionnaire complied with recommendation R8; and 4 (1998), 5 (2000) and 6 (2001) companies showed compliance with R9. We can once again conclude that there is not enough differentiation in the companies of our sample regarding this group of recommendations.

This sample problem does not exist in G1. Owing to this, one will have to conclude upon the relevance of the results and observe the lack of performance differences between the companies that follow and those that do not follow 3 out of the 4 recommendations regarding information disclosure. In other words, investors do not seem to reward companies that disclose information. By the same token, they do not penalise them. This might be explained, we speculate, by two circumstances. On the one hand, investors resort to financial intermediaries and these may not require that the information be disclosed in order to know how corporate governance is carried out in each of the Portuguese companies. On the other hand, it is not costly to generate and disclose information.

This is not true for R4. This recommendation is related to information disclosure on dividend policy. It seems that investors do not like what they see, when they look at the announced dividend policy. In other words, investors seem not to penalise those societies that do not disclose information regarding the firm's dividend policy, but seem to penalise those that announce their policy³³.

³¹ Heteroskedasticity was not present in any of the (i), (ii) and (iii) regressions. These results are not reported.

³² G3 matches R10 exactly, for R10 is the only variable of this group.

³³ In future work it would be interesting to check whether this is a generalised effect or if the market distinguishes between different dividend policies.

It could also happen that investors may not take into account the informational aspects of corporate governance and therefore do not think it relevant. However, this hypothesis hardly coincides with the results obtained for G3 (R10), and particularly G4 (R14), since many aspects of the information referring to G1 is based on the disclosure of solutions related to the organisation and structure of the company (in G4). Thus, market does not seem to be indifferent to the essence, but only to the way and manner the information is disclosed. This being so, the interest of the first group of CMVM recommendations would only be investors' protection, particularly those investors that seem to have more difficulty in obtaining information from financial intermediaries³⁴, and those that do not have enough market power to penalise non-complying companies.

As previously explained, group G3 only controls the compliance of recommendation R10 on the *regulation of situations regarding conflicts of interest among members of the board and of the company*. Table 4 shows that this is a relevant variable. Therefore, there is evidence that companies that show less concern for the level of prevention and clarification of situations related to conflicts of interest among members of the board and the company show higher performances and vice-versa. Owing to the fact that this is somewhat unexpected, it is important to emphasise that this variable controls only one recommendation of the two that integrate the group, since none of the questionnaires quantifies the compliance or non-compliance of recommendation R11.

The most significant fact regarding corporate governance variables is the result for G4. This variable shows a positive sign in all table 3 regressions. The analysis of individual recommendations shows that the essential of this positive effect is due to R14. Among the 4 groups of CMVM recommendations, only G4 refers to recommendations on the organisational structure of the companies and the *modus operandi* of the board members. As seen in 2.1., one has included recommendations regarding the organisation of the board of directors and the executive commission, so that they represent the many interests of shareholders. Entailed in this group is the recommendation that the board of directors should include one or more independent members, so as to maximise the interests of the company. Our results regarding R14 indicate that companies that abided by the CMVM recommendation on the organisational structure and the manner of functioning of the board of directors show higher estimates for abnormal returns. However, the other recommendations included in G4 (R12, R13, and R16) do not exhibit any relevant effect, R12 showing a positive effect when we include all 13 recommendations as explanatory variables.

As depicted in the introductory part of the paper, there is the perception that the concerns on effectiveness and efficiency have not always presided the recommendations of supervisory authorities. Besides this and as previously mentioned, there are theories that defend the idea that the presence of independents members creates a negative relationship with the performance of the board of directors and consequently the company (Baysinger, Kosnik and Turk (1991), Porter (1992) and Zahra (1996)).

This result seems to indicate that even though performance concerns were not embodied by the CMVM at the time of the issue of its recommendations, these measures cannot be associated with abnormal negative performances. Quite to the contrary, there is indication of a positive association between the above-normal returns and the level of compliance of the

³⁴ Resorting only to bank reception desks, for example.

recommendation of that supervisory authority²⁶. On the other hand, it is true that we cannot consider R13 responsible for a negative and significant effect. It is also true that when the executive committee exists and operates according to the recommended terms the society tends to exhibit higher abnormal returns. On top of this, we have also noted a slightly positive relationship between R12 and the performance of the society.

The results in Tables 3 and 4 further allow us to conclude that accumulated returns are relevant in explaining the cross differences of the weekly abnormal returns notwithstanding the inclusion of the ‘momentum’ effect. All CR12 coefficient estimates are positive, meaning that abnormal returns are higher when the absolute returns are higher too. From here, one can conclude that companies with higher exposure to the different factors of return generation show higher abnormal returns²⁷.

Finally, it is important to note the relevance of variable P20. The P20 effect cannot be confused in this context with the size effect. Actually, when one repeats the regression and excludes W, P20 remains significant. On the other hand, the size effect was already accounted for upon the estimation of equation [1] in the first step²⁸. The P20 effect must therefore be interpreted as an ‘award’ that is required by investors so that they invest in less liquid companies. These variable coefficient estimates are all negative, meaning that, other things constant, being part of the PSI20 index creates loss of performance. Or, to be more accurate, not being in the PSI20 means, *ceteris paribus*, higher equilibrium returns in order to compensate lower liquidity characterising these stocks.

Table 5 (next page) allows us to understand how different is the exposure of companies to each cross differentiation factors. For each corporate governance variable (G, G1, G2, G3 and G4) we divided the 154 observations into two groupings. One grouping includes the observations with a compliance degree higher than the median³⁵. The other grouping included the remaining observations. As for G4 we also divided the 154 observations by way of putting on one side those compliant with all the four G4 recommendations and on the other the remaining companies.

Using the combined results of table 3 and the average value of the variables (G3, G4, R12 and P20) of each grouping into which the sample was divided (table 5), we defined the signs of the expected contribution from each factor for the differential in the abnormal return between compliant and non-compliant companies²⁹.

Results show that the different factors have opposing signs. For instance, if one divides the sample considering G4, either by using a criterion division of 100% compliance degree or of 75%, only variable G4 reacts in the direction of the compliant companies showing higher abnormal returns. To the contrary, G3, R12 and P20 react the opposite way. Being so, one still needs to assess which is the dominant effect³⁰.

²⁶ It is obvious that only part of the estimates of α were statistically different to zero, which aligns with the idea of market efficiency and with the conviction that the equilibrium model used is adequate in explaining returns. In any case and without prejudice to further studies, the statistical association is still significant.

²⁷ It need not be necessarily so, due to the fact that companies with lesser exposure to risk factors (lower normal return) have the higher abnormal returns.

²⁸ Therefore, it is not surprising that W is insignificant in tables 3 and 4.

³⁵ Or equal to the median, should it be higher than the average.

²⁹ It was considered that the expected direction was undefined (null value) if the difference between the average value of the various groupings would be less than 10%.

³⁰ However, this issue is not studied in this paper.

TABLE 5: EXPOSURE TO CROSS DIFFERENTIATION FACTORS

	G			G2			G4		
	G>=0,45	G<0,45		G2>=0,5	G2<0,5		G4=1	G4<1	
G3	0,7176	0,4058	<0	0,5263	0,5852	>0	0,8000	0,5625	<0
G4	0,6059	0,4203	>0	0,4868	0,5278	=0	1,0000	0,4896	>0
R12 x 100	-0,017	0,003	>0	-0,0261	-0,0058	<0	-0,0700	-0,0040	<0
P20	0,482	0,116	<0	0,4211	0,3037	<0	0,6000	0,2986	<0
	G1			G3			G4		
	G1>=0,5	G1<0,5		G3=1	G3<1		G4>=0,75	G4<0,75	
G3	0,6300	0,4815	<0	0,9889	0,0000	<0	0,7561	0,5133	<0
G4	0,5425	0,4861	>0	0,5444	0,4922	>0	0,8110	0,4181	>0
R12 x 100	-0,0060	-0,0125	>0	-0,0192	0,0071	<0	-0,0095	-0,0078	<0
P20	0,4500	0,0741	<0	0,3667	0,2500	<0	0,3902	0,2920	<0

Notes: (I) In each row, G3 and G4 represent the average value of the respective variable for each grouping in which the 154 observations were divided into; R12x100 corresponds to the average of the CR12 variable multiplied by 100 for each grouping; P20 is the average of the variable P20 for each grouping. (II) In column we identify the variable under which the 154 recommendations were divided into (G, G1, G2, G3 or G4) and the criterion divisions of the sample in each case. (III) The symbols >; <; =0 indicate the expected effect of each variable, using results from table 4 for the difference of abnormal return between portfolios of compliant and of non-compliant companies.

5. CONCLUSIONS

Some conclusions of undeniable relevance can be drawn from this study. One concludes, in the first place, that there is a positive relationship between compliance with CMVM recommendations on the *structure and functioning of the board of directors* and abnormal returns. This relationship, however, is mainly attributed to the compliance with recommendations on the executive committee. On top of this, it was possible to obtain a positive and significant association between estimated abnormal returns and recommendation R14, as well as with recommendation R12.

Another interesting result was obtained for R13, regarding independent directors: a negligible impact on the performance of the society. We have also found evidence of a negative relationship between G3 and the companies' performance. The disclosure of information regarding the society's dividend policy was also found negatively correlated with abnormal returns, suggesting that investors have not liked the information that companies have disclosed regarding these matters. Strengthening the robustness of our results, one is to note that our equilibrium model – depicted by equation [1] – is a complete model, controlling the returns' formation process through 5 factors.

Furthermore, this study demonstrates the existence of a “negative” premium, as regards abnormal return for companies that are part of the PSI20 index. This may stem from the fact that investors do not demand a liquidity premium to invest in such companies. Since there is a significant correlation between the compliance with CMVM's recommendations on the structure and functioning of the company's board of directors and the inclusion in the PSI20

²⁹ It was considered that the expected direction was undefined (null value) if the difference between the average value of the various groupings would be less than 10%.

³⁰ However, this issue is not studied in this paper.

index, this means that liquidity concurs towards the annulment of the abnormal returns coming from the organizational structure adopted. Hence, the investment in “better governed” stocks does not guarantee beforehand that positive abnormal returns are obtained.

We should finally note that it would be important to study the relationship between recommendation compliance and firm’s exposure to the different factors of return generation. It would be interesting to evaluate whether corporate governance effects are stronger than other return generating effects, originating profitable strategies for portfolio creation. This will be done in future studies. Finally, the disclosure of information regarding the dividend policy deserves future attention as well.

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