

Proving that good management pays

A new equity index created by M&E and BDO uses a unique set of management and business performance data to identify and weigh a selection of Hong Kong-listed companies. Based upon back data, the index provides impressive performance against the Hang Seng index. Richard Morrow reports.

Investors and index providers love to discuss the importance of good leadership, risk management and corporate governance to a company's prospects and its stock performance. Yet few existing equity indices make much effort to identify such qualities. Instead, most benchmarks focus on the largest and most liquid stocks, or tend to adopt an industry focus.

It's a gap that the new M&E BDO Asiamoney Stars Index aims to fill, at least in Hong Kong. This brand new stock index has been created as a means of ascertaining which companies listed in the city have the most responsible, transparent management in place.

The index uses existing publicly available data to identify which companies possess genuinely responsive, active management, and tracks these companies. The idea is to demonstrate that companies exhibiting such qualities tend to perform better and see their stock valuations outperform the broader market as a result.

William Cox, CEO of M&E, the data analysis company that created the index's rating methodology, says his decision to build it arose from the global financial crisis.

"During the crisis the credit rating agencies were criticised for failing to accurately analyse the asset quality or predict the insolvency of companies around the world," he says. "This led to efforts such as ours to quantify companies with the best management and put them into a portfolio to reward mid-term management performance."

The new index combines facets of both traditional stock indices and the more data-focused analysis of the credit rating agencies.

Cox says most stock indices tend to pre-screen the included stocks and later weigh them according to market capitalisation. In contrast the Stars

index weighs each company according to the value of its management and business process quality before adding a market cap weighting.

Equally the rating agencies focus on offering individual ratings based upon data on companies that they collect. But Cox says his analytical approach is based more upon calculation than decision-making.

"It's a matter of our analysis philosophy; each has strengths," he says. "Moody's and Standard & Poor's are very thorough in terms of collecting data, including inside data, but they then make decisions based upon that data at a very high level. We determine what publicly available data points to use and then make calculations based upon that data, so it's less likely to affect the overall result."

The purpose of these efforts is to offer investors a new stock index benchmark that they can use to track companies with strong management and business processes, and to incentivise companies listed in Hong Kong to improve their operations and transparency.

Both are targets that *Asiamoney* feels should be promoted to improve corporate governance and good corporate management in Hong Kong.

FINDING THE PERFORMERS

Creating an index based on corporate leadership and operations is not an easy undertaking. M&E has sifted through mounds of publicly available information provided by BDO to quantify the management and business processes of Hong Kong-listed companies.

Cox focuses on gaining data in four areas: verifying the compliance of the targeted companies with norms and good business practices; monitoring their performance in financial and business areas; analysing their business strategy; and considering the risks of their business.

All told M&E uses almost 350 data points to assess each company included in the index. Examples include revenues and profitability, declared statements about corporate governance and corporate sustainable responsibility. Companies that have insufficiently clear data or policy descriptions, or those that have no information available at all, are marked down.

Initially 17 companies have been included in the index. Cox says that deciding upon these stocks took some time.

"They were all pre-screened according to 40 knockdown criteria and ratios that we have, for their relatively financial validity compliance, practices, transparency," he says. "We looked at more than 30 leading companies that were considered market leaders."

The weightings of the companies are adjusted each month, according to whether the pertinent company information improves (or not), and then on changes to market cap.

THE STANDOUT STOCKS

Back-testing the M&E BDO Asiamoney Stars Index using historical data has led to some impressive performance. Its base index value outperformed the Hang Seng Index's (HSI) by a monthly median of 8.24% from the beginning of 2011 until the end of September 2012. It outperformed the HSI by 17% in September alone.

This back-testing has offered up some somewhat surprising results. Power Assets Holdings ranks as the most impressive company included in the index between January 1, 2011 and September 30, 2012, albeit by a very narrow margin. It is respectively followed by Swire Pacific, CLP

M&E BDO ASIAMONEY HONG KONG STARS INDEX

PARTICIPATING COMPANIES

Cathy Pacific Airways	293:HK
Cheung Kong Holdings	1:HK
China Life	2628:HK
China Mobile	941:HK
CLP Power	2:HK
Henderson Land Development	12:HK
Hong Kong Exchanges & Clearing	388:HK
HSBC	5:HK
Hutchison Whampoa	13:HK
Lenovo Group	992:HK
Manulife Financial Corp.	945:HK
MTR Corp.	66:HK
Power Assets Holdings	6:HK
Shangri-La Asia	69:HK
SmarTone Telecommunications Holdings	315:HK
Standard Chartered	2888:HK
Swire Pacific	19:HK
Wharf Holdings	4:HK

Power, Hong Kong Exchanges & Clearing (HKEx) and HSBC.

In fact, each of these companies has seen variable stock performance over the 21 months covered.

Power Assets' stock valuation has risen from HKD49.55 on January 4, 2011 to HKD65.85 on September 28, 2012. Despite coming second in the index Swire has done less well, falling from HKD116.96 to HKD95 over the time period. CLP Holdings' saw a small uptick from HKD63.60 to HKD65.90, HKEx's slid from HKD185.60 to HKD117.20 and HSBC's share valuation moved from HKD80.30 to HKD72.95.

Evidently a good ranking doesn't guarantee good stock performance over any set period of time. Instead Cox says the idea is to identify the characteristics of companies that possess good management and business processes, and thus will most likely outperform over extended periods of time.

RETROSPECTIVE STRENGTH

Cox can point to past performance to back up such assertions. M&E has already enjoyed some success in Brazil, where it has been running the M&E Latin Finance Brazil Stars Index in cooperation with *Asiamoney's* sister publication *Latin Finance* since 2009.

That index outperformed the Brazil's Ibovespa benchmark index by over 40% between January and September this year. Cox notes that the "management effect" tends to take some time to kick in, as the sustained benefits of better management and business processes accrue.

The Brazil Stars Index also features individual ratings of each company, to demonstrate which possess higher overall standards when it comes to management, operations and information disclosure.

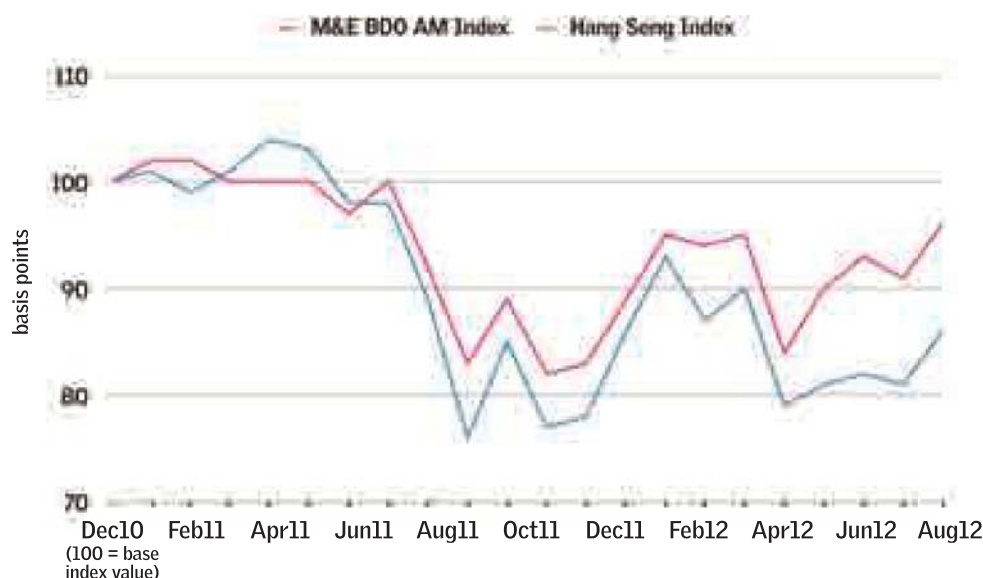
Cox says he chose to focus on Hong Kong's stock market due to a few factors. "It is a sophisticated stock market right in the heart of the Chinese realm, and it's a bridge between China and Western Europe in virtue of its British heritage," he says. The size of the stock market doesn't hurt either.

He adds that the relatively poor performance of the Hang Seng index has also offered an opportunity for a new approach. "In the past people could easily buy equities in Hong Kong and Shanghai and make money, but now you have to stock pick. The question is how best to do that. You have the conventional methods and our methods, and I hope that our approach will help serious investors stock picks."

PLANS TO COME

Cox intends to introduce individual ratings for the included companies in the Hong Kong index in terms of their respective management processes too. However this is likely to take place after six months, during which he and BDO intend to actively engage with the companies included in the index to have them provide more information and agree to a full onsite analysis of their information.

M&E BDO ASIAMONEY HONG KONG STARS INDEX vs HANG SENG INDEX (DEC 10 - SEP 12)



SOURCE: ASIAMONEY

While Cox declines to say how the companies in Hong Kong would rate today, he notes that all of them would currently rank lower than their counterparts in Brazil, which possess an average ranking of '82'. He notes that this is down to three major factors.

The first is, perhaps surprisingly, transparency. Put simply, the information disclosure of Brazilian companies is far superior to their counterparts in Hong Kong.

"Brazil has several big blue chips and when Lula [former president Luiz Inácio Lula da Silva] was elected [in 2003] he reformed the entire governance code, which has meant that companies have striven to be extremely transparent over the past five to seven years," Cox says. "Added to this most companies in Brazil have ADRs [American depositary receipts] listed on the New York Stock Exchange which means that they have to file SEC 20-F forms and meet Sarbanes Oxley requirements. That requires revealing a lot of financial data."

Listed companies in Hong Kong have not had to improve their information disclosure to as high a degree. Cox notes that information is often particularly lacking in the fields of corporate governance and corporate and social responsibility, where companies often offer little more than blandishments about their commitment to such values.

The second factor is the volatility of Hong Kong's stock market over the past three years. "There has been extreme volatility in the Hong Kong stock market in recent years, and the risk scores reflect that; they are three times as high as comparable companies in Brazil," Cox says. "The debt ratios and financing costs of companies in Hong Kong have soared one year and plunged the next, and those areas are related to asset quality, interest costs and top line revenue."

It will be interesting to see whether Hong Kong companies become more willing to divulge more information to the index in order to affect their eventual rankings, once they realise that this is being tracked. For the good of market clarity, it would be good for them to do so.

Every three months *Asiamoney* will publish the M&A BDO *Asiamoney* Stars Index's latest performance statistics, alongside analysis about updates and changes to the index. Expect to see the next update in our February edition. ▲