HOW MUCH BOARD TURNOVER IS BEST?

Additional commentary from Spencer Stuart

Decisions about board composition are nuanced and complex, influenced by a wide variety of factors. Our study of board turnover and corporate performance is meant to spark and inform discussion about board succession, not to prescribe specific targets.

Consensus is growing in support of the idea that the regular addition of new directors is good for the board and for the company. indeed, support for annual director elections and for increased transparency around director nominations suggests that some shareholders favor increased turnover. New board members, the thinking goes, bring fresh perspectives, challenge orthodoxy and ask previously unasked questions. Furthermore, by creating the conditions for non-disruptive renewal, boards can proactively shape themselves for anticipated market, technological and strategic shifts.

But what evidence is there that companies and shareholders actually benefit when new directors join a board? If they do benefit, how much turnover is desirable?

To explore these questions, Spencer Stuart and Equilar, which tracks and reports governance, executive compensation and individual director data, studied board turnover and shareholder returns for S&P 500 companies, examining the relationship between director additions and corporate performance over a 10-year period. Highlights from our findings, published in the April 2014 ***Harvard Business Review***, lend support to arguments in favor of board renewal and thoughtful board succession planning.

We found that a moderate amount of turnover correlates with higher shareholder returns. The data showed the following:

- Companies that added three or four directors over a three-year period outperformed their industry peers, suggesting an optimal amount of turnover.
- Most boards miss this optimal zone: In the study, board turnover fell outside it about two-thirds of the time.
- The worst performers tended to be companies with either no director changes at all in three years or five or more changes.

A deeper look at the study

Board composition and renewal have attracted greater attention in recent years. Boards themselves are considering how to promote ongoing renewal. Governance activists have pushed U.S. boards to eliminate classified structures and move to annual director elections and have become more vocal in questioning how director independence is defined. In light of the growing attention to the issue of board renewal, we embarked on a study of board turnover among S&P 500 companies, examining director additions and shareholder returns from 2003 to 2013.

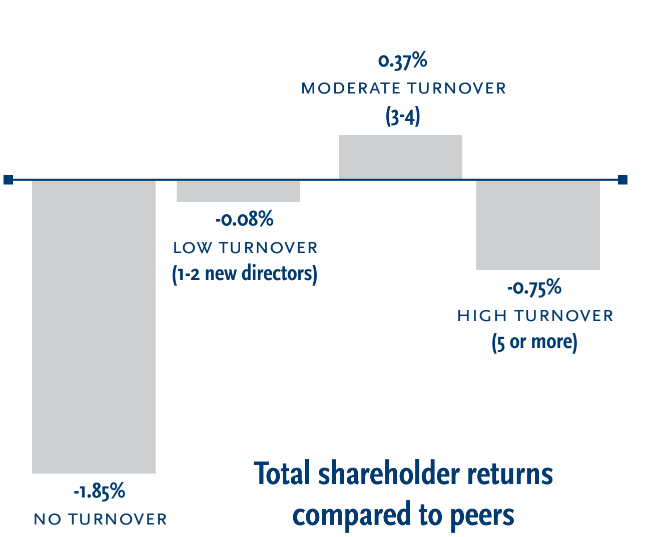
All together, turnover and performance data for 400 companies were analyzed. We excluded companies with unusually sized boards (fewer than four or more than 14 independent directors) as well as companies that experienced unusually large swings (a 50 percent or greater change) in total shareholder returns in a three-year period. We recorded approximately 50,000 director events and collected approximately 20,000 measures of performance. All the data were provided by Equilar and were derived from public filings.

Companies were grouped into four categories based on their turnover rate during rolling three-year periods: no turnover, low turnover (1-2 new directors), moderate turnover (3-4 new directors) and high turnover (5 or more new directors). For each group of companies that had a similar level of turnover in a given period, we assessed their total returns to investors relative to industry peers over a subsequent, multiyear period.

Boards that had moderate turnover — adding three to four directors over three years — consistently outperformed their peers, besting the industry total shareholder returns by 0.37 percent on average. By comparison, boards with no turnover or high turnover underperformed their industry peers, by 1.85 percent and 0.75 percent, respectively.

Some turnover is better than none

A HAPPY MEDIUM



Previous research has suggested that a high degree of director turnover correlates with poor company performance, and that is what we expected to find, too. And, in fact, companies in the high-turnover category — those that added five or more directors in a three-year period — underperformed the industry average more than those in the low-turnover and moderate-turnover categories. However, the worst-performing category on average was the group with no turnover over a three-year period; no turnover correlates with poorer performance than high turnover, our study found.

The majority of companies in the study experienced some turnover, but only one-third of the turnover we observed fell into the optimal zone of three to four new directors in a three-year period. The largest turnover category was the low-turnover group, which underperformed industry peers on average, but only modestly. In other words, many companies in many years of our study fell short of the optimal zone but not disastrously so. The two most commonly observed levels of turnover (1-2 and 3-4) showed the best performance and, combined, may represent a "safe" zone of sorts. More significant performance lags show up outside of this zone.

While the findings suggest that the positive effects of board renewal manifest themselves in better shareholder returns — and that the absence of renewal correlates with negative consequences for the company and its shareholders — this does not mean that a board that does not add directors for three years will necessarily perform poorly. There could be very good reasons why a board might not add directors in that time frame, such as a newly created board for a spin-off or new public company or a board that added several directors just outside the time frame.

What could be at stake?

A company's long-term shareholder return is, of course, influenced by many more factors than the strength of its governance practices and board composition, not the least of which are the company's management and strategy. But the correlation between board turnover and performance suggests that board composition and renewal are topics that boards and CEOs should not ignore.

Among the four groups, three-year relative total shareholder returns ranged from a negative 1.85 percent to a 0.37 percent gain: a 2.22 percent spread. A small movement in three-year relative total shareholder returns can yield significant creation or destruction of shareholder value. To illustrate, consider a hypothetical S&P 500 company with a market capitalization of $15 billion that performed according to the average levels found in the study: The difference between being in the "no turnover" group and the "moderate turnover" group would equate to roughly $1 billion in additional shareholder value creation in a three-year period.

Takeaways for boards

A board's effectiveness — and its contribution to company performance — is a function of a variety of factors, including composition, culture, processes and leadership. Furthermore, the strength of a company's governance and board leadership is just one of many contributors to a company's long-term shareholder return. Decisions that boards and CEOs make about board composition are nuanced, and influenced or affected by many factors, including director retirements, planned board succession, activist shareholder intervention, mergers and acquisitions, leadership transitions and others.

While the findings suggest that a modest amount of turnover is a characteristic of the leadership and governance behaviors that drive shareholder value over time, we are not making the case with this study that boards should manage turnover to a specific target or that adding a new director will cause corporate governance to improve. There are compelling reasons why boards choose to add a new director or not, and these reasons are not revealed by the numerical data. We believe board renewal can improve a board's effectiveness, but caution against viewing the findings as prescribing a specific level of turnover; this research shows correlation, not causation. We don't assume that specific levels of turnover — or any turnover — will lead directly to performance gains.

However, the correlation between a healthy level of turnover and strong corporate performance suggests that, if they haven't already, boards and CEOs may want to include board turnover and succession planning on their governance agenda, for example:

- In reviewing these findings, boards may want to understand their board's rate of turnover and how it compares to the optimal rate, and consider the reasons why. Chairmen and CEOs may want to ensure that turnover is on the board's agenda and discussed by the full board periodically.
- When the turnover rate falls outside the optimal zone, boards will want to satisfy themselves about the reasons why — and be prepared to communicate them to investors, who may increasingly consider board turnover as one of the many variables they use in assessing the quality of a company's governance and leadership.
- Boards should reflect on their level of turnover when making decisions that could impact turnover, such as extending the mandatory retirement age, considering term limits or changing the size of the board.

Board composition and succession planning will likely remain important governance topics for some time to come. While the findings of this study suggest that board turnover should be part of the conversation, it also is important to recognize what this study does not reveal. For example, many boards look for specific profiles when adding new directors — former or active CEOs, executives with digital expertise, candidates with diverse backgrounds and financial experts, to name just a few. Do these individual attributes contribute more or less to performance outcomes? We did not attempt to analyze how certain types of individual director changes, within a given turnover range, may correlate with better performance.

Conclusion

Having an engaged board of directors with diverse and relevant expertise can be a powerful asset to management and the company. Natural director turnover from director retirements or departures can provide opportunities to refresh the board with new and needed skills and increase the diversity of perspectives on the board. The findings from our research showing a correlation between turnover and company performance suggest that boards and nominating committees may want to be more proactive in evaluating their board turnover and thoughtfully planning for board succession.

About the authors

George Anderson is a member of the firm's North American Board Practice. **Julie Hembrock Daum** leads the North American Board Practice and serves on the board of directors of Spencer Stuart. **Noah Shamosh**, a Spencer Stuart consultant, specializes in executive assessment, leadership development and organizational design and strategy.

About Spencer Stuart

Spencer Stuart is one of the world's leading executive search firms. Privately held since 1956, Spencer Stuart applies its extensive knowledge of industries, functions and talent to advise select clients — ranging from major multinationals to emerging companies to nonprofit organizations — and address their leadership requirements. Through 55 offices in 30 countries and a broad range of practice groups, Spencer Stuart consultants focus on senior-level executive search, board director appointments, succession planning and in-depth senior executive management assessments.

Spencer Stuart Board Services

The premier firm for board counsel and recruitment, Spencer Stuart conducts well over half of all director assignments handled through executive search. For more than 25 years, our Board Practice has helped boards around the world identify and recruit independent directors and provided advice to chairmen, CEOs and nominating committees on important governance issues. In the past year alone, we have conducted more than 400 director searches. We are the firm of choice for both leading multinationals and smaller organizations, conducting more than one-third of our assignments for companies with revenues under $1 billion.

Social Media @ Spencer Stuart

Stay up to date on the trends and topics that are relevant to your business and career.

@SpencerStuView

Amsterdam
Atlanta
Barcelona
Beijing
Bogota
Boston
Brussels
Budapest
Buenos Aires
Calgary
Chicago
Copenhagen
Dallas
Dubai
Frankfurt
Geneva
Hong Kong
Houston
Istanbul
Johannesburg
London
Los Angeles
Madrid
Melbourne
Mexico City
Miami
Milan
Minneapolis/St. Paul
Montreal
Moscow
Mumbai
Munich
New Delhi
New York
Orange County
Paris
Philadelphia
Prague
Rome
San Francisco
Santiago
Sao Paulo
Seattle
Shanghai
Silicon Valley
Singapore
Stamford
Stockholm
Sydney
Tokyo
Toronto
Vienna
Warsaw
Washington, D.C.
Zurich