Corporate Governance and Stock Returns in Istanbul Stock Exchange

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This paper investigates whether good corporate governance leads to higher common stock returns in Istanbul Stock Exchange (ISE) or not. We examine the case of Turkish firms using an investment strategy that holds only the firms listed in Extended ISE Corporate Governance Index (CGI) over the period August 2005 – July 2010. In order to adjust for market risk, market model time series regression analysis is conducted. We find that Extended ISE CGI (the portfolio of well-governed firms) underperforms ISE All Index (benchmark portfolio). This result shows that an investor who prefers an investment strategy that holds only the firms listed in ISE CGI over the period August 2005 – July 2010 cannot earn abnormal returns. This is consistent with efficient capital markets hypothesis.

INTRODUCTION

After corporate scandals such as Enron and WorldCom in the United States (the US), and Marconi, Parmalat, and Royal Ahold in European Union (EU) countries corporate governance has received a lot of attention in the financial community. According to the OECD definition, corporate governance is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return. Corporate governance ensures that stakeholders have sufficient, reliable, timely, comprehensible, cost-effective and detail information to follow the company's stock return and operating performance. Good corporate governance implications have some advantages both for companies and countries. Good corporate governance is the key to the integrity of corporations, financial institutions and markets, and central to the health of our economies and their stability. In addition to that, companies practicing good corporate governance principles have lower cost of capital because of sufficient information disclosure, they have better financial capabilities and liquidity, and also the probability of the exclusion from the capital markets is lower for the companies implementing good corporate governance.

The concept and implementation of corporate governance is relatively new in Turkey. Capital Markets Board of Turkey (CMB) published CMB Principles of Corporate Governance in 2003 based on Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance. In addition to the principles, Istanbul Stock Exchange (ISE) started to calculate ISE Corporate

Governance Index (CGI) in 2007. ISE CGI aims to measure the price and return performances of ISE-listed companies with a corporate rating of minimum 6 over 10.

Recently some empirical evidence points out the relationship between corporate governance and stock returns. In their pioneering study, Gompers et al. (2003) demonstrate that an investment strategy that bought the firms in the lowest decile of the index (strongest shareholder rights) and sold the firms in the highest decile of the index (weakest shareholder rights) would have earned abnormal returns of 8.5 per cent per year during the sample period. In their empirical research, Drobetz et al. (2004) also find that trading strategies from sorts on governance index values generate abnormal returns. These findings are not consistent with efficient capital markets. On the other hand, Bauer et al. (2004), Core et al. (2006) and Aman, Nguyen (2008), demonstrate that risk-adjusted returns are insignificant across governance-based portfolios.

In this paper, we analyze whether good corporate governance leads to higher common stock returns in ISE or not. We examine the case of Turkish firms using an investment strategy that holds only the firms listed in Extended ISE Corporate Governance Index (CGI) over the period August 2005 – July 2010. We also analyze whether the firms listed in Extended ISE CGI can gain higher equity returns (abnormal returns) after adjusting for the market model. This paper can be summarized as follows. In introduction section, we explain the corporate governance concept and its applications in Istanbul Stock Exchange. We review the literature studying the relationship between the corporate governance and stock returns. In next section, we construct our data set and explain our research methodology. We conduct our analysis and the results of the research are stated. We use Extended ISE CGI as a high governance-based portfolio and analyze the performance of this index with market model by conducting time series regression analysis. After adjusting for market risk factor, we demonstrate whether abnormal return becomes significant for high governance-based portfolio in ISE over the period August 2005 – July 2010. In last section, conclusions of our research are drawn and the implications of the results for investors are discussed.

A BRIEF OVERVIEW OF CORPORATE GOVERNANCE

In the accounting and finance literature, particularly in the US, an agency theory perspective is commonly used to explain the concept of corporate governance (CG) (Kalbers, 2009, p.193). According to Shleifer and Vishny (1997), corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997, p.737).

A broader definition would be to define corporate governance as a set of mechanisms through which firms operate when ownership is separated from management. Corporate Governance (CG) is the system by which companies are directed and controlled (Claessens, 2006, p.4).

In practice there are four principles of good corporate governance, which are: Transparency, accountability, responsibility and fairness. CG principles are important for a firm but the real issue is concerned with what corporate governance actually is. CG is concerned with creating a balance between the economic and social goals of a company including such aspects as the efficient use of resources, accountability in the use of its power, and the behavior of the corporation in its social environment (Aras and Crowther, 2009).

Corporate governance has been on the agenda for a long time around the World. Increasing research interest has occurred not only in the US where the subject is well established as a significant focus of business research, but also there is growing interest across Europe and developing countries. Turkey is no exception with a growing interest in corporate governance from academics, business circles, policymakers and regulators and with recent government initiatives to improve corporate accountability and control in the financial sector (Ararat and Ugur, 2003, p.71).

Good corporate governance leads to better company performance, higher profitability and efficiency. In other words, good CG is largely correlated with better operating performance and market valuation of companies. The aim of CG principles is to increase both shareholder value and satisfaction of other stakeholders. Achievement of this aim is largely linked with the development of capital markets in which the CG principles are understood by both investors and shareholders (Arsoy and Crowther, 2008). 2007

World Bank Report identifies points for implementation of corporate governance in extensively differing regimes, and political, economic and social environments. The major elements of corporate governance are defined as competitive markets, financial discipline and well-regulated and liquid security markets (World Bank Corporate Governance Report, 2007).

Corporate governance is concerned with the relationships among management of a business, its board of directors, its shareholders and lenders, and its other stakeholders. Good CG follows principles that can vary significantly among countries, and are currently the subject of various initiatives designed to achieve agreement on an acceptable framework of basic standards in which a central role is attributed to the OECD's Principles of Corporate Governance. Implementation of good corporate governance requires satisfactory performance on the part of several different parties from both the private and public sectors (Cornford, 2006, p.26-27).

Corporate governance has recently received more attention because of lots of scandals and crises. Recent corporate scandals in the US and elsewhere (Enron, Arthur Andersen, Worldcom, Tyco International in the US; Parmalat and Cirio in Italy; Daiwoo Group in Korea; Allied Irish Bank, US/Ireland, Nortel in Canada etc.) have led to a wide-ranging re-examination of standards for corporate governance with repercussions that extend also to financial regulation (Cornford, 2006, p.19). Corporate scandals have forced politicians, financial authorities, and supranational organizations to search for more effective governance practices. Governance practices reflect, in fact, differences in culture, traditional financing options, corporate ownership patterns, and legal origin (Zattoni and Cuomo, 2008).

CORPORATE GOVERNANCE IN TURKEY

Due to the current efforts of Turkey trying to become a member of EU, the recent global scandals of large corporations in the most developed markets of the world, the competition of emerging markets to attract global foreign direct investment, corporate governance is the "hot" topic in Turkey. Corporate governance models can vary according to the system of corporate ownership and management control mechanisms prevailing in a country. In Turkey, a market-oriented corporate governance and control system cannot be said to exist, since the flotation ratios of listed companies and share dispersion levels are low (Okutan, 2007). According to Ararat and Ugur (2003), Turkey's investment environment is quite slimy for the investors. Low liquidity, high volatility, high cost of capital and limited new capital formation are the characteristics of the Turkish capital market. Shortcomings in the legal and regulatory framework contribute substantially to the risks of investing in equity markets in Turkey (Ararat and Ugur, 2003).

Turkey has developed its own corporate governance code in 2003. Turkey still needs to have good corporate governance practices in order to attract and retain the capital it needs for investment and economic growth. Hence, Turkey has adopted many regulations, especially for the listed companies majority of which are controlled by a single family as the controlling shareholder (Altintas et al. 2007).

There are two types of corporate governance model namely Anglo-Saxon Model (such as United Kingdom and the United States) and Continental European Model. In the Anglo-Saxon Model, the objective of the corporation is maximization of shareholder value. On the other hand, in the Continental European Model, shareholder value has secondary importance. Their approach is labeled as the stakeholder model of CG. There have been some differences and similarities between Turkish CG Model and Anglo-Saxon and/or Continental European Model. The Turkish CG Model is that a hybrid case whereby ISE firms display important similarities and differences with both systems (Tuzcu and Fikirkoca, 2005).

In Turkish finance literature corporate governance has become an increasingly important issue. Numerous scholars are working on CG structure. Here are some examples of work on this issue. Altintas et al. (2007) focus on monitoring information related to corporate social responsibility of Turkish listed companies in ISE-30 Index between 2003 and 2005. The research's framework is composed of three categories; corporate governance, environmental policy, and social policy. The results disclose that the

majority of the companies in ISE-30 Index positively commit themselves to adhering to the Corporate Governance Principles (Altintas et al., 2007).

According to Yurtoglu (2003), overwhelming majority of Turkish publicly listed companies are ultimately owned and controlled by families who organize a large number of companies under a pyramidal ownership structure or through a complicated web of inter-corporate equity linkages (Yurtoglu, 2003, p.16).

A corporate governance issue, emerging from the Turkish system, seems to be weaknesses in minority shareholder rights, although new measures are being taken, including the adoption of new corporate governance rules of best practice (Demirag and Solomon, 2003, p.4). As La Porta et al. (2000) report, in many countries, expropriation of minority shareholders and creditors by the controlling shareholders is extensive. (La Porta et al., 2000, p.27) Turkey is among those countries. Procedures for minority shareholders to voice their views are extremely limited and, as with many countries around the world, lessening the divide between majority and minority shareholder rights is an essential step towards improving corporate governance standards. Furthermore, such improvements in minority shareholder rights are required in order to prevent expropriation of minority shareholder wealth by majority shareholders through abuse of power and concentration. Indeed, better protection of minority shareholders has been found to be significantly associated with higher corporate valuation (La Porta et al., 2002, p.1147).

Kahyaoglu and Bozkus (2010) investigate the relationship between stock return asymmetries, i.e. stock market return volatility and corporate governance by using the data of selected companies listed on Istanbul Stock Exchange (ISE) and they test the hypothesis whether there is a correlation between the quality of corporate governance, concentration of ownership and the positive skewness of ISE listed company returns. The authors find that there is a relation between stock market return volatility and the quality of corporate governance both at the firm level and market level in Istanbul Stock Exchange.

Durukan et al. (2006) examine the data on the nonfinancial firms listed in Istanbul Stock Exchange (ISE) during the period 1993-2003. In this study, the authors use three different measures of earnings in the analysis. Earnings before tax come out to be the major measure. The authors' findings show that Turkish corporate governance system is not ineffective, but this evidence on its own cannot be interpreted as it being effective. The CEOs in Turkey are evaluated based on the accounting based measures mainly the pretax income figure which may be the reflection of a corporate governance system.

Bektas and Kaymak (2009) examine the relation among performance, board attributes, and ownership issues in Turkish banks, they regress return on assets (ROA) on several independent variables. They find that there is a significant linear relationship between board composition and performance. This variable has a negative and statistically significant value at 5% significance level. In other words, there are dominant shareholders who appoint small boards. To be successful, a bank may appoint a majority of insiders to establish better informal contacts with the environments or may choose a board made up of outsiders to better adapt to the formal governance system. On the other hand, the authors' results suggest that concentrated ownership is generally not preferred, and their finding supports the use of concentrated ownership, as it reduces the negative implications of tenure on bank performance.

THE EMPIRICAL LITERATURE REVIEW

The empirical literature related with corporate governance can be structured along three lines. These are the research on the relationship between stock returns and corporate governance, the empirical research on the association between firm value and corporate governance and the research examining the impact of corporate governance on firm performance. In this paper, the research area is only limited to the relationship between stock returns and corporate governance. Other two research areas are not within the scope of this paper.

Gompers et al. (2003) in their pioneering research use the incidence of 24 governance rules and construct their governance index for 1.500 large firms during the 1990s. They also construct two main portfolios according to this governance index; these are the dictatorship portfolio including firms in the

highest decile of the index and the democracy portfolio including firms in the lowest decile of the index. Democracy portfolio has the lowest management power or the strongest shareholder rights, while dictatorship portfolio has the highest management power or the weakest shareholder rights. Subsequently, they examine the performance of an investment strategy that is buying shares in democracy portfolio and short selling shares in dictatorship portfolio. This long-short investment strategy earns an average annual return of about 8.5 per cent after adjusting portfolio returns for risk factors with Carhart (1997) model.

Drobetz et al. (2004) examine the impact of corporate governance on stock returns over the period 1998-2002 in Germany. They construct a broad corporate governance rating (CGR) for German public firms. They use the Fama-French three factor model for risk factors and conduct time series regression analysis. As a result of this study, an investment strategy that is buying high-CGR firms and short selling low-CGR firms earns abnormal returns of around 12 per cent on annual basis during the sample period.

Bauer et al. (2004) analyze whether good governance leads to higher equity returns in Europe or not. They use Deminor Corporate Governance Ratings for companies included in the FTSE Eurotop 300 Index and follow the approach of Gompers et al. (2003). They examine the performance of an investment strategy that is buying shares in good governance portfolio and short selling shares in bad governance portfolio. They analyze both the United Kingdom sample and European Monetary Union sample and employ Carhart (1997) four-factor model for risk factors. As a result of this study, the performance differential between the good governance and the bad governance portfolios is found as 6.83 per cent annually. The regression constants (alpha values) are consistently positive, though they are statistically insignificant at the 5 per cent level. This shows that good governance does not lead to higher equity returns in UK and Europe.

Cremers and Nair (2005) investigate how internal governance mechanisms (shareholder activism) interact with external governance mechanisms (market for corporate control). The proxies for internal governance used are the percentage of share ownership by public pension funds and the percentage of share ownership by the largest blockholder. They find that an investment strategy that is buying stocks with high takeover vulnerability and high public pension fund (blockholder) ownership and short selling stocks with low takeover vulnerability and high public pension fund (blockholder) ownership generates an annualized abnormal return of 10 to 15 per cent on which proxy is used for internal governance. On the other hand, they find that an investment strategy that is buying stocks with high takeover vulnerability and low public pension fund (blockholder) ownership and short selling stocks with low takeover vulnerability and low public pension fund (blockholder) ownership does not generate any statistically significant abnormal return.

Aman and Nguyen (2008) investigate the case of Japanese firms using their own governance index. They use the index to form five portfolios and analyze monthly returns of these portfolios over the period 2000-2005. They find that risk-adjusted returns are insignificant across all five governance-based portfolios. This result shows that there is no relationship between stock returns and corporate governance in Japan.

Johnson et al. (2009) reexamine Gompers, Ishii, and Metrick's (2003) findings of significant long-term abnormal returns for firms sorted on governance index values. They show that the industry distributions of democracy firms and dictatorship firms differ statistically and economically from each other, and from the population of firms. Using one thousand biased random samples of hedge portfolios with governance-neutral nonevent firms (non-dictators minus non-democracies), they find that adjusting returns by their respective Fama and French (1997) 48-industry median returns over rejects the null hypothesis of zero abnormal returns. In contrast, tests based on three-digit SIC industry-adjusted returns are well specified. An approach that adjusts returns based on industry and characteristics –size, book-to-market, and momentum– is also well specified. Using either of the well-specified methods, they find statistically zero long term abnormal returns for event-firm hedge portfolios (long democracies and short dictatorships).

Cremers and Ferrell (2009) examine the association between corporate governance and abnormal stock returns for the period 1978-2007. They construct a corporate governance database consisting of a large sample of firms starting in 1978. For the thirty years period, they find strongly statistically significant abnormal returns using the Carhart (1997) four-factor model associated with going long good governance

corporate firms and shorting those with poor governance. They use both value-weighted and equally-weighted portfolios and the result is not different. They document that there is a statistically significant relationship between good corporate governance and positive abnormal stock returns. However, it is stated that this relationship has been weakening especially over the period 1990-2007 and this is the result of market efficiency.

Comparison of findings from these studies shows that there is no such a certain relationship between good corporate governance and positive abnormal stock returns. The relationship between corporate governance and stock returns can be changed as the sample, country or risk factor model differs. Although there are lots of researches on corporate governance in ISE, there is no empirical research on which the relationship between good corporate governance and positive abnormal stock returns in ISE is examined. This study aims to fill this gap.

DATA DESCRIPTION

There is no detailed corporate governance ratings database for all the firms listed in Istanbul Stock Exchange. Because of this reason, we cannot construct two main portfolios (a portfolio consisting of well-governed firms and a portfolio consisting of poorly governed firms) based on a corporate governance ratings database. However, there is an Istanbul Stock Exchange Corporate Governance Index (ISE CGI) in which companies applying Corporate Governance Principles are included. ISE CGI aims to measure the price and return performances of ISE-listed companies with a corporate governance rating of minimum 6 over 10. The corporate governance rating is determined by the rating institutions incorporated by Capital Market Board in its list of rating agencies as a result of their assessment of the company's compliance with the corporate governance principles as a whole. Calculation of the Corporate Governance Index started on 31.08.2007 after the Exchange was notified of 5 companies with Corporate Governance Rating of minimum 6 over 10. For companies included in ISE Corporate Governance Index, there is an annual listing/registration fee advantage.

In our study, we use ISE Corporate Governance Index as a portfolio consisting of well-governed firms. However, the main drawback is that the ISE CGI started at the end of August of 2007 and the time period over August of 2007 to July of 2010 is very limited. In order to overcome this drawback, following Bauer et al. (2004) we extend our analysis backwards, assuming that corporate governance ratings are constant for a limited number of months only for the first 5 companies which are included in ISE CGI at the beginning of the index. Firstly, we construct a portfolio consisting of these 5 companies as a well-governed portfolio and then we measure the performance of this portfolio over the period August of 2005 to September of 2007. After that, we combine monthly returns of both extended portfolio and ISE CGI. By doing so, we have a new dataset covering 60 months to measure the performance of a well-governed portfolio which is called as Extended ISE CGI. This approach seems reasonable. On the other hand, we use ISE All Index as a benchmark portfolio while comparing the performance of Extended ISE CGI. ISE All Index is comprised of the stocks traded on National Market except investment trusts. The financial data used in our analysis is obtained from Istanbul Stock Exchange database.

EMPIRICAL ANALYSIS AND RESULTS

To analyze the relationship between stock returns and good corporate governance, we measure the performance of value-weighted corporate governance portfolio (Extended ISE CGI) consisting of well-governed firms listed in ISE CGI. We also analyze whether there is any difference between Extended ISE CGI and ISE All Index in terms of their stock returns. Monthly returns of Extended ISE CGI and ISE All Index are value-weighted. Calculations of monthly returns of extended portfolio depend on the principle that portfolio is value-weighted and the weights are updated at the end of each month using the firms' monthly market values. Monthly ISE CGI and ISE All Index returns and monthly stock returns of the extended portfolio are obtained from Istanbul Stock Exchange database.

We adjust the monthly returns of Extended ISE CGI portfolio according to the Market Model. Market Model was developed by Black, Jensen and Scholes (1972) and has been using widely both in literature and practice for performance measurement. The time series regression with the market model is stated in Figure 1.

FIGURE 1
MARKET MODEL EQUATION

$$r_{i,t} - r_{f,t} = \alpha_i + \beta_i (r_{m,t} - r_{f,t}) + \varepsilon_{i,t}$$

$[r_{m,t} - r_{f,t}]$ is the market's excess return over the risk-free rate. We calculate the market returns ($r_{m,t}$) as the monthly returns of ISE All Index, because this index includes almost all stocks in Turkish equity market. The risk-free rate ($r_{f,t}$) is the rate on treasury bills with the shortest maturity. The difference $[r_{m,t} - r_{f,t}]$ measures the return on a zero-investment portfolio financed at the risk-free rate and fully invested in the market portfolio. $[r_{i,t} - r_{f,t}]$ is Extended ISE CGI portfolio's excess return over the risk-free rate. The intercept term α_i is supposed to capture the abnormal return unexplained by exposure to market risk factor. The slope β_i is the only systematic risk factor beta coefficient. $\varepsilon_{i,t}$ stands for residuals.

Normal distribution, nonexistence of both autocorrelation and heteroscedasticity assumptions for residuals and stationary assumption of time series must be tested in order to use time series regression analysis.

TABLE 1
JARQUE – BERA NORMALITY TEST RESULTS

Observations (Residuals)	Sample Period	Jarque-Bera
60	2005/08 – 2010/07	0.2754 *(0.8714)*
The exact *p* value is reported in parenthesis.		

Normal distribution is tested with Jarque-Bera Normality Test for residuals as stated in Table 1. With 0.2754 Jarque-Bera and 0.8714 probability values, residuals are normally distributed. Durbin-Watson d statistic is used for detecting serial correlation. Critical Durbin-Watson d statistics at significance points of d_L and d_U at 5% level of significance are 1.549 and 1.616 respectively. Time series regression result, with 1.9085 Durbin-Watson statistics, shows that there is no serial correlation or autocorrelation among residuals.

TABLE 2
WHITE HETEROSCEDASTICITY TEST RESULTS

Observations (Residuals^2)	Sample Period	F-statistic	Obs*R-squared	Scaled explained SS
60	2005/08 – 2010/07	0.3505 *(0.7059)*	0.7288 *(0.6946)*	1.1213 *(0.5708)*
The exact *p* values are reported in parenthesis.				

Homoscedasticity is tested with the White Heteroscedasticity Test as stated in Table 2. As a result of White Heteroscedasticity Test, observation multiplied with R^2 value is found as 0.7288 and probability value is found as 0.6946. According to the test results, homoscedasticity assumption cannot be rejected.

TABLE 3
AUGMENTED DICKEY – FULLER TEST RESULTS (Constant and Linear Trend)

Portfolios	Extended ISE CGI	ISE All Index
Augmented Dickey Fuller test statistic	-6.3817 *(0.0000)*	-7.0410 *(0.0000)*
Test Critical Values		
1% Level	-4.121303	
5% Level	-3.487845	
10% Level	-3.172314	
MacKinnon (1996) one-sided *p* values are reported in parenthesis.		

Lastly, stationary assumption of time series is tested with Augmented Dickey-Fuller Test as stated in Table 3. Test results show that both Extended ISE CGI and ISE All Index's excess return time series do not have a unit root. After the basic assumptions of time series regression analysis are tested, we conduct time series regression analysis on Extended ISE CGI's excess returns (dependent variable) and ISE All Index's excess returns (independent variable) as stated in Table 4.

TABLE 4
DESCRIPTIVE STATISTICS AND PERFORMANCE ATTRIBUTION REGRESSION RESULTS

PANEL A: DESCRIPTIVE STATISTICS OF MONTHLY RETURNS (AUGUST 2005 – JULY 2010)

Portfolios	Mean	Standard Deviation	Minimum	Maximum
Extended ISE CGI	1.58%	0.0962	-18.24%	20.92%
ISE All Index	1.84%	0.0923	-22.44%	22.12%

PANEL B: DESCRIPTIVE STATISTICS OF MONTHLY EXCESS RETURNS (AUGUST 2005 – JULY 2010)

Portfolio	Mean	Standard Deviation	Minimum	Maximum
Extended ISE CGI	0.32%	0.0974	-20.02%	19.75%
ISE All Index	0.59%	0.0933	-24.22%	20.95%

PANEL C: PERFORMANCE ATTRIBUTION REGRESSION FOR EXTENDED ISE CGI PORTFOLIO (AUGUST 2005 – JULY 2010)

$$r_{i,t} - r_{f,t} = \alpha_i + \beta_i (r_{m,t} - r_{f,t}) + \varepsilon_{i,t}$$

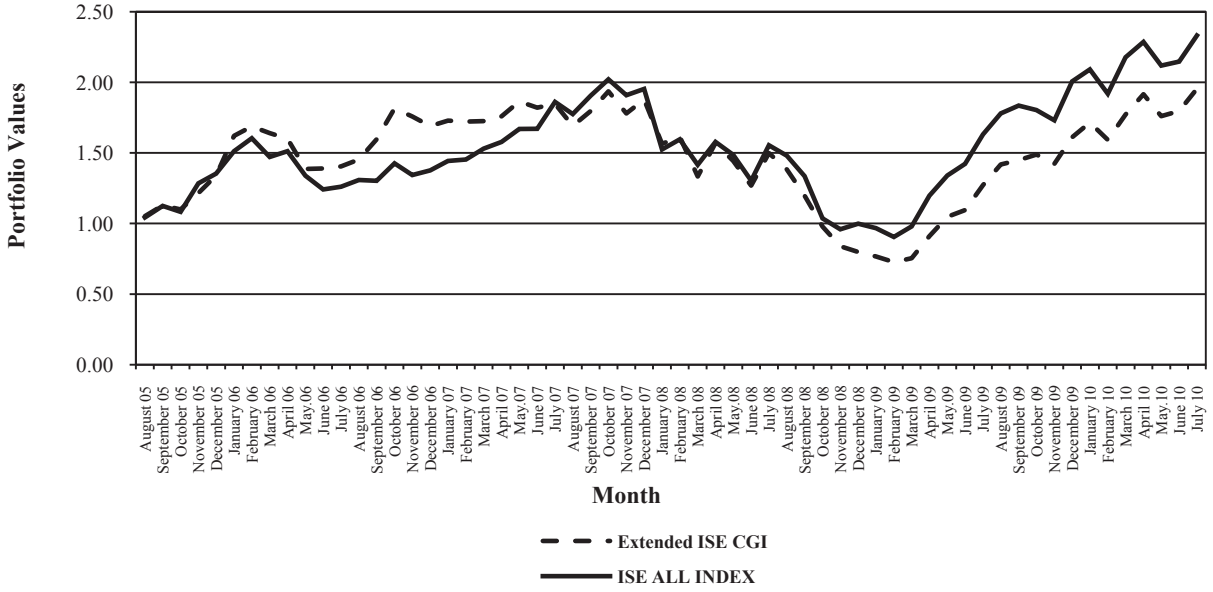
Variable	Coefficient	Std. Error	t-Statistic
$\alpha_{\text{Extended ISE CGI}}$	-0.0024 *(0.6628)*	0.0054	-0.4382
$\beta_{\text{Extended ISE CGI}}$	0.9454 *(0.0000)*	0.0580	16.2910
R^2		0.8206	
Adjusted R^2		0.8176	
Durbin-Watson stat		1.9085	
The exact *p* values are reported in parenthesis. Ordinary Least Squares method is conducted.			

We find that Extended ISE CGI portfolio generates lower monthly absolute and excess returns than ISE All Index portfolio over the sample period August 2005 – July 2010. The Graph 1 also indicates that

the absolute cumulative returns of Extended ISE CGI are lower than ISE All Index returns at the end of sample period. This graph shows the development of the value of Extended ISE CGI and ISE All Index from August 2005 – July 2010 assuming 1 Turkish Lira is invested in the portfolios in August 2005.

Mainly, we conduct time series regression analysis and find that risk-adjusted return (abnormal return) of Extended ISE CGI portfolio represented by the regression constant $\alpha_{ISE\ CGI}$ is negative and it is statistically insignificant at the 5 per cent level over the period August 2005 – July 2010.

GRAPH 1
CUMULATIVE RAW RETURNS:
EXTENDED ISE CGI AND ISE ALL INDEX (AUGUST 2005 – JULY 2010)



CONCLUSION AND IMPLICATIONS

Good corporate governance is the key to the integrity of corporations, financial institutions and markets, and central to the health of our economies and their stability. The concept and implementation of corporate governance is relatively new in Turkey. Good corporate governance is widely associated with better performance and well-governed corporations generally have higher stock returns. However, sometimes stock prices cannot fully reflect cross-sectional differences in governance. Excess returns can only result from exposure to identified risk factors. When investors recognize the better firm performance and lower risk level of well-governed firms, the market values of the well-governed firms increase and the opportunity for additional returns disappears.

In this paper, we analyze whether good corporate governance leads to higher common stock returns in ISE or not. We investigate the case of Turkish firms using an investment strategy which is buying only the firms listed in ISE Corporate Governance Index over the period August 2005 – July 2010. We find that risk-adjusted return (abnormal return) of Extended ISE CGI portfolio is statistically insignificant over the period August 2005 – July 2010. An investment strategy, buying only the firms listed in Extended ISE CGI during the period August 2005 – July 2010, cannot generate abnormal returns.

The results of this study can be explained by lower risk level of well-governed firms, well-governed firms with high governance ratings generate lower stock returns because of their lower risk level. This result is also consistent with market efficiency, because screening based on publicly available information about corporate governance cannot be expected to earn excess returns. Only the expectation of rating changes and new declarations not currently reflected in stock prices can generate abnormal returns. Main

limitation of our study is the fact since we do not have a detailed corporate governance ratings database for all the firms listed in ISE, and we cannot construct two main portfolios (a portfolio consisting of well-governed firms and a portfolio consisting of poorly governed firms) based on a corporate governance ratings database. In the future, a study including all the firms in ISE should be done by constructing a comprehensive corporate governance ratings database for all the firms listed in ISE.

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