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IDEA WATCH

How Much Board Turnover Is Best?

by George M. Anderson and David Chun

GOVERNANCE *by George M. Anderson and David Chun*

How Much Board Turnover Is Best?

Some criticize boards for leaving the evolution of their composition to chance, allowing director retirements to dictate the pace of change. Support for annual director elections and for increased transparency around director nominations suggests that some shareholders would like to see more turnover. Is there evidence that companies and shareholders actually benefit when boards add fresh blood? If so, how much change is desirable?

To explore these questions, we studied board turnover and shareholder returns for the S&P 500 companies from 2003 to 2013. Using data from Equilar, we tracked when independent directors joined and left each board and counted the turnover across rolling three-year periods, grouping the companies into four categories according to the results. We then examined each company's performance (using total shareholder returns relative to the industry average) in the subsequent three-year period to see how shareholders fared after new directors took seats in the boardroom. Our analysis revealed some intriguing patterns:

- Companies that replaced three or four directors over a three-year period outperformed their peers, suggesting an optimal amount of turnover.
- Most boards miss this optimal zone: In our 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.

The decisions governing board composition are nuanced and complex. We're not suggesting that boards manage turnover to achieve a specific target, or that simply replacing directors will somehow produce an increase in shareholder returns. Rather, our analysis indicates that a modest amount of turnover tends to be a characteristic of the leadership and governance behaviors that drive shareholder value over time. That stands to reason: New directors bring fresh perspectives and new skills, and they may be more likely than established members to challenge orthodoxy and raise previously unasked questions.

Understanding the correlation between board turnover and company performance can help inform certain decisions. For example, a company's chairman, CEO, and directors should be aware of the board's turnover rate and how it compares with the optimum we found. They should discuss turnover periodically and, when the rate falls outside the optimal zone, reflect on why—and be prepared to explain the reasons to investors. Boards should also keep the zone in mind when considering actions such as extending the mandatory retirement age and changing the board's size.

Over the years boards have grown more engaged, more independent, and more effective. Attending to turnover—and how it may affect performance—is another step in that direction.

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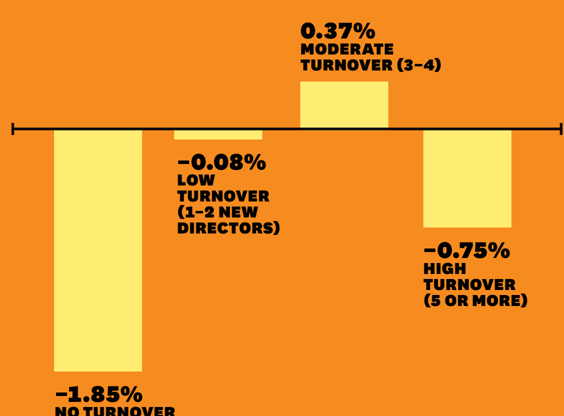
On a rolling three-year basis, we divided firms into four groups according to director turnover, then calculated annual **total shareholder returns** during the subsequent three-year period relative to the industry average. The results: Companies and investors do best with moderate turnover.



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