In Search of Greatness:

How to Choose an Independent Board Leader

Russell Reynolds Associates

What makes a great board leader – and how do you know?

When US boards look for a new non-executive leader – or a director candidate who could fill that role when the time comes – they often try to identify ideal candidates by looking at backgrounds and experiences. It is a worthwhile endeavor, as the independent leader has an outsized influence on how effective a board is. Russell Reynolds Associates' 2016 Board Culture survey showed that the strength of the chair was the single biggest differentiator between the most and least effective boards. However, what is often unclear is how closely the shorthand criteria used to select a chair actually relate to a board's subsequent performance.

To get a better sense of whether there are tangible aspects that define great board leaders in the US, we ranked S&P 500 companies based on their returns to shareholders over a three-year period and closely analyzed the independent board leaders – chairs or lead directors – for the top 50 and bottom 50 performers. We considered previous roles, tenure on the board, age and compensation of the independent board leaders.

What we learned is that there is a surprising lack of measurable difference between the two groups. Looking at both medians and averages, the leaders of both top and bottom performers were nearly identical in just about every variable we studied.

So, what does matter in identifying a good candidate to lead the board? The results make it clear that it's not what a director has done earlier in their career, or how long they have been a director, but how they act in the boardroom.

When a board is choosing a lead director or independent chairman from among its members, "you're looking at the style and characteristics of a fellow director: how active they are on the board, how they interrelate with other members of the board and the CEO, and their ability to lead, particularly when it comes to drawing out quieter members," said Charles A. Tribbett III, co-head of Russell Reynolds Associates' Board & CEO Advisory Group.

In this report, we will take an in-depth look at which factors are most important to weigh when it comes to board leader performance and provide a framework for boards to use when planning a transition.

Digging into data

Measuring a board's performance is a difficult and imprecise exercise. Non-financial metrics, such as board composition, committee structure, or number of meetings attended are relatively easy to track, but do not always translate into meaningful results. Financial performance such as profit growth or investment returns are more to the point, but they hinge on any number of factors beyond the board's control, from industry dynamics to operational efficiencies to the willingness of a CEO to listen.

In 2016, we measured board effectiveness via first-hand feedback, asking 369 public-company directors from a dozen countries to rate their boards in a survey. This time around, we wanted to explore whether any external measure might indicate board effectiveness. With the various constraints of financial measures in mind, we chose to look at Total Shareholder Return (TSR), or the change in share price between two dates, taking into account any dividends or stock splits that may have occurred over that time.

While TSR is influenced by many factors other than board performance, it has the advantage of focusing solely on the benefits or disadvantages that accrue to shareholders – the group to whom the board is ultimately responsible. To account for the long-range nature of board work, and the likelihood of a lag between decision and outcome, we included TSR performance over three years and only considered leaders who were in their role for all or substantially all of that period.

We then took a close look at the independent directors whom the boards had chosen as leaders – either non-executive chairmen or lead directors – for companies with the highest 50 TSR, as well as those with the lowest 50 TSR. Those in the top group were at companies that earned shareholders double- and triple-digit returns over the course of 2015 to 2017 (an average gain of 140 percent), while those in the bottom group universally lost money for shareholders over that time (an average loss of 23 percent).

METHODOLOGY

We ranked S&P 500 companies by Total Shareholder Return for the period from Jan. 1, 2015 to Dec 31, 2017. We then analyzed a total of 137 companies (67 top performers and 70 bottom performers), excluding boards which had a leadership transition during that time or which did not have an independent leader, to arrive at the top 50 and bottom 50. The final lists represented a variety of industries, with the top 50 dominated by technology (22 percent), industrials (18 percent) and healthcare (18 percent) companies and the bottom 50 led by consumer (30 percent), healthcare (16 percent) and energy (14 percent) companies.

What the numbers say

We first looked at titles of the non-executive board leaders, often a controversial topic among US governance experts. While conventional wisdom once held that an independent board chair was superior to a lead director, the data showed no correlation between board leadership structure and TSR. Seventy percent of top 50 companies used lead directors compared to 68 percent of bottom 50 companies. The balance - 30 percent of the top 50 and 32 percent of the bottom 50 - used independent chairmen.

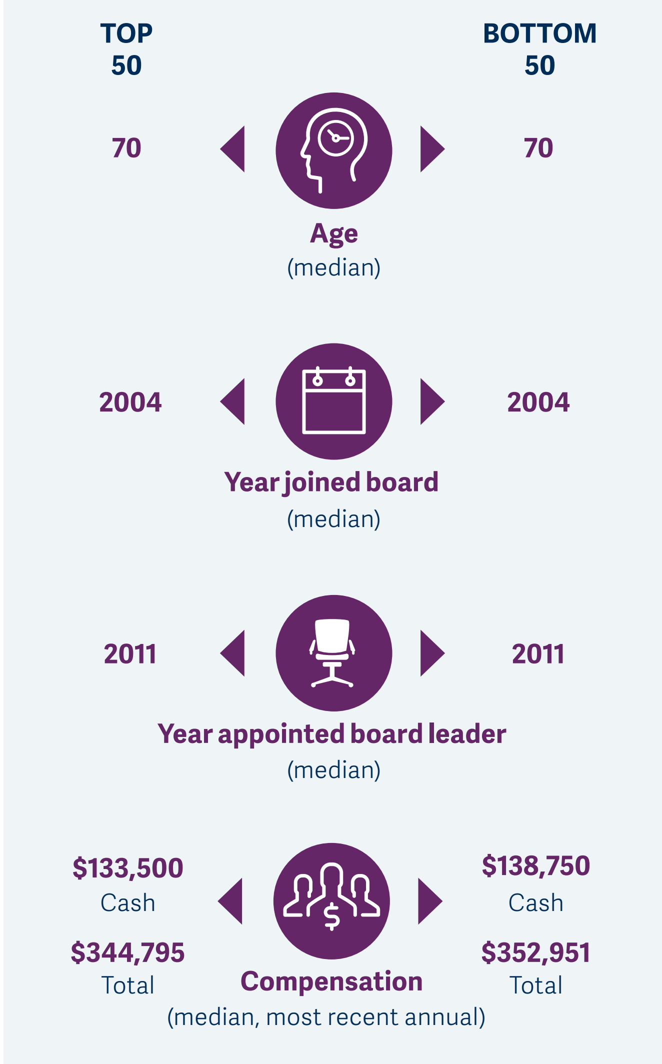
We also observed that board leadership structures are often in flux, with companies choosing to combine or separate the CEO and chair roles based on CEO transitions and director availability. At least 10 percent in each group made changes to their structure in the past three years.

Over the years, the question that has become more relevant than what the independent board leader is called is what he or she does. "You always have to ask if the board leader is setting the agenda and running the meetings so they can bring in different points of view and enable dissent – or simply nodding at the CEO's agenda," said Anthony Goodman, a member of RRA's Board & CEO Advisory Group.

In line with that, the data showed some evidence that the absence of an independent leader of any sort – an increasingly rare practice – may be detrimental. Six companies among bottom performers used only executive leaders, who often held substantial ownership stakes in the company, compared to just two companies in the top group. While these numbers are small, they may directionally suggest that leaders with such vested interests in the company may not be able to step back enough to allow others sufficient input.

We then looked at other statistics, such as age, board tenure and compensation. Similar to board leadership structure, most of these other factors varied little between top and bottom performers.

Commonly-disclosed board leader data shows little relationship to performance

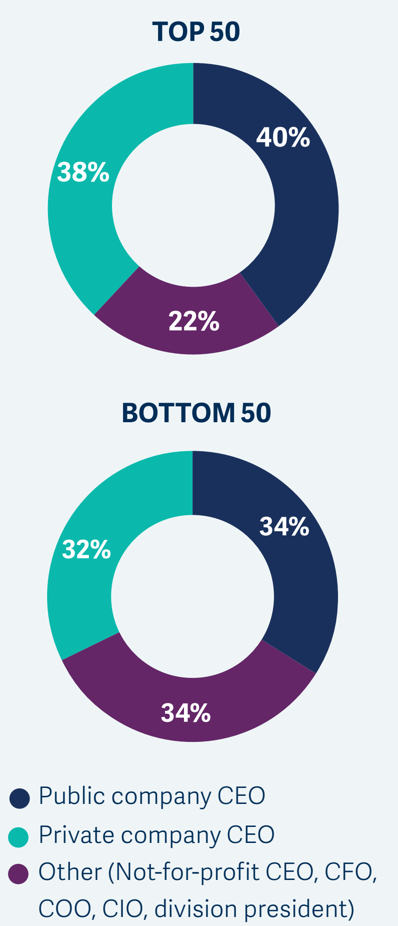


The slightly higher cash compensation that bottom 50 board leaders receive could be attributed to the companies attempting to make up for poor stock performance with cash, or to fewer leaders in the bottom 50 electing to receive their cash compensation in stock. However, it is surprising that median total compensation, which includes all stock-based awards, is higher for directors at lower-performing companies.

Does a board leader's background matter?

The data showed a slight difference here: 40 percent of board leaders in the top group had past or current experience as a public-company CEO, compared to 34 percent in the bottom group.

Board leader backgrounds: CEOs are popular, but not ubiquitous



Public-company CEOs are often the first choice for a board leadership position, in part because their experience makes them well-suited to represent the company to investors. "The first question is always: Who would an institutional investor most like to meet with and spend time with? Who is the most credible person?" said Tribbett.

Board members who have been public company CEOs themselves may also be seen as better sounding boards for the current CEO, particularly if that person is a first-time CEO. However, this experience is clearly not a universal requirement, as the majority of board leaders at both top- and bottom-performers have not been public-company CEOs.

Looking more closely at the data, we find two small trends that offer some interesting points of differentiation between top and bottom 50 board leaders' backgrounds. For one, 18 percent of top performers have a leader with venture capital or private equity experience, about twice the level of bottom performers. Two, top performers are about half as likely as bottom performers to have a leader whose only other board leadership experience is as an executive chairman. (About 40 percent of board leaders in both groups have past experience as independent board leaders.) Taken together, these trends suggest that the best board leaders are skilled at bringing external, objective perspectives to the group, helping them see the company as a shareholder would.

The intangibles that matter most

Without question, the most important intangible in choosing a board leader is his or her chemistry with the CEO. "If the board members like this person but the CEO can't stand them, they're not going to be very successful," said Goodman.

Beyond that highly subjective criteria, however, a number of other personal qualities can help predict how well someone will do in the role of independent chairman or lead director.

When directors rated their leaders in RRA's Board Culture survey, they pointed to three hallmarks of effective chairs: They encourage independence, they actively seek different points of view, and they foster high-quality debates.

Similar themes came through in our conversations with consultants who specialize in board leader searches in the UK, where nearly every large public company has an independent chair for regulatory reasons, and such chairs are often appointed with no prior experience on the board they are to lead.

When considering a recently retired CEO, for example, a top question is "is whether the person is ready to take his or her hand off the steering wheel; "capable of fostering high-quality debates rather than making unilateral decisions, said Zoe Gibson, a senior member of RRA's Board and CEO Practice based in London. Some signs of that readiness: the CEO has invested in grooming internal succession candidates, and/or has a successful business track record that has ended on a high note, leaving the person with nothing to prove.

To adequately seek different points of view, board leaders should also be great listeners, ideally with an exceptional ability to recall who contributes what to the board discussions, said Emma Combe, also a member of the Board and CEO Practice in London. "Especially with today's diversity agenda, you want to make sure everyone gets equal share."

Finally, when it comes to promoting independence, courage is crucial. Board chairs who cannot strike the balance between encouraging and challenging the CEO – or other board members when necessary – are almost certain to fail when difficulties arise.

Looking across the wealth of external research on this topic, these three themes continue to resound. INSEAD's Corporate Governance Centre recently surveyed 200 board chairs from 31 countries, and interviewed 80 chairs, along with 60 board members, shareholders, and CEOs to understand what made a good board chair. Of the eight points of advice that emerged in an ensuing *Harvard Business Review* article, How to Be a Good Board Chair, the first was "Be the guide on the side" – in other words, focus on encouraging other board members to participate and debate rather than campaigning for a particular agenda. "If you want to occupy center stage, look for another job. Great chairs create conditions that allow others to shine," said one US survey participant. Underscoring this result, board chairs who were considered effective took up 5 to 10 percent of airtime during meetings; compared to the 20 to 30 percent that less-effective chairs consumed.

5 signs of a bad board leader

To help put those positive qualities in perspective, we asked our experts what defines the people who fail in board leadership roles.

- Wants the role too much, sees it as a sign of self-importance. Refuses to work with others on big decisions.
- Fails to set the agenda, but rather lets the CEO or executive chairman dictate what the board covers.
- Allows the most talkative directors to dominate discussions, failing to (politely) cut them off and bring in other directors' viewpoints.
- Communicates unevenly to other directors – for example, sharing something important in a committee meeting and then forgetting to announce it to the board as a whole.
- Shrinks back from tough discussions with the CEO or underperforming directors.

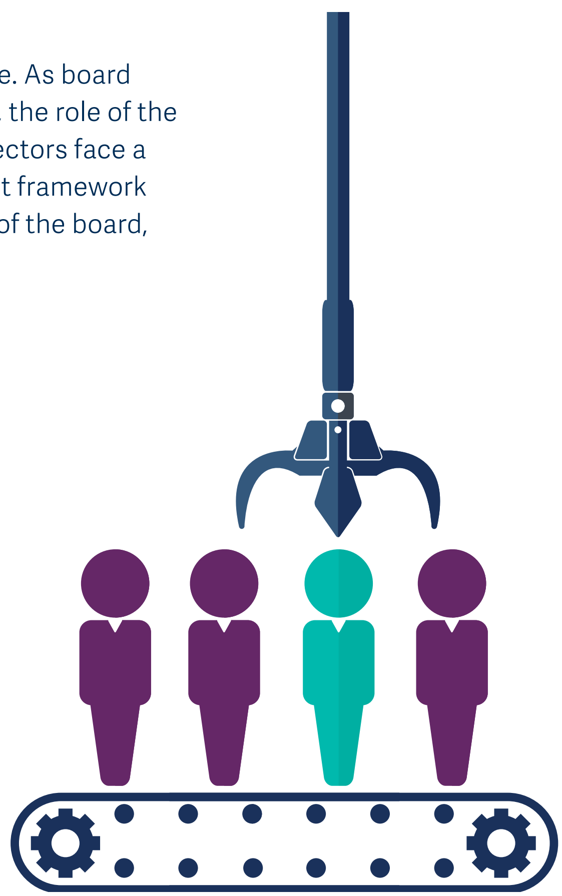
To avoid these less-than-optimal behaviors, boards should consider the following questions when evaluating a candidate for leadership:

Questions for board members approaching a leadership transition

- What has the current board leader done well and not so well? Which areas of improvement are most important?
- How would current board members rank their choices of future leaders, and how does that jibe with the CEO's ranking?
- What past experience does a prospective leader have in running meetings, and what type of behaviors did he or she exhibit in that context?
- How well is the prospective leader likely to work with the CEO?
- Where is the prospective leader in his or her own career, and how difficult is he or she likely to find it to cede ultimate decision-making authority to someone else?
- Is the candidate known as a listener or a talker?
- How long is the tenure of the next board leader expected to be, and how well does that match what the candidate is looking for?

Choosing well every time

Ultimately, choosing a great board leader is part art and part science. As board structures and corporate governance standards continue to evolve, the role of the independent board leader is only likely to grow more important. Directors face a difficult decision each time they make a transition, but with the right framework and analysis, can make excellent choices every time, to the benefit of the board, the company, and shareholders.



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