A Study of Founder-Led Companies and Why They May Outperform over Time

Stocks with founders in leadership roles may present opportunities for active managers.

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- An entrepreneurial spirit, commitment to the business, focus on innovation, and long-term incentive alignment with shareholders are common qualities of corporate founders that may lead to a company's success.
- To test the hypothesis that these traits may lead to strong stock returns, we studied the returns of a universe of founder-led stocks relative to the broader U.S. and global markets, and observed that as a group they have outperformed over time.
- By applying fundamental research to this attractive starting universe, portfolio managers may be able to add additional value for shareholders.

Seasoned investors and academics alike have posited that companies with founders still at the helm or in influential roles have outperformed the broader stock market over time.[1] While it is challenging to pinpoint precisely why these companies may have produced strong long-term results, several common qualities of corporate founders could be at play.

First, an entrepreneurial spirit, profound knowledge of their businesses, and commitment to their customers are important traits of successful executives that may be more pronounced in founding leaders. Beyond that, founders in leadership roles often own large equity stakes in their businesses, which may represent a significant portion of their net worth. Thus, they tend to spend company resources as they would their own. Further, with such a financial interest in the success of their businesses, founders may be more focused on long-term results and may not be as reactive to short-term pressures or trends. Thus their goals may be better aligned with those of their shareholders.

Research has also suggested that founder-led companies tend to be more innovative. As an example, S&P 500 index companies with founder-CEOs have acquired 31% more patents than those run by hired executives.[2] Consistent innovation may help companies remain relevant and overcome competitive pressures, often leading to success over the long term.

Founder-led companies span most sectors

To understand more about the characteristics of founder-led stocks, we explored the sector composition of companies with founders still at the helm (Exhibit 1). We identified roughly 750 Russell 3000 Index stocks with founders in leadership roles spanning 10 of the 11 sectors (utilities was the only sector not represented). The highest proportion of these companies fell within technology and health care, at least in part because these sectors tend to hold a greater number of younger companies likely to still be run by their founders. Technology and health care are also often characterized as scientifically advanced, higher growth segments of the market. Overweights to these sectors have provided an incremental performance advantage relative to the broader market over certain time periods.

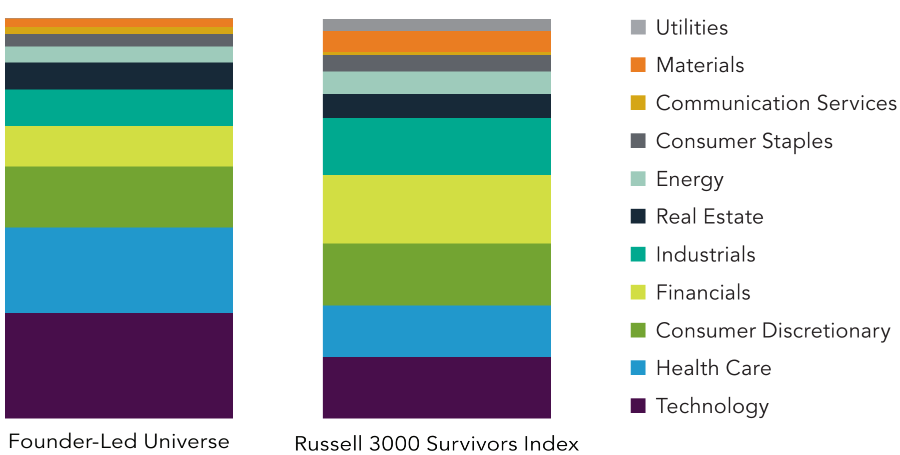
Some sectors tend to have fewer founder-led stocks because they are more capital intensive and generate less free cash flow. Corporate founders in these sectors may be more likely to cede control to allow for an injection of capital.

Creating a universe of founder-led stocks

To build a basket of U.S. founder-led companies to study, we started with the Russell 3000 Index, representative of the broad U.S. stock market. We identified companies within the index with founders in positions of influence (e.g., serving as CEO, on the board of directors, or in another leadership role). Because corporate governance data has historically been challenging to obtain, we identified those founder-led companies in business as of November 2015—when we began to more systematically study the impact of corporate founders—and calculated their returns starting in May 2007.

EXHIBIT 1: Our universe of U.S. founder-led stocks spans 10 of 11 sectors, with the highest concentrations in technology and health care.

Average Sector Composition



Based on those stocks in the Russell 3000 Index with founders in position of influence (on the management team or board of directors). Period studied: May 2007 through Jan. 2019. Source: FactSet.

To mitigate survivorship bias when studying the performance of the founder-led universe, we evaluated returns relative to a comparable Russell 3000 Survivors Index—also composed of only those companies in business as of November 2015—and calculated their returns starting in May 2007. Because we began curating corporate governance data in November 2015, from November 2015 through January 2019, the returns of the founder-led universe are compared to the standard equal-weighted Russell 3000 Index.

We explored the performance of global founder-led stocks based on the MSCI World Investable Market Index (IMI) using a similar methodology. Our analysis compared stocks identified as founder led as of January 2019 with index constituents still in business as of the same date.

A study of returns

To test the hypothesis that founder-led stocks as a group have outpaced the broader market, we examined the returns of the nearly 25% of publicly traded companies with founders in leadership roles.[3] We found that the U.S. founder-led universe outperformed its survivors index on an annualized basis over the period studied (Exhibit 2).

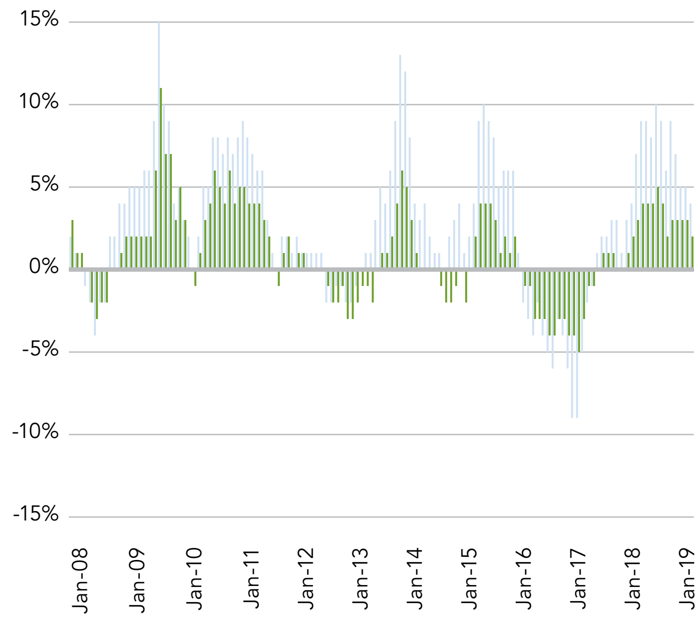
Because the technology and health care sectors have outperformed in some recent years and over longer periods, we also studied the returns of a "sector-neutral" founder led universe with a similar sector composition to the broader market, to determine whether sector effects alone were driving the outperformance. As expected, the excess returns of the sector-neutral universe were more muted but persisted, at 0.9% on an annualized basis versus 2.5% for the original founder-led universe. Founder-led returns were also favorable on a rolling 12-month basis, with founder-led stocks outperforming in the majority of periods.

EXHIBIT 2: This universe of founder-led stocks outpaced the broader U.S. market over the period studied.

Annualized Returns (May 2007–Jan. 2019)

U.S. Founder-Led Universe	Sector-Neutral U.S. Founder-Led Universe	Russell 3000 Survivors Index
10.5%	8.9%	8.0%

Rolling 12-Month Excess Returns of U.S. Founder-Led Stocks



Past performance is no guarantee of future results. This chart is for illustrative purposes only and does not represent actual or future performance of any investment option or strategy. Returns compounded annually. Methodology for U.S. stocks consistent in all exhibits. Please see "Creating a universe of founder-led stocks" for methodology details. Russell 3000 Survivors Index and the U.S. founder-led universe are equal weighted. Excess returns: returns of the U.S. founder-led universe (blue) and sector-neutral U.S. founder-led universe (green) relative to the Russell 3000 Survivors index. Performance includes reinvestment of dividends. Source: FactSet.

Globally, the results were similar. The founder-led universe outperformed the survivors index by 2.1% on an annualized basis, while the sector-neutral universe outperformed by 1.0% over the period studied (Exhibit 3, page 4).

The potential opportunity set for active management

The positive excess returns of both U.S. and global founder-led stocks suggest these universes may be attractive starting points for active portfolio managers. While the group as a whole has outpaced the market over time, the performance among individual founder-led stocks has varied—some have outperformed significantly, while others have lagged behind the broader market. In fact, the return differential between the best- and worst-performing groups of Russell 3000 founder-led stocks was modestly higher than that of the broader market over the period studied (Exhibit 4).

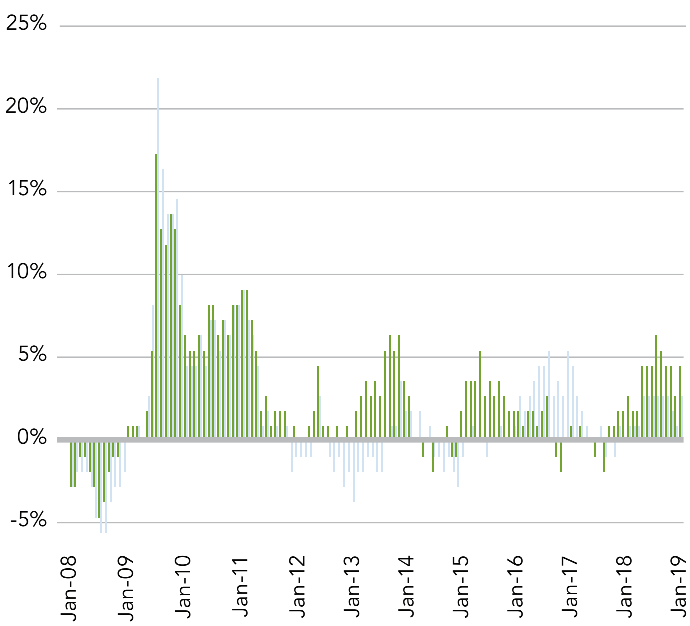
This return differential between the best and worst stocks in the universe is one way to measure the dispersion of returns. In general, higher return dispersion can lead to more opportunity for active stock-pickers. Because portfolio managers seek to own stocks that are more likely to outperform and avoid those likely to trail the market, a broader range of returns may present a better opportunity set.

EXHIBIT 3: We also observed outperformance by global founder-led stocks.

Annualized Returns (May 2007–Jan. 2019)

Global Founder-Led Universe	Sector-Neutral Global Founder-Led Universe	MSCI World IMI Survivors Index
7.5%	6.4%	5.4%

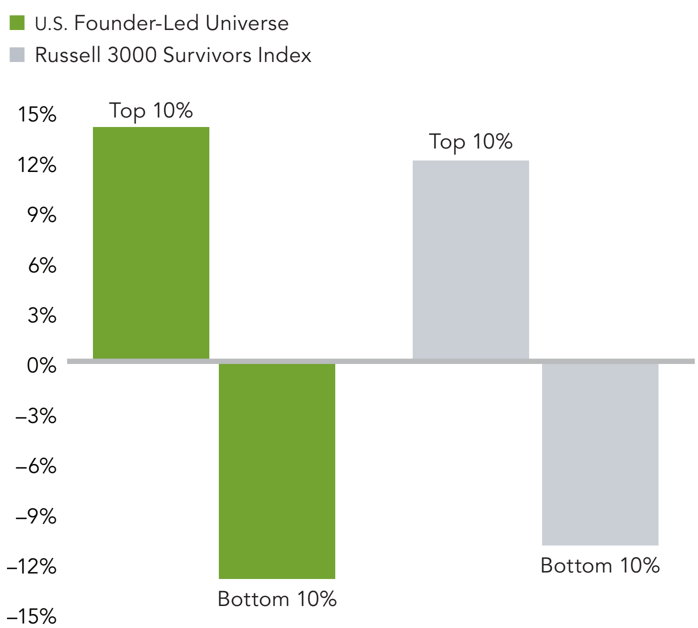
Rolling 12-Month Excess Returns of Global Founder-Led Stocks



Past performance is no guarantee of future results. This chart is for illustrative purposes only and does not represent actual or future performance of any investment option or strategy. Returns are compounded annually. Please see "Creating a universe of founder-led stocks" for methodology details. MSCI World IMI Survivors Index and the global founder-led universe are both equal weighted. Excess returns: returns of the global founder-led universe (blue) and sector-neutral global founder-led universe (green) relative to the MSCI World IMI Survivors index. Performance includes the reinvestment of dividends. Source: FactSet.

EXHIBIT 4: With higher returns and modestly higher return dispersion than the broader stock market, the founder-led stock universe may be appealing for active managers.

Dispersion of 1-Month Returns (Top and Bottom 10% of stocks)



Past performance is no guarantee of future results. Period studied: May 2007 through Jan. 2019. Source: FactSet.

To simulate an active manager targeting companies they believe are likely to outperform, we used return-on-equity, share buybacks, and earnings momentum as three fundamental factors an active manager may consider when screening for stocks.[4] We then isolated those companies that landed in the top half of the U.S. founder-led universe based on all three metrics. This equal-weighted portfolio of select founder-led stocks returned 12.7% annually on average over the period studied—approximately 2.2% higher than the overall founder-led universe and about 4.7% higher than the broader U.S. market.

In addition to screening for certain fundamental factors, active managers often rely on additional fundamental research and analysis in pursuit of owning outperforming stocks. As an example, portfolio managers often try to select companies in a position to increase their forward earnings faster than their peers.

Fundamental research may be particularly critical when selecting among founder-led stocks. The universe's higher return dispersion implies that there is more potential upside, but also greater potential downside (Exhibit 4). Thus, by applying company-by-company fundamental research and assessing issues such as industry structure and management execution, active investors may be better able to identify potential winners among founder-led stocks, and avoid those likely to lag.

Investment implications

Successful corporate founders tend to be extremely committed to their customers and dedicated to innovation. Their long-term incentives are also often aligned with those of their shareholders. These traits can benefit founder-led companies and likely contributed to the outperformance observed in our study. Furthermore, active portfolio managers may be able to unlock even more potential by applying company-by-company fundamental research to this attractive starting universe.

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Endnotes

[1] See, for example, Fahlenbrach (2003) and Lee (2016), below.

[2] Source: Lee (2016), below.

[3] Based on the Russell 3000 Index as of Jan. 31, 2019.

[4] Return on equity: The amount, expressed as a percentage, earned on a company's common stock investment for a given period. Share buyback: the transaction of a company buying back its own shares to reduce the number of shares outstanding. Earnings momentum: identifying those companies with earnings estimates rising the fastest.

Sources

Fahlenbrach, R., 2003, Founder CEOs and Stock Market Outperformance, The Wharton School, University of Pennsylvania, Working Paper.
Lee, Joon Mahn, Jongsoo Kim, and Joonhyung Bae, Founder CEOs and Innovation: Evidence from S&P 500 Firms (February 17, 2016).

Index definitions

The MSCI World Investable Market Index (IMI) captures large, mid, and small cap representation across 23 developed market countries.

The Russell 3000 Index is a market capitalization-weighted index designed to measure the performance of the top 3,000 stocks within the U.S. equity market.

The S&P 500® index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The Chartered Financial Analyst (CFA) designation is offered by the CFA Institute. To obtain the CFA charter, candidates must pass three exams demonstrating their competence, integrity, and extensive knowledge in accounting, ethical and professional standards, economics, portfolio management, and security analysis, and must also have at least four years of qualifying work experience, among other requirements.

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