



## The canary in the coal mine

### Why governance matters: the market's earliest warning

For many investors, corporate governance is treated as a background consideration, important, but secondary to earnings, valuation and growth. In practice, it carries far greater significance. How a company is run reflects its values – the way it treats its people, the way it operates and whether it is committed to sustainable outcomes. Governance is also one of the most reliable early indicators of financial and investment risk, often providing warning that returns are at risk well before this is visible in reported numbers. This article takes a closer look at this second dimension - governance as a financial risk signal.

Financial regulators consistently identify governance as a core driver of financial risk. The Australian Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC), and The Organization for Economic Co-Operation and Development (OECD) each highlight that governance weaknesses, when left unaddressed, can allow misconduct to escalate, erode investor confidence, and ultimately translate into material financial losses.<sup>1,2,3</sup>

Markets are generally efficient at pricing known information: revenue growth, margins, balance sheets. They are far less efficient at pricing fragility, the slow accumulation of risk that occurs when oversight weakens, incentives misalign, or accountability erodes. Governance analysis can identify asymmetric downside risk before it is reflected in prices.

Australian markets provide unusually clear examples of this dynamic. In many cases, governance signals were visible months or years before financial damage

became apparent. For investors who take governance seriously, this analysis can better distinguish between short-term noise and genuine long-term risk.

#### Governance as a downside-risk indicator

From a portfolio perspective, governance weaknesses tend to exhibit three characteristics:

1. They are leading indicators: governance deterioration often precedes earnings downgrades, not the reverse.
2. They create asymmetric outcomes: upside remains capped, while downside expands materially.
3. They correlate in stress: governance failures frequently coincide with regulatory action, funding pressure or loss of customer trust, increasing drawdown risk at precisely the wrong time.

Common early signals include:

- Board instability or declining independence
- Concentration of decision-making power without effective checks
- Repeated conduct or operational issues framed as isolated events
- Defensive or opaque disclosure during periods of challenge

Individually, these may not justify portfolio action. Collectively, they often indicate that risk is compounding beneath the surface.

<sup>1</sup> APRA, July 2019. 'Transforming Governance, Culture, Remuneration and Accountability.'

<sup>2</sup> ASIC Corporate Governance Taskforce, October 2019. 'Director and officer oversight of non-financial risk report.'

<sup>3</sup> OECD, September 2023. 'G20/OECD Principles of Corporate Governance 2023.'

## Governance factors in U Ethical's investment process

At U Ethical, our fundamental analysis begins with considering a company's governance – the quality of its management, its strategy, its balance sheet discipline – as complete a view as possible of how a company runs. Our belief is that a well governed company that has a holistic view of risks and opportunities, be it climate, corporate conduct or human capital management, is a company that is more likely to deliver stable long-term returns.

When we don't have comfort in the governance and management quality of a company, we don't invest. One example of an area that can cause U Ethical to make a decision to not invest in a company no matter what the financials is the issue of related parties and related party transactions.

## Australian examples: governance risk and capital outcomes

According to the Australian Accounting Standards Board<sup>4</sup>, a related party is "a person or entity that is related to the entity that is preparing its financial statements," while a related party transaction is "a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged."

Related parties and related party transactions are a normal part of business, but it is important for companies to disclose them because they potentially could affect profit or loss and financial position of a company.

### Johns Lyng Group



In 2024, an episode of ABC's Four Corners<sup>5</sup> delved into strata management fees and attracted a flurry of media attention, raising questions about the relationship between JLG, Bright & Duggan (owned by JLG) and Steadfast Group (an insurance company that is also a shareholder in JLG).

JLG met our initial screening criteria on investment and ESG grounds. However, our investment team was not comfortable with these relationships and decided not to invest.

In the wake of media coverage, the stock price fell sharply, and subsequent disappointing earnings announcements saw the stock price fall to around a third of its share high point through 2024 and 2025. In June 2025, Johns Lyng Group accepted an offer from Pacific Equity Partners valuing the business \$1.3 billion, or \$4 per share.<sup>6</sup>



### Portfolio implications

Governance concerns can become crystallised as earnings compression and permanent loss.

<sup>4</sup> Australian Accounting Standards Board (AASB), May 2019. AASB 124.

<sup>5</sup> ABC News, September 2024. The Strata Trap.

<sup>6</sup> Australian Financial Review, July 2025. 'Johns Lyng agrees to \$1.3b takeover bid from private equity suitor'.



## Qantas

Qantas demonstrates governance risk as a regulatory and reputational drag. Conduct and disclosure issues accumulated over time, well before regulatory action over cancelled flights forced penalties and remediation.<sup>7</sup>

For a capital-intensive business, this translated into higher political and regulatory scrutiny, reduced goodwill with customers, and a reassessment of long-term risk rather than immediate solvency concerns.



### Portfolio implication

Governance weaknesses can increase long-duration risk in capital-intensive holdings, affecting terminal value assumptions rather than short-term earnings.

## WiseTech Global

WiseTech illustrates governance risk as a valuation-multiple shock, rather than an earnings event. The company's operating performance remained strong, yet governance concerns such as board resignations, public disagreement, questions around independence triggered a sharp reassessment of key-person and oversight risk.<sup>8</sup>

The resulting drawdown reflected a higher risk premium applied to future cash flows, despite near-term fundamentals remaining largely unchanged



### Portfolio implication

Governance risk can compress multiples suddenly, increasing drawdown risk even in structurally attractive growth assets.



## Optus

Optus' data breach and subsequent nationwide outage were widely framed as technology failures. From a governance perspective, they were failures of operational-risk oversight.<sup>9</sup>

Early signals included underinvestment in resilience, unclear accountability and slow, inconsistent crisis communication. Each incident was treated as isolated. Together, they revealed a governance blind spot.

The financial consequences followed later: customer churn, remediation costs, higher ongoing capex and heightened regulatory scrutiny.

## Star Entertainment Group

Star represents the most severe governance failure outcome. Years of regulatory findings around culture, controls and suitability preceded the company's liquidity stress.<sup>10</sup>

In highly regulated industries, governance is not just about efficiency, it underpins the licence to operate. Once regulator confidence erodes, equity value can be impaired rapidly and permanently.

<sup>7</sup> Australian Competition and Consumer Commission, October 2024. 'Federal Court orders Qantas to pay \$100m in penalties for misleading consumers'.

<sup>8</sup> WiseTech Global - ASX Announcement, February 2025. 'Board changes and guidance update'

<sup>9</sup> Australian Communications and Media Authority, November 2024. 'Optus pays \$12 million penalty for Triple Zero outage.'

<sup>10</sup> NSW Independent Casino Commission, 2022. 'The Bell Review of The Star'.

## Governance and exclusion: when risk is no longer diversifiable

An important but often under-acknowledged role of governance analysis in portfolio construction is exclusion.

Certain governance risks cannot be diversified away or compensated for through valuation:

- Licence-to-operate risk
- Persistent regulatory non-compliance
- Cultural breakdown that undermines accountability
- Concentrated power with no credible checks

In these cases, governance failure changes the distribution of outcomes, introducing binary or fat-tailed risks that are inconsistent with capital-preservation objectives. No amount of expected return can reliably compensate for the possibility of sudden, permanent impairment.

Excluding such companies from the investable universe is therefore not about reducing opportunity, it is about removing unrewarded risk.

Taken together, these examples show governance risk expressing itself through different financial channels, valuation, cash flow, regulation and solvency. The experience of Australia's major banks, however, complicates the picture.

### What about the major banks?

The experience of Australia's major banks, Westpac, ANZ, National Australia Bank, Commonwealth Bank of Australia, complicates the narrative.<sup>11</sup>

Governance failures were real, AML breaches, fees-for-no-service, and systemic conduct issues. Yet shareholder outcomes were comparatively resilient.

#### Where governance did impact returns:

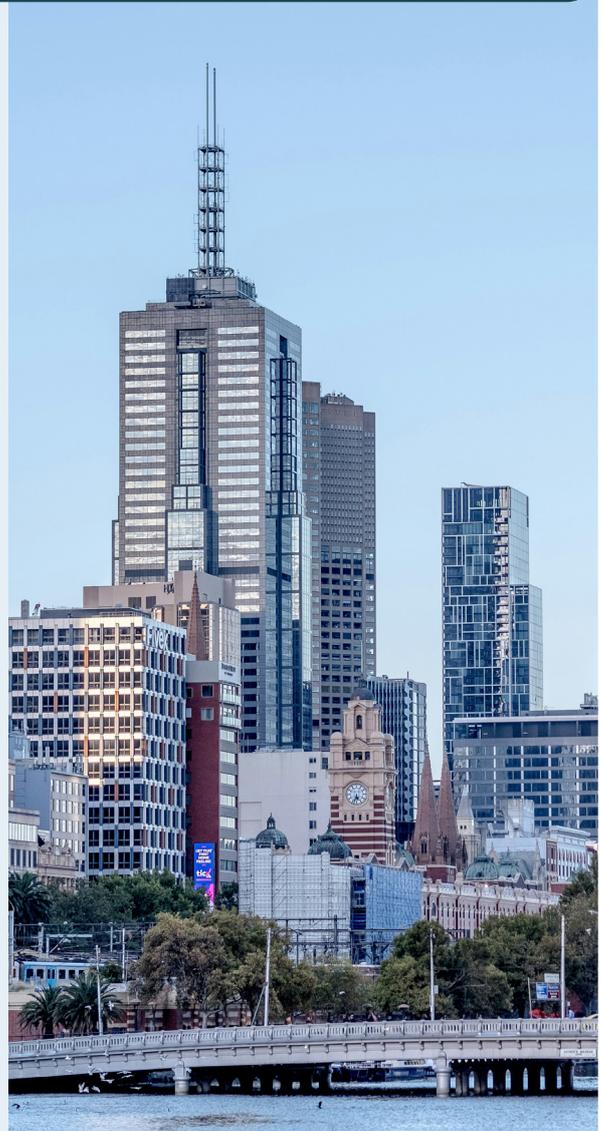
- Large penalties and remediation costs reduced earnings in specific years
- Ongoing compliance uplift structurally lowered return on equity
- Management distraction constrained strategic flexibility

These were genuine costs, but they were largely absorbed, not franchise-destroying.

#### Why banks looked different:

- Oligopolistic market structure allowed costs to be passed through
- Implicit government support reduced tail-risk pricing
- Scale diluted the impact of governance failures

The key insight is not that governance did not matter but that systemic protection muted the signal. Past survivability should not be confused with immunity.



<sup>11</sup> The Royal Commission Report, February 2019. 'Misconduct in the Banking, Superannuation and Financial Services Industry'.

## Governance and portfolio risk

For portfolio construction, governance analysis serves three functions:

### 1. Downside filtering and exclusion

Identifying companies where governance weakness increases the probability of sharp drawdowns or permanent impairment.

### 2. Position sizing

Governance fragility argues for smaller position sizes or higher required returns, even where fundamentals appear attractive.

### 3. Risk concentration management

Governance risk is a correlation risk. When governance fails, regulatory, funding and sentiment shocks tend to occur together, causing previously independent exposures (idiosyncratic risks) to move in unison (systematic risk). This collapse in diversification typically occurs during market stress, increasing drawdown severity and reducing the effectiveness of traditional portfolio construction tools, sharply undermining diversification when it is most needed.

In this sense, governance acts as a risk-concentration lens, highlighting where apparent diversification may be illusory. This is why governance risk is especially dangerous, it increases tail risk, not just volatility.

## Why we focus on governance

We focus on governance because it has shown to be one of the earliest indicators of future financial risk. In Australian markets, significant value destruction has rarely occurred without advance warning in the form of weakened oversight, misaligned incentives, cultural drift or poor accountability.

Governance analysis allows risk to be assessed before it is visible in earnings or share prices. This is a risk-management discipline aimed at assessing the durability of long-term returns and avoiding situations where trust, regulatory confidence or operational resilience are quietly eroding.

## The canary in the coal mine

Governance failures rarely arrive as sudden shocks. They develop gradually, through small decisions and tolerated behaviours that compound over time. By the time earnings are affected, the repricing of risk is often abrupt.

From a portfolio-construction perspective, governance is not about predicting scandals. It is about recognising where downside risk is increasing asymmetrically, and where capital may be exposed to outcomes that traditional financial analysis struggles to anticipate.

In markets where value is often lost suddenly but signalled quietly, governance remains one of the most effective tools investors have to manage downside before it becomes visible in the numbers.

This information is provided by Uniting Ethical Investors Limited (ABN 46 102 469 821) (AFSL 294147), trading as U Ethical. U Ethical can be contacted on 1800 996 888 or by mail and in person at Level 6, 130 Lonsdale Street, Melbourne VIC 3000.

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## U Ethical

Level 6, 130 Lonsdale Street,  
Melbourne VIC 3000

**Website** [www.ueethical.com](http://www.ueethical.com)

**Email** [info@ueethical.com](mailto:info@ueethical.com)

**Telephone** 1800 996 888