



Does institutional short-termism matter with managerial myopia?

Yu-Fen Chen ^{a,1}, Fu-Lai Lin ^{b,2}, Sheng-Yung Yang ^{c,d,*}

^a Department of Business Administration, Da-Yeh University, 168, University Rd., Dacun, Changhua 51591, Taiwan

^b Department of Finance, Da-Yeh University, Taiwan

^c National Chung-Hsing University, Taiwan

^d Asia University, Taiwan



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ABSTRACT

Literature regarding the impact of institutional investors on firm's research and development (R&D) expenses supports that institutional ownership facilitates managerial discretion on R&D expenses in the US. However, the scenario may change when considering institutional investment horizon. This study investigates whether managerial myopic investments on R&D exist in an emerging market, Taiwan, and whether institutional investing exacerbates managerial myopic behavior. Results indicate that corporate managers cut R&D spending to meet short-term earnings goals in Taiwan. Domestic institutional short-termism will intensify managerial myopia. Conversely, foreign institutional ownership acts as a buffer to facilitate R&D.

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1. Introduction

Corporate expenses on research and development (R&D) activities are crucial drivers of corporate innovation, which contributes to firm's competitive advantages and economic sustainable development. However, due to the characteristics of R&D expenses, corporate managers face the dilemma of R&D investment strategies. Firstly, R&D activities appear to be long-term investments where R&D corporate earnings are uncertain and slow. Secondly, accounting rules require firms to expense R&D fully and immediately. Both factors may induce managerial myopia to sacrifice firm's long-term investments for short-term earnings (Bushee, 1998). Managerial myopia may increase when firm stocks attract institutional holdings and corporate managers care about institutional investors' preferences. This paper uses dedicated sample

firms in an emerging market, Taiwan to investigate whether corporate managers cut R&D spending when facing prior earnings decrease. Furthermore, this study explores whether institutional investing intensifies managerial myopia.

Literature regarding determinants of R&D activities focuses on two streams. One is managerial myopia stating that pressure from quarterly financial reports may induce corporate managers to boost short-term earnings by reducing R&D spending (Bushee, 1998; Cheng, 2004; Dikolli, Kulp, & Sedatole, 2009; Porter, 1992). The other involves external pressures of institutional investing. Institutional sophistication and activism provide a buffer between impatient individual investors and corporate managers. This buffer allows corporate managers to focus on projects with long-term value (Bushee, 1998; David, Hitt, & Gimeno, 2001; Wahal & McConnell, 2000) and supports the positive relation between institutional ownership and corporate R&D spending (Aghion, Van Reenen, & Zingales, 2013; Bushee, 1998; David et al., 2001; Wahal & McConnell, 2000; Le, Walters, & Kroll, 2006; Jiang, Waller & Cai, 2013). However, some institutional investors are passive to exert monitoring efforts (David et al., 2001) and some are transient, with short-term investment horizons according to institutional portfolio turnovers (Bushee, 1998; Dikolli et al., 2009) or the stock ownership by mutual funds (Le et al., 2006). The role of institutional investing on corporate R&D investments remains confusing.

Like in most emerging markets, individual investors dominate Taiwan stock markets. However, due to institutional big money and trading resemblance between Taiwan and other emerging countries, realizing whether and how institutional investing influences managerial

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^{*} Corresponding author at: Department of International Business, Asia University, 500, Lioufeng Rd., Wufeng, Taichung 41354, Taiwan. Tel.: +886 4 2332 3456x1936; fax: +886 4 2333 7042.

E-mail addresses: yfchen@mail.dyu.edu.tw (Y.-F. Chen), flin@mail.dyu.edu.tw (F.-L. Lin), shengyang@asia.edu.tw (S.-Y. Yang).

¹ Tel.: +886 4 8511888x3018.

² Tel.: +886 4 8511888x3200.

myopia in Taiwan is equally important. Institutional investors divide into foreign institutional investors and domestic ones, which comprise securities investment trust companies and proprietary traders. Since regulations in Taiwan do not allow institutional investors to participate in the board, these investors pressure corporate policies implicitly through trading activities.

This paper makes two contributions to literature. First, as managerial myopia is more likely to happen when firms suffer from prior earnings decline and managers struggle to reverse earnings, this paper directly tests whether managerial myopic investment exists by using dedicated sample firms, whose earnings decline by an amount that may be reversible by cutting R&D. Second, though Le et al. (2006) examine institutional moderating effects on the relationship between R&D spending and firm performance, this paper complements literature by investigating institutional moderating effects on managerial myopic behavior.

The paper has the following structure: Section 2 reviews literature and develops hypotheses. Section 3 designs the research. Section 4 presents empirical results. Section 5 concludes this paper.

2. Theory and hypothesis development

Agency theory (Jensen & Meckling, 1976) suggests that agency conflicts lead to the divergence between agent's decisions and those decisions that maximize the welfare of the principal. Though incentive contracts help to solve agency problems, managerial risk aversion still dominates incentive alignment as managerial payoffs relate to volatile stock prices. Hence, managers may take actions to reduce the uncertainty of firm performance to limit the risk to managers' wealth and employment (Alessandri & Pattit, 2014; Fama, 1980; Holmstrom, 1982; Hart, 1983). Corporate R&D investing decisions are akin to a scenario where returns from R&D investments are uncertain and slow, but R&D cut can boost short-term earnings (Bushee, 1998; Cheng, 2004).

2.1. Managerial myopia

Corporate managers encounter a trade-off between long-term and uncertain investments in R&D activities, and between short-term and certain earnings by cutting R&D spending. Expected costs of R&D include the negative impact of immediate R&D expense on short-term accounting earnings and stock performance. Performance from both financial statements and stock markets affects CEO compensation and job security (Cheng, 2004; Dechow & Skinner, 2000), which induces managerial myopic behavior. Managerial myopia comprises underinvestment in long-term, intangible projects such as research and development, advertising, and employee training to meet short-term earnings goals (Bushee, 1998; Porter, 1992). Research from Dechow and Sloan (1991) provides evidences that managers cut R&D to meet short-term earnings objectives. Wahal and McConnell (2000) find a positive relationship between changes in operating income and R&D expenditures, implying that managerial myopia exists. However, in Bushee's (1998) study, sample firms suffering from prior earnings decline and cutting R&D are relatively fewer than those suffering from prior earnings decline but increasing R&D. Furthermore, in Bushee's (1998) subsample where managerial myopic behavior is more likely to happen, the coefficient from the distance of expected earnings to earnings target is not statistically significant, implying that corporate managers do not manage earnings through R&D cut. Empirical evidences in relation with managerial myopic behavior are still confounding. According to the argument of career concern and Taiwan accounting rules, this paper expects managerial myopia to exist and suggests the following hypothesis.

H1. Corporate managers are more likely to cut R&D expenses as firms suffer from earnings decline by an amount that may be reversible by reducing R&D.

2.2. Institutional moderating effect on R&D

Internal governance mechanisms seeking to prevent managerial myopic behavior focus on the arrangement of CEO compensation contracts (Cheng, 2004; Dikolli et al., 2009); while external pressure falls on the market power of institutional investors (David et al., 2001; Le et al., 2006). Literature on institutional influence on R&D focuses more on the relationship among institutional ownership, portfolio turnover and R&D spending, than on institutional moderating effects on R&D (Le et al., 2006). Following subsections briefly review direct and moderating effects of institutional investing on R&D.

Wahal and McConnell (2000) do not support the argument of institutionally induced myopia, but the superior investor hypothesis. This hypothesis indicates that institutional investors act as buffers between firms and impatient individual investors, allowing managers to have longer investment horizons. Aghion et al. (2013) also find a positive relationship between R&D and institutional ownership, mainly due to institutions' ability to select the most innovative firms.

Studies by Kochhar and David (1996), and Le et al. (2006) support the active investor hypothesis and suggest that institutional investors can potentially act as efficient governance mechanisms. Bushee (1998) also indicates that large ownership and sophistication allow institutional investors to monitor and discipline managers, ensuring that managers choose R&D levels to maximize long-run value rather than meet short-term earnings goals.

Wahal and McConnell (2000) also suggest that institutional investors with short-term portfolio performance exacerbate individual shareholders' impatience. Individual investors communicate their impatience to corporate managers through pressure on stock prices. Thus, institutional ownership and trading activities exacerbate managerial myopia, implying an institutional moderating effect on R&D. David, Yoshikawa, Chari, and Rasheed (2006) emphasize the moderating effects of foreign institutional ownership because of intensifying R&D investment when firms' growth opportunities are available. Following above arguments, this study focuses on institutional moderating effects and proposes the following hypothesis.

H2. A higher percentage of institutional ownership moderates managerial myopia.

Shleifer and Vishny (1990) suggest that institutional investors with short-term investment horizons will frequently turn over stocks in their portfolio to capitalize on all possible short-term gains. Bushee (1998) finds that high turnover trading by institutional investors exacerbates myopic investment behavior when institutional ownership in a firm is high. Wahal and McConnell (2000) suggest that managerial myopia in the 1990s derives from institutional investors with short-term horizons. However, their results do not support that active institutional trading intensifies managerial myopia. On the basis of critics of institutional short-termism, the third hypothesis is as follows.

H3. Institutional short-termism exacerbates institutional moderating effects.

3. Research design

3.1. Data

Data consist of two datasets from TEJ (Taiwan Economic Journal) database containing listing firms from Taiwan Stock Exchange and Gre Tai Securities Market (OTC), excluding those in financial service industry. One of the datasets provides the fundamentals of listing firms in Taiwan stock markets, comprising earnings before tax, R&D expenditure, net sales, book-to-market ratio, total assets, total debts, cash flow from operations, capital expenditure, net tangible assets, and shares outstanding for each stock. The other provides institutional trading

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