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The effect of CEO luck on the informativeness of stock prices: Do lucky CEOs improve stock price informativeness?

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ABSTRACT

CEOs are "lucky" when they are granted stock options on days when the stock price is lowest in the month of the grant, implying opportunistic timing and severe agency problems (Bebchuk et al., 2010). Using idiosyncratic volatility as our measure of stock price informativeness, we find that lucky CEOs improve the informativeness of stock prices significantly. In particular, CEO luck raises the degree of informativeness by 4.39%. Powerful CEOs who can circumvent governance mechanisms and successfully practice opportunistic timing of options grants are so secured in their positions that they have fewer incentives to conceal information, thereby improving informativeness.

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1. Introduction

''Lucky'' CEOs are awarded stock option grants on days when the stock price is lowest in the month of the grant (Bebchuk et al., 2010). Moreover, it is reported that CEO luck tends to be associated with weak governance mechanisms, such as a lack of majority of independent directors on the board. Taken together, CEO luck seems to imply managerial opportunism and ineffective corporate governance that fails to prevent managerial rent-seeking behavior. Motivated by agency theory, we seek to understand how CEO luck influences the informativeness of stock prices. Based on the literature, we advance two competing hypotheses. First, the opacity hypothesis argues that, to be able to practice opportunistic timing of option grants, the CEO has to exercise so much power that he can circumvent the governance mechanisms that seek to prevent such opportunistic behavior. Powerful CEOs tend to be well secured in their positions, exacerbating managerial entrenchment. Entrenched CEOs may be less motivated to provide transparent information to the capital markets and other external parties (Bertrand and Mullainathan, 2003; Ferreira and Laux, 2007; Fu and Liu, 2008). The opacity hypothesis therefore predicts that firms where CEOs are ''lucky'' experience less transparency, resulting in a more opaque information environment.

On the contrary, the transparency hypothesis predicts the opposite, i.e. CEO luck is associated with more transparency. Powerful and entrenched CEOs who can circumvent governance mechanisms and practice opportunistic timing are so insulated from removal that they have fewer incentives to conceal information, thereby enhancing transparency. Furthermore, entrenched CEOs tend to adopt a ''quiet life'', where they choose to make investments that require less executive effort (Bertrand and Mullainathan, 2003). To the extent that lucky CEOs make less risky investments, cash flows become more predictable, thereby improving financial statement informativeness. The transparency hypothesis thus suggests that lucky CEOs improve informativeness (Armstrong et al., 2012).[2]

We follow the literature and use idiosyncratic volatility as our measure of stock price informativeness (Morck et al., 2000; Ferreira and Laux, 2007; Jin and Myers, 2006; Gul et al., 2011). Morck et al. (2000) argue that idiosyncratic stock price movements reflect the incorporation of firm-specific information into stock prices. Jiang et al. (2009) argue that idiosyncratic volatility contains information about future earnings. Our empirical evidence reveals that firms with lucky CEOs experience significantly more stock price informativeness, even after controlling for other firm characteristics, particularly corporate governance variables such as Gompers et al.'s (2003) Governance Index and institutional ownership. We estimate the magnitude of the effect of CEO luck and find that lucky CEOs are associated with a 4.39% increase in stock price informativeness.

We also execute additional analysis that minimizes the possible effect of endogeneity. First, we run a fixed-effects analysis, which is less vulnerable to the endogeneity bias caused by unobservable firm characteristics that remain constant through time. Second, we execute a two-stage least squares (2SLS) analysis that reduces the bias due to reverse causality. Both the fixed-effect and the 2SLS results confirm that firms with lucky CEOs experience significantly better stock price informativeness. Our conclusion does not appear to be confounded by endogeneity.

[2] There are two arguments in support of the transparency hypothesis. First, for fear of being removed, inefficient or opportunistic managers may not disclose certain information that may reveal their inefficiencies or poor performance. The result is a more opaque information environment. However, CEOs who command considerable power in the firm are more entrenched and are thus significantly less vulnerable to being removed. As a result, their motivation to conceal information is much weaker. Firms with more powerful CEOs thus have a more transparent information environment, relative to those firms with weak CEOs, who are more motivated to hide certain information. The second argument is based on the quiet life hypothesis (Bertrand and Mullainathan, 2003). Powerful and entrenched CEOs may adopt a ''quiet life'', where executives make investments in projects that require less demanding executive decisions and efforts. Risky and complex projects tend to demand more executive attention. Therefore, the quiet life hypothesis suggests that entrenched CEOs are more likely to invest in low-risk projects. The cash flows of low-risk projects are more predictable than those of high-risk projects. With more certainty, the information in the financial statements is more predictive of future performance. As a result, there is an improvement in financial statement informativeness. For empirical evidence in favor of the transparency hypothesis, please see Armstrong et al. (2012), Jiraporn et al. (2012), and Jiraporn et al. (forthcoming).

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