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The effect of ownership structure on the price earnings ratio — returns anomaly☆

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ABSTRACT

It is well known that firms with low price to earnings ratios (value firms) earn higher stock returns in the long term than high price to earnings firms (growth firms). This study investigates how insider ownership affects this relation. We show that when insider ownership is high, returns decline for low P/E firms and improve for high P/E firms. These findings are rationalized in the context of entrenchment and alignment of incentive effects. For low P/E firms, low stock returns reflect the inability of boards of directors and outside shareholders to influence poorly performing entrenched management. For high P/E firms, boards of directors and outside shareholders are less likely to intervene since higher returns reflect increased agency incentives for value-creating managers.

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1. Introduction and motivation

Prior studies document the systematic tendency for firms with low price to earnings ratios (LPE) to earn higher stock returns and firms with high price to earnings ratios (HPE) to earn lower stock returns, in both the United States and in international markets (Campbell & Shiller, 2001; Capaul, Rowley, & Sharpe, 1993; Fama & French, 2002). In this study, we provide evidence that suggests insider ownership alters this relation. That is, when insider ownership is high, companies with low (high) price to earnings ratios earn lower (higher) stock returns. Similar results are obtained for operating performance; in the year following valuation, earnings decrease for high insider ownership–low price to earnings (HIO–LPE) firms and increase for high insider ownership–high price to earnings (HIO–HPE) firms.

We theorize that low price to earnings ratios (P/Es) are, in part, a function of management's inability to create value and therefore may suggest a lack of management capability. Although monitoring and the threat of sanctions by boards of directors and outside shareholders against poorly performing managers could mitigate this outcome, when these same managers own and control a significant portion of the firm, little can be done and returns decline. Conversely, when earnings multiples are high and entrenched managers have been successful in creating value, there is relatively little need for actions by boards. Indeed, high P/Es may reflect, at least in part, market-based assessments of management's ability to achieve superior operating results. Furthermore, a higher stock price reinforces agency incentives associated with the alignment of interests between managers and other shareholders. Consequently, relative to other high P/E firms, returns for firms with high insider ownership increase.

In contrast to prior research that document increasing (decreasing) returns for low (high P/E) firms, results of this study document that in the presence of high insider ownership, returns decrease for low P/E firms and increase for high P/E firms. Using a similar methodology, we also investigate the effect of insider ownership on operating results for low and high P/E firms. Similar to our findings for stock returns, we show that the relation is modified by insider ownership; when insider ownership is high, operating performance decreases for low P/E firms and increases for high P/E firms.

Although entrenched high insider ownership may render boards ineffective, we argue that the relevancy of this effect is conditional on the value of the firm. That is, for HIO–LPE firms, the inability of boards to remove or change ineffective entrenched managers has value reducing implications and indeed may foster future poor performance. However, for highly valued firms where capable managers successfully have created value for themselves and other shareholders, board ineffectiveness is less relevant. Indeed, since a manager's personal wealth increases as the value of the firm rises, owner–manager alignment incentives to sustain high performance also increase.

☆ Data availability: all analyses are based on publicly available data.

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The contributions of this study should be important to boards, investors, and researchers. To the extent that the relevance of boards' inabilities to monitor entrenched managers is conditional on high and low market valuations, investors and analysts should consider these factors. For example, if HIO impairs financial performance for low P/E firms, investors that favor value companies might enhance their investment performance by avoiding HIO–LPE firms. Conversely, growth investors might improve their investment performance by actively seeking ways to hold more high P/E firms with HIO. Finally, assumptions related to the optimal contracting between boards and managers could be modified to reflect changes in agency incentives related to high and low P/E firms when insider ownership is high.

2. Literature and hypotheses

Numerous prior studies report that firms with low price to earnings ratios outperform firms with high price to earnings ratios (Basu, 1977; Campbell & Shiller, 2001; Dreman & Lufkin, 1997). Skinner and Sloan (2002) provide evidence of the inferior returns of growth stocks and suggest that this is the result of excessively high expectations for future earnings.

Agency theory asserts that increased equity ownership by managers reduces costs associated with the principal–agent relation (Eisenhardt, 1989; Jensen & Meckling, 1976; Jensen & Murphy, 1998). Empirical research on the efficacy of this assertion within the context of high insider ownership has not, however, been definitive. Oswald and Jahera (1991) find positive associations between insider ownership and return on assets, return on equity, and excess returns. Hudson, Jahera, and Lloyd (1992) find a positive relation between insider ownership, firm size, and abnormal returns. Other studies instead identify a non-linear relation between ownership and performance. Using a cross-section of 371 *Fortune* 500 firms, Morck, Shleifer, and Vishny (1988) show that Tobin's Q initially increases at low levels of insider ownership (0 to 5%), then declines as ownership approaches 25%, and finally rises as ownership by directors exceeds 25%. They conjecture that costs associated with entrenched managers eventually give way to benefits induced by alignment of interests with outside shareholders. In a similar study, McConnell and Servaes (1990) show a curvilinear relation between Tobin's Q and the percentage of shares owned by insiders. They document an upward sloping curve until insider ownership reaches 50%, after which the slope turns slightly downward. Himmelberg, Hubbard, and Palia (1999) assert that the relation between insider ownership and financial performance is endogenous.

In a more recent study, Neumann and Voetmann (2003) document that a bell shaped curve characterizes the relation between management ownership and performance. They explain that at a threshold of ownership, management takes advantage of shared ownership, which is evidenced by higher abnormal returns. Beyond this threshold, however, stock performance declines due to increasing management entrenchment. Davies, Hillier, and McColgan (2005) present results that show a double humped curve. They assert that at the second local maximum managers become sufficiently entrenched to ignore external monitoring, yet their interests remain insufficiently similar to those other shareholders. Eventually, at high levels of ownership, interests converge and Q rises with ownership (i.e., >75% ownership). Bhabra (2007) shows that various measures of firm value (Tobin's Q, market to book, and return on equity) decrease at intermediate levels of insider ownership. Houmes, Boylan, and Dickins (2009) use preliminary results on the relation between stock performance and insider ownership to assert that agency costs associated with high ownership may alter alignment of interest incentives.

Although the findings of these studies differ, one common result is the value decreasing effect of high levels of insider ownership, suggesting that alignment of interest incentives may give way to the ineffectiveness of non-influential boards on entrenched managers. Weston, Kwang, Chung, and Siu (1998) report that hostile takeover attempts never have been effective when insider ownership is greater than 30%. Boyle, Carter, and Stover (1998) show an inverse relation between high insider ownership and the number of anti-takeover provisions. Stulz (1988) reports that when management ownership is high, the likelihood of takeover decreases significantly since high ownership managers are immune from important external controls and discipline.

In this paper, we link the two strands of literature to study the effect of insider ownership on the relation between earning and performance. We argue that the relation is not unidirectional and that high insider ownership modifies this association. An important objective of senior management is to increase shareholder value. By definition, high P/Es reflect the accomplishment of this important goal. Therefore, even though boards may have little recourse against entrenched equity holding managers, there is relatively little need to constrain or remove value creating executives of high P/E firms. Indeed, from a performance perspective, high valuation is prima facie evidence of able and competent leadership. Furthermore, rising stock prices enhance agency incentives as increases in the manager's personal wealth and stake in the firm coincide with similar increases for outside shareholders.

Conversely, low P/Es are evidence that managers have been unsuccessful in creating value. Indeed, the inability of managers to create value, even though they have much to lose through their large equity stakes, suggests particularly low capability. For these firms, the inability of boards to affect needed leadership change has especially severe value reducing implications.

Consequently, high levels of management ownership mitigate the well-known tendency for low (high) P/E firms to improve (reduce) financial performance. That is, relative to other low P/E firms, in the year following valuation, high insider ownership–low P/E firms exhibit lower financial performance. Conversely, the lower financial performance usually observed for high P/E firms increases. These assertions are tested in our main hypothesis that high insider ownership reduces the tendency for low (high) P/E firms to achieve higher (lower) financial performance.

3. Sample and methodology

3.1. Sample

From Compustat and ExecuComp[1] we obtain financial and insider ownership data over the period 1995–2012. In addition, we obtain end of fiscal year buy and hold returns with dividends reinvested and end of fiscal year stock prices per share from the Center for Research in Stock Prices (CRSP). The primary tests of this study examine the relation between financial performance and insider ownership conditional on P/E. Financial performance is measured according to the firm's market (returns) and operating (earnings) performance. After eliminating firms with missing Compustat and CRSP data, the total number of firm year observations for our models is 12,138. All continuously measured variables are winsorized across the pooled sample at the 1st and 99th percentiles.

3.2. Methodology

Univariate tests and linear regression are used to evaluate the relation between financial performance and lagged high insider ownership conditional on lagged levels of P/Es. High insider ownership and P/Es are lagged in all models because the effects of high insider ownership

[1] ExecuComp files consist of data collected from the annual proxies of firms listed on the Standard and Poor's (S&P) 500, the S&P MidCap 400, and the S&P SmallCap 600 Index. They also include active companies that have been removed from these indices as well as the past years when new firms are added. Although data is available beginning in 1992, data collection begins with 1995 due to the small number of observations in prior years 1992–1994.

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