



CEO turnover and the reduction of price sensitivity



Michael J. Alderson, Naresh Bansal, Brian L. Betker*

John Cook School of Business, Saint Louis University, St. Louis, MO 63108, USA

ARTICLE INFO

Article history:

Received 25 June 2013
Received in revised form 13 January 2014
Accepted 15 January 2014
Available online 23 January 2014

JEL classification:

G31
G32
M12

Keywords:

CEO changes
Managerial incentives
Executive compensation
Investment policy
Financing policy

ABSTRACT

We examine managerial compensation and wealth sensitivities around CEO changes. The average new CEO is incentivized to increase the risk of the firm primarily because he holds significantly less stock than his predecessor, and in fact riskier policy choices are subsequently implemented. Similar results are obtained in a subsample of CEO changes that are due to retirements and deaths, which alleviates concerns about endogeneity. Our findings indicate that firms seem to be limited in their ability to mitigate the risk-averse behavior caused by large CEO shareholdings.

© 2014 Elsevier B.V. All rights reserved.

1. Introduction

Managerial incentives are formed from the sensitivity of CEO wealth to changes in the price and volatility of the firm's common shares. Price sensitivity (delta) may discourage riskier policy choices at the corporate level, while volatility sensitivity (vega) does the opposite. The replacement of a CEO may provide an interesting opportunity to examine the structure of those incentives. The transition creates the potential for a cliff change in the level of the CEO's delta, because the departing CEO often leaves the job having accumulated a significant number of shares that the replacement CEO does not bring to the position.

CEO turnover thus allows us to examine the extent to which the relative levels of price and volatility sensitivity are replicated in the incentive package of the new CEO, and if not, to determine whether the change has an impact on firm policies. Here we find that the average new CEO is provided with the same level of vega as his predecessor, but has a significantly lower delta. The decline in relative price sensitivity creates incentives to implement riskier policy choices which are borne out in subsequent investment and financing decisions.

This creates a puzzle. If riskier policy choices were optimal, why didn't the firm attempt to overcome the higher level of risk aversion displayed by the prior CEO with additional vega? And if riskier policy choices are not optimal, why doesn't the firm provide the new CEO with enough delta to avoid them? Controlling for changes in optimal financing and investment policies, we would expect the old and new CEOs to be similarly incentivized. Yet, they are not, so the sample firms appear to adopt a riskier profile simply because an obstacle to pursuing greater risk (in the form of high CEO share ownership) is eliminated with the leadership change.

We think that the answer to the puzzle lies with limitations in the firm's ability to manage the competing roles of managerial share ownership as a source of both incentive alignment and risk aversion. Agency theory holds that firms should offer a package

* Corresponding author at: Saint Louis University, St. Louis, MO, 63108, USA. Tel.: +1 314 977 7154; fax: +1 314 977 1479.
E-mail address: betkerbl@slu.edu (B.L. Betker).

of options and stock grants which, in conjunction with the manager's existing shareholdings, form the optimal combination of volatility and price sensitivity. Managerial share ownership creates a direct link between manager wealth and valuable corporate-level investment, producing an alignment of incentives that motivates managers to maximize the stock price.

However, stock ownership also causes the wealth of the manager to change as the value of the firm fluctuates. In the presence of such price sensitivity, and in conjunction with significant amounts of non-diversifiable human capital, a risk-averse manager avoids risky investment and financing policies because her expected utility of wealth is reduced by the potential for downside outcomes. As the tenure of the successful CEO lengthens, her holdings of stock may increase to the point that the risk aversion effect dominates the incentive effect (Benson and Davidson, 2009). The results here suggest that there are limits to either the willingness or the ability of the firm to mitigate high levels of risk aversion caused by direct stock ownership, thereby causing the departure of the CEO to be significant in terms of resetting incentives.¹

Our empirical study begins with 940 CEO replacements (resignations, as well as deaths and retirements) with 5425 firm-year observations over the period 1992 through 2011. As with any study of managerial incentives and firm policies, we are concerned with the direction of cause and effect. In this case, that concern applies if changes in the investment and financing opportunities facing the firm prompted the installation of a new CEO, who was then provided with the incentive structure to exploit those opportunities. We attempt to circumvent that problem by examining a subsample that consists of CEO changes caused by deaths or retirements. These events are less likely to be accompanied by changes in the optimal investment and financing opportunities of the firm, thereby allowing the relation between the incentive structure of the new CEO and the policies that he implements to be considered relatively free of endogeneity concerns.

The death and retirement subsample produces qualitatively similar results: delta is reduced in relation to vega, and in the cross section riskier firm policies are adopted when relative price sensitivity is lower. As it is unlikely that the optimal investment and financing policies of the firm changed simply because the CEO died or retired, it appears that the accumulated shareholdings of the departing CEO constitute a barrier to the pursuit of riskier investment and financing policies.

Our study makes several contributions to the literature. We document how the managerial incentives and compensation offered to a new CEO compare to those of her predecessor. There is a voluminous literature on CEO turnover and changes in firm policy² but to our knowledge no one has related these changes to managerial incentives as measured by delta and vega. We demonstrate that the risk profile of the average firm shifts around a CEO change because of a change in the relation between the price and volatility sensitivity of CEO wealth, supporting the view that managerial incentives affect firm policies. This question has been studied, but existing results are mixed. For example, Coles et al. (2006) find that increasing vega implements riskier firm policies, whereas Hayes et al. (2012) find no change in firm policies after a sharp reduction in CEO vega. Our paper adds to the evidence in this area by taking another look, from another angle, at the issue.

The rest of the paper proceeds as follows: the second section reviews the literature on managerial incentives and the econometric issues that must be dealt with in order to estimate the relation between incentives and policy variables. Section 3 discusses the data and provides summary statistics. Section 4 discusses our estimation methods and our empirical findings, and Section 5 concludes the paper.

2. Background

A considerable body of literature has examined the relation between managerial incentives and the selection of corporate investment and financing policies. The connection between the two has been theorized to follow two stages: specific incentive terms are determined which reflect the characteristics of both the firm and of the individual manager, and those incentive terms then influence policy selection.

Delta is generated by stock and option positions which cause the wealth of the manager to change as the value of the firm fluctuates. At low levels, delta incents managers to accept positive NPV projects, but as delta increases it may cause a risk-averse manager to avoid valuable but risky policy choices because they reduce her expected utility of wealth (Parrino et al. 2005). Vega, generated by stock options, may offset the effect of risk aversion by making the expected wealth of the manager increasing in volatility (Haugen and Senbet, 1981).³ Firms should therefore offer a package of options and stock grants which, in conjunction with the manager's existing shareholdings, form the optimal combination of vega and delta.

Empirical evidence on the relation between CEO vega and firm policies is mixed. On the one hand there is a sizable literature that suggests that managers with greater vega take on more firm risk: they favor debt over equity financing; they also direct more dollars to research and development than to capital expenditures (Coles et al. 2006). A higher vega also leads managers to utilize more short term borrowing (Brockman et al. 2010), increase equity exposure in the pension fund (Anantharaman and Lee, 2012) and reduce cash holdings (Chava and Purnanandam, 2010). In contrast, however, Lewellen (2006) finds that higher option ownership is associated with decreased debt financing, while Hayes et al. (2012) report that the policy choices of firms did not change when the implementation of FAS 123R generated a sharp reduction in vegas.

¹ Volatility sensitivity, generated by option positions, counters that risk aversion effect by increasing the expected wealth of the manager. That occurs because option payoffs are a convex function of changes in firm value.

² See, e.g., Fee et al. (2013) and the many references therein.

³ Other theorists, in contrast, argue that increasing vega may reduce risk-taking incentives; for example, Lambert et al. (1991), Carpenter (2000), Hall and Murphy (2002), and Ross (2004).

Download English Version:

<https://daneshyari.com/en/article/5093646>

Download Persian Version:

<https://daneshyari.com/article/5093646>

[Daneshyari.com](https://daneshyari.com)