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The effect of overvaluation on investment and accruals: The role of information

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ABSTRACT

This paper examines whether the effect of overvaluation on accrual and investment is weak in a good information environment using the naive manager hypothesis and the monitoring hypothesis. The results show that CEOs recognize overvaluation and reduce their shareholdings regardless of the extent of the information environment and the naive manager hypothesis is not supported. However, managers in a good information environment do not respond to overvaluation with accrual or investment, and more institutional investors help to reduce overvaluation-driven behaviors. Thus, the monitoring hypothesis is supported. These findings are free from causality concerns and robust for alternative measures of misvaluation.
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1. Introduction

Prior research shows that managers invest more, initiate more dividends, and use more accruals in response to equity overvaluation (Baker et al., 2003; Baker and Wurgler, 2004; Badertscher, 2011; and Chi and Gupta, 2009; Polk and Sapienza, 2009). These responses may be due to managerial interest in increasing stock prices in the short horizon rather than maximizing long-run fundamental value (Baker and Wurgler, 2012; Stein, 1996). Jensen (2005) argues that market overvaluation can exacerbate conflicts of interest between managers and shareholders, which is detrimental to fundamental value. Although the literature widely reports this phenomenon, its solution remains an open question, and researchers have yet to address fully whether any existing mechanism can deter the overvaluation effect.

This study investigates whether the overvaluation effect is weak in a good information environment compared to a poor information environment. We propose two hypotheses: the monitoring hypothesis and the naïve manager hypothesis. According to the monitoring hypothesis, a good information environment helps outside investors to identify corporate actions intended to exploit overvaluation. A good information environment allows financial intermediaries to monitor management misbehavior

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better (Healy and Palepu, 2001; Jensen and Meckling, 1976). Thus, these intermediaries are more likely to detect agency problems such as inflated earnings through management or negative net present value investments. Given outside investors' monitoring, managers do not respond even though they recognize overvaluation. Consequently, the effect of overvaluation on accruals and investment is weaker.

According to the naïve manager hypothesis, managers' expectations correspond with optimistic investors' expectations for the firm because they buy into the market's positive outlook. This correspondence can occur when the information environment is good. In a good information environment, many financial intermediaries and institutional investors collect and process information about the firm's fundamental value. This fundamental information influences investors' trading decisions and is reflected in the market price, so that the market is likely to be efficient (Piotroski and Roulstone, 2004). Thus, under a good information environment, managers may believe that the market is efficient even when it is actually overvalued, and they do not take any corporate action.

Both the monitoring hypothesis and naïve manager hypothesis share the same prediction that managers are less likely to respond to overvaluation in a good information environment; therefore, we first test this implication. We examine two corporate decisions: earnings accrual and capital investment. Capital investment is positively related to the cash flow of companies, whereas earnings accruals only affect reported earnings but not cash flows. Both investment and accruals, however, can affect stock prices (McConnell and Muscarella, 1985; Sloan, 1996).

Our sample consists of firms listed on the NYSE, Amex, and Nasdaq from 1987 to 2011. We find positive misvaluation–accrual and positive misvaluation–investment sensitivities for firms with a poor information environment. Conversely, consistent with our hypotheses, the sensitivities are significantly weaker for firms with a good information environment, such as S&P 1500 firms, firms covered by more analysts, large firms, and firms audited by the Big Eight auditors. Among all measures, S&P inclusion and Big Eight auditors have a stronger effect in reducing sensitivities.

We then test the monitoring hypothesis against the naïve manager hypothesis by examining CEOs' personal shareholding decision. The difference in the implication of the two hypotheses lies in whether CEOs in a good information environment are less likely to recognize the market is overvalued. Under the naïve manager hypothesis, managers of firms with a good information environment fail to recognize that the market price is overvalued, and therefore overvaluation and personal shareholding should not be related. In contrast, under the monitoring hypothesis, managers recognize overvaluation: CEOs realize that they can profit by selling shares, and thus overvaluation should be strongly related to holdings.

Our evidence shows that, regardless of the quality of the information environment, strong negative misvaluation–shareholding relation exists. In other words, although accruals and capital investment are higher for overvalued companies, CEO shareholding is lower. Therefore, our findings suggest that managers recognize the market price is overvalued and respond with capital investment and accruals decisions. Given that managers will reduce their shareholdings in a good information environment, our results support the monitoring hypothesis but not the naïve manager hypothesis.

Sophisticated investors are as important as a good information environment in helping investors to identify corporate actions that exploit overvaluation. As a measure of investor sophistication, we examine whether accruals and capital investment are higher for overvalued firms with more institutional shareholding. We find that firms with higher institutional shareholding have weaker misvaluation–accrual and misvaluation–investment sensitivities. Therefore, having more sophisticated investors also helps to deter the overvaluation effect.

To provide further support for the monitoring hypothesis, we examine the impact of the overvaluation-driven actions on future returns. Given the managerial response to overvaluation, the stock price is likely to be maintained at or pushed to a level higher than the fundamental, and the future stock return will be negative. In our sample, we find that the impact of accruals and investment on future returns are less negative under a good information environment and higher institutional shareholding. This finding is again consistent with our hypothesis that outside investors are less deceived by overvaluation-driven actions.

Our measure of misvaluation for each individual company is the ratio of the market value of equity to its fundamental value. We estimate the fundamental value of equity using the regression approach in Rhodes-Kropf et al. (2005). We use an instrumental variable estimation to ensure that an estimation error or endogeneity does not drive our results. The exogenous instrument used is the buying pressure from mutual funds proposed by Khan et al. (2012). A firm is likely to be overvalued if it is subject to substantial uninformed buying from mutual funds that experience large capital inflows. The instrumental variable estimation provides similar results.

We also estimate the fundamental value of equity using a discounted residual income approach (Frankel and Lee, 1998; Ohlson, 1990). The advantage of the residual income approach is that it is based on a valuation model and uses analysts' forecasts. The drawback is that the requirement of analysts' forecasts data biases against finding a significant misevaluation effect. Rhodes-Kropf et al.'s regression approach uses information from financial statements and can be applied to a larger sample. Therefore, we use the regression approach for the majority of the study and confirm its robustness using the discounted residual income approach for a subsample for which analysts' forecasts are available. Furthermore, we provide various robustness checks using different measures of misvaluation.

Whether managers respond to overvaluation depends on managerial horizon and firm opaqueness (Polk and Sapienza, 2009). When managers care about existing short-term shareholders and the short-term price or when firms are more opaque and the expected duration of misvaluation is long, managers respond to overvaluation. Using turnover as a measure of managerial horizon and R&D intensity as the proxy for firm opaqueness, we find that a good information environment and high institutional shareholding significantly reduce the impact of misvaluation on accruals and investment when turnover or R&D intensity is high. That is, the information environment and institutional ownership play a role exactly when they are needed most.

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