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Stock market speculation and managerial myopia

Ingmar Nyman

Hunter College and the Graduate School, City University of New York, New York, NY, USA

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Abstract

This paper extends the analysis of managerial share price concerns by allowing informed trading in the stock market. It is shown that because they decrease the manager's information advantage vis-à-vis the stock market, individual investors who trade on private information improve the efficiency of corporate investment. This improvement does, however, fall short of first-best efficiency. Moreover, a stronger managerial share-price concern increases the expected profit from informed trading. Hence, by encouraging individual investors to collect information about corporate decisions and trade on it, managerial myopia tends to automatically bring forth a partial solution to the problems that it causes.

JEL classification: D21; D82; G31
Keywords: Managerial myopia; Corporate investment; Informed trading; Stock market incentives

1. Introduction

Does the stock market discipline corporate managers to stay on the straight and narrow or does it lead their decision making astray? The answer depends on how much the stock market knows about corporate decisions: a well-informed stock market can provide accurate incentives that lead to profit-maximizing decisions, but an ill-informed one distorts incentives away from profit maximization. The question therefore arises as to how the stock market can obtain information that enhances its ability to provide managerial incentives. The purpose of this paper is to study one natural way this can happen, namely,

E-mail address: ingmar.nyman@hunter.cuny.edu.

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through speculative trading by individual investors with access to private information about corporate decisions.

The importance of information for stock market incentives has been analyzed in the literature on so-called managerial myopia, which is when corporate managers care not only about the long-run profit of their firms, but about their short-run valuation in the stock market as well (see Grant, King, & Polak, 1996 for a survey). This research concludes that even a stock market that is adept at processing information in the sense that its valuations reflect all available information cannot guide corporate decisions unless it fully understands them. In particular, if a manager has private information about corporate investment decisions—either because the stock market cannot discern these decisions or because it lacks information about their consequences—then managerial myopia can lead to inefficient investment. The reason is that the manager attempts to use his/her investment to fool the stock market and boost the short-run share price at the expense of long-run profits. If his/her private information consists of hidden actions, then the manager tries to generate good news in the short run by distorting investment towards projects where the market is better at discerning it (Paul, 1994; Stein, 1989). If his/her private information consists of hidden information, then the manager tries to hide bad news temporarily from the market by overinvesting in projects with a high ex ante expected profit (Bizjak, Brickley, & Coles, 1993; Brandenburger & Polak, 1996; Brennan, 1990; Stein, 1988). The end result is overinvestment in projects that the stock market either is able to see or wants to see.

Although they point to the information that the stock market has access to as a key determinant of corporate decision making, all existing models of managerial myopia take it as exogenously given. The contribution of this paper is to allow stock market information to be affected by individual investors by introducing informed stock market trading into a hidden-information model of managerial share-price concern. This provides two important results. The first is a characterization of the effect of informed trading on corporate investment decisions. The model confirms the intuition that informed stock market trading can alleviate the inefficiencies caused by managerial myopia: with access to more of his/her information, the market makes the manager bear more of the cost of his/her inefficient investment in the form of foregone long-run profit. However, because all private information cannot be revealed if trading on it is to be profitable, first-best efficiency is not restored completely even when traders are as well informed as the manager. Specifically, corporate investment is always weakly more efficient with informed trading than without it, and strictly so when three conditions are satisfied. First, the fraction of informed traders in the market must be high enough to allow the information that they reveal to make enough of a difference. Second, the extent of managerial myopia must be high enough to make investment inefficient, but at the same time low enough to prevent the manager from persisting in his/her inefficient behavior when the market becomes better informed. Third, the market's preference for its favorite project must be strong enough to make it worth the manager's while to pursue it inefficiently, but at the same time weak enough to make him/her willing to abandon it when the market becomes better informed.

The second significant result that the analysis produces is that one should in fact expect rational and self-interested individual traders to prevent myopic managers from letting their decision making stray too far from the norm of profit maximization. The comparative statics analysis shows that the expected profit from informed trading increases with the manager's concern with the short-run share price. Hence, the new assumption made in this paper that managers with share-price concerns interact with informed stock market traders is in fact quite reasonable because managerial myopia gives traders the incentive to