Note 4

Evidence on Managerial Myopia and Corporate Investment

1. Corporate investments in new projects take long time to complete (their benefits usually arise in the long run), the future is uncertain and long run investments are risky. While essential for the future growth of the firm, corporate long run investment are likely to depress earnings and cash flows in the short term. For this reason, corporate investment is highly susceptible to the CEO's managerial myopia. If managerial short-termism (myopia) is widespread, it can adversely impact the CEO's investment decisions and the future growth of the firm.

2. Managers may undertake myopic actions that boost short-term performance, because they can sell the bulk of their holdings or move to other firms before the long-term cost of their decisions is realized. (A measure of corporate investment is capital expenditure. Reductions in capital expenditures increase a firm's free cash flows and sometimes also earnings. This may lead to a temporary stock price increase, which managers can exploit it exercising vested options and selling equity (e.g., Hirshleifer [2001], Rappaport [2005]). Financial analysts also often use free cash flows to value companies. A decline in capital expenditure will increase the firm's cash flow, which may lead the analyst to overestimate the firm's earnings, and thus its stocks.

3. The CEO does not receive ownership of stock options or restricted stocks until the grants vest, which typically occurs a three-to-five year period. Once options vest, executives are generally free to exercise them and sell the underlying shares – vesting periods are usually the only explicit mechanism to prevent executives from unwinding their equity incentives. Shorter vesting periods allow executives to sell equity more quickly, and also to forfeit less equity when leaving the firm. In other words, shorter vesting periods may increase the chance of short-termism / managerial myopia.

4. A testable implication of the presence of managerial myopia is that close to the time when the CEO's stock option grants vest, investment in long run projects is likely to decline. Or in other words, as the option grants' vesting time approaches, the CEO is likely to engage in activities that increase stock prices so that he or she can cash in, and sell the stocks at higher price.

5. To test this hypothesis, Ladika and Sautner (2014) investigate a historical period in the U.S corporate finance when corporate boards decided to reduce the vesting periods of stock options that had already been granted to CEOs to avoid taxes. In December 2004, the Financial Accounting Standards Board (FASB) in the US required all firms to begin expensing the fair value of newly granted stock options, as well as previously granted *unvested* options, in fiscal year 2005. Prior to the requirement, firms did not have to factor the cost of stock option compensation into accounting earnings. FASB allowed firms to avoid an accounting charge on previously granted, out-of-the-money options by accelerating these options to

vest before the requirement took effect. More than 700 firms, including about 15% of S&P 1500 firms in 2005 accelerated most previously granted stock options so that they vested immediately, instead of over several years as originally scheduled. Accelerating firms avoided on average an accounting expense equal to 23% of net income (Ibid, p.4).

6. To test the presence of impact of the CEO's short termism, the researchers have looked at the data on the investment behaviour of the CEOs for whom the vesting period of their stock options was shortened. The shortening of vesting periods of the option grants lowered long term investment, supporting the presence of short-termism or, in other words, managerial myopia.

7. The researchers found that a 10% decrease in the vesting periods of the CEO's stock option grants led to an absolute decrease of 0.023 in contemporaneous industry-adjusted capital expenditure. That is, for a company with total assets of $327 million, a shortening of the vesting period of the CEO's option grants by about 10% led to a decrease in investment (capital expenditure) by about $7.5 million relative to the industry average. Accelerating the maturity of option grants noticeably lowered CEOs' willingness to invest in long run projects (p.20, see the table 5 in the paper on Blackboard).

8. If managerial myopia and managerial short-termism is widespread, it is important that corporate boards and shareholders design compensation contracts and governance mechanisms that incentivise managers to focus on long-term value creation. Standard stock option grants do not entirely achieve the objective, and secure necessary risky investment and future firm growth.

Source: Ladika, T. and Z. Sautner (2014), The Effect of Managerial Short-Termism on Corporate Investment, working paper, Available on Blackboard.