Note 5

Further Evidence on Managerial Myopia and its Impact on Investment

1. Edmans et al. (2014) investigate the link between the CEO's short-term incentives and real investment decisions. The paper seeks to statistically test myopia theories of CEO's behaviour (Stein, 1998, 1989). The theories build on the plausible assumption that since the benefits of intangible investments, such as investment in R&D, are only visible in the long run, their immediate effect is to depress the firm's earning and thus current stock prices. Consequently, if the CEO is concerned with the firm's short-term stock price, he will fail to invest in essential projects that will bear fruit only in the long run. A manager aligned with the firm's short-term stock price for any reason may turn down valuable investment opportunities.

2. The CEO may be concerned with the firm's short-term stock price for different reasons. The market may assess the performance based on the firm's short-term stock price; the board of directors may assess the CEO's performance by judging the short-term stock price; or the CEO may expect to sell the equity (stocks) he owns in the short term. Equity that vests in the short-term may cause short-termism by refocusing the CEO's attention towards short-term stock price.

3. Edmans et al (2014) use a rich data set on the U.S CEOs' compensation pay contracts which offers information on the vesting time of CEOs' stock options and their restricted stocks to identify increases in equity sales that arise from scheduled vesting of the CEO's existing stocks and option holdings. The reason for focusing on such cases is that scheduled vesting is predictable by the CEO (he knows when his stock options vest in advance), and so he is able to change investment in anticipation to increase the short-term stock price and benefit from the price rise.

4. Edmans et al. (2014) measure investment using the growth in R&D, advertising, and capital expenditure, scaled by total assets, and also study individual components of this measure.

5. The researchers find that CEOs who are likely to sell more equity in the short term, due to the imminent vesting of their stock or options, cut research and development ("R&D), advertising, and capital expenditure. Such CEOs are more likely to meet or marginally beat analyst earnings forecasts.

6. The analysis reveals a negative and significant relationship between nearly all measures of investment growth and instrumented equity sales. An interquartile increase in vesting-induced equity sales is associated with a 0.25 percentage point decline in the growth of R&D scaled by lagged total assets, which corresponds to 4.5% of the average R&D / assets ratio, and an average decline of $2.2 million per year. (see Edmans et al. (2014), Table 2, p. 40)

Further, vesting-induced equity sales are associated with a higher likelihood of meeting or marginally beating analyst earnings forecasts: an interquartile increase in vesting-induced equity sales is associated with a 0.81 percentage point increase in the likelihood of beating the forecast by up to one cent, compared to the unconditional likelihood of 12.2%.

7. These results provide empirical support for managerial myopia theories and, more broadly, evidence that CEO contracts affect real decisions. Incentive contracts affect managers' behaviour, i.e., CEO pay actually matters and executive compensation has real effects.[1]

8. The task in the essay is to build on these researches and devise a compensation contract that reduces managerial myopia, ensuring that the CEO invests in long-term investment projects. The first few pages of Edmans et al (2014) paper are quite relevant to the essay.

Edmans, A, Fang, V. W., and K. A. Lewellen (2014), Equity Vesting and Managerial Myopia, Available on Blackboard.

[1] Edmans, Goncalves-Pinto, Wang, and Xu (2014) show that CEOs strategically release news in months in which their equity vests, to boost the stock price and stock liquidity.