Managerial Opportunism: The Interface of Manager Optimism and Investor Sentiment

Extended Abstract

In this paper, we examine how managers can opportunistically take advantage of short-term stock mispricing. In particular we examine activities around stock splits and investigate how market-wide investor sentiment and manager overconfidence affect managers’ opportunistic behaviour in relation to the stock split decision. In addition, we analyse the extent to which managers time the market following splits. As well as considering irrational investors, we also build on the irrational managers’ strand of the literature and examine the opportunistic behaviour of managers at the interface of manager and investor irrationalities.

The paper explores the coexistence of investors’ irrationality and managers’ irrationality in the context of stock splits, in light of the argument that “nominal share prices and stock splits (not “settings”) are not associated with any confounding, “real” motivation involving firm fundamentals” (Baker, Greenwood and Wurgler 2009, p.2563). Prior studies have shown that stock splits are associated with post-announcement positive abnormal returns (see Grinblatt, Masulis and Titman 1984; Ikenberry, Rankine and Stice 1996; Desai and Jain 1997; Ikenberry and Ramnath 2002; Titman, Wei and Zhao 2016), creating a suitable platform for managers to time the market. Within this context our analysis examines both the decision to announce a split and insider trading following a split, using US market data for the period January 1996 to December 2016. Stock split data and share price data are gathered from ‘CRSP Stock Events - Distribution Information’ and ‘CRSP Stock/Security Files’, respectively, for all shares that have share codes of 10 or 11. As the main proxy for market-wide investor sentiment, we employ the Baker and Wurgler (BW) sentiment index (as in Baker and Wurgler (2006)). The proxy for manager irrationality is based on Campbell, Gallmeyer, Johnson, Rutherford and
Stanley (2011)\(^1\) and manager overconfidence is measured using option data downloaded from Compustat-Capital IQ ExecuComp – Annual Compensation and Company Financials. Insider trading data is from Thomson Reuters Insider Filings database. Following Jeng, Metrick and Zeckhauser (2003) and Cohen, Malloy and Pomorski (2012), we use Securities and Exchange Commission’s (SEC) Form 4 filings and concentrate on open market purchases and sales by insiders, excluding options exercises and private transactions.

The analysis starts by examining the roles of market-wide investor sentiment and manager overconfidence in explaining the stock split decision. Consistent with Baker, Greenwood and Wurgler (2009), we find that firms are more likely to split when prices, returns, and volatility are higher, the industry average share price and firm size are lower, and the low-price premium is at higher levels, all else equal. From the perspective of irrational managers’, firms of overconfident CEOs are not found to be more or less likely to split. In contrast, from the perspective of irrational investors, sentiment does matter; firms are more likely to split during higher market-wide investor sentiment periods. When irrationality is considered from both sides within a ‘coexistence’ view, results hold when either a continuous sentiment variable or a categorical sentiment variable is applied. That is, in line with expectations, a higher level of market-wide investor sentiment increases the likelihood of a stock split, all else constant.

The next stage investigates insider trading activity around stock splits and attempts to examine the use of splits as an opportunistic tool by managers. We investigate whether previous insider buying activity has a significant link with the split likelihood as a more direct test for whether managers decide on a split in an opportunistic fashion. Specifically, we examine whether the likelihood of a stock split is related to preceding insider buying activity. A

\(^1\) Malmendier and Tate (2015, p.41) develop an alternative measure for CEO overconfidence that incorporates “details of individual option packages” (e.g. individual grant dates, expiration dates, etc.), and hence, allows the assessment of “the timing of exercise relative to expiration (or grant) dates”. However, this measure can only be constructed from 2006 onwards due to data unavailability for earlier years.
significant negative relationship is found between stock split likelihood and the extent of past period insider buying activity. The significant relationship is also apparent when only ‘opportunistic’ trades are considered.

The next part of our investigation involves examining whether opportunistic behaviour of managers (i.e. insider selling after splits) is affected by investor irrationality (sentiment) and/or manager irrationality (overconfidence), by considering ‘opportunistic’ CEO net insider selling. Results show a significant negative relationship between overconfident CEOs and their opportunistic net insider selling. In general, a greater level of insider selling can be expected around splits from the perspective of both signalling and information asymmetry motives. In particular we argue that if the market is rational, overconfident CEOs are expected to sell less. However, if the market is irrational, but managers are rational, a higher level of sentiment will lead to a greater level of selling. If both sides are considered irrational, overconfident CEOs will not sell less in high sentiment periods, as they would also think that stocks are overvalued and be tempted to sell too. However, we find that market-wide investor sentiment does not significantly affect opportunistic CEO net selling.

To extend our understanding of the issues, we also examine the impact of splits on insider trading in good governance and easy-to-arbitrage firms. Following Yun (2009) internal governance is measured using data on the fraction of outstanding shares held by 5% blockholders and those held by institutional investors, where a larger fraction of shares held by these investors is considered to suggest better internal governance. With respect to easy to arbitrage firms we follow Baker and Wurgler (2007) and sort stocks according to their recent return volatility; specifically the standard deviation of monthly returns over the prior year is used and decile portfolios are formed. Results suggest that CEO opportunistic selling around splits is lower among easy-to-arbitrage firms. However, there is no significant difference in opportunistic selling of CEOs between high and low good governance firms.
Finally, building on Devos, Elliott and Warr (2015), we examine immediate insider trading activity around split announcements to determine the extent to which insider selling is delayed until after split announcements. We find that insiders tend to delay selling activity until after split announcements suggesting they opportunistically time the market for their own benefit.

Our paper stands within the behavioural corporate finance literature, a strand of work surveyed in Baker and Wurgler (2013). One main contribution of our work is that, to our knowledge, it is the first study to examine the opportunistic behaviour of managers when considering irrationality from both sides, investors and managers. Stein (1996) asserts that managers with a short horizon may utilize any market inefficiency caused by investor irrationality and cater to time-varying investor demands. A number of catering theories are proposed for different types of corporate actions where irrationality principally comes from the investor side and many corporate decisions are evidenced to be motivated by managerial incentives with short-term share price considerations.\(^2\) Short-term ‘irrational’ investor demand for stocks that are associated with specific corporate actions are well-rehearsed. Our study reflects on market-wide investor sentiment as an investor irrationality dimension and complements the evidence with the consideration of irrational managers within the framework.

Second, we contribute to the literature on the motives for stock splits. A number of hypotheses are put forward to explain the motive behind stock splits (e.g. trading range hypothesis (Copeland 1979), signalling hypothesis (Grinblatt, Masulis and Titman 1984), optimal tick size hypothesis (Angel 1997), information asymmetry reduction hypothesis (Brennan and Copeland 1988)). Baker, Greenwood and Wurgler (2009) further offer a catering explanation for stock splits by proposing a catering theory of nominal stock prices, where

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managers deliver shares at lower price levels when investors value low-price firms highly in
the market. Building on Baker, Greenwood and Wurgler (2009), we examine the role of
market-wide investor sentiment and manager overconfidence in firm-level splitting activity to
consider opportunistic managerial behaviour.

The study also contributes to the insider trading literature. Devos, Elliott and Warr
(2015) find significantly higher levels of insider selling after split announcements, consistent
with opportunistic CEO behaviour. We provide deeper and more direct tests for opportunistic
manager behaviour and examines the link between stock splits and insider trading considering
‘routine’ vs. ‘opportunistic’ insider trading, corporate governance, ‘higher’ vs. ‘lower’ level
insiders and difficult to value and arbitrage stocks. Our findings provide important new insights
within the field of behavioural corporate finance and shed new light on the opportunistic
behaviour of managers within a novel setting.

References:


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