Do Investors Value Managerial Honesty?

From the Enron scandal to the subprime crisis to the Bernie Madoff scam, corporate fraud and managerial misconduct have rattled shareholder value and investors’ trust over recent decades. Initiatives to eradicate such behavior have been numerous. They have included changes to the structure of managerial compensation, strengthening board members’ skill sets and auditors’ independence, and an increase in regulation throughout the corporate world. Yet little is known about whether investors influence managers by making investment decisions based on perceived managerial honesty. So, is further regulation required to improve ethical management and promote honest corporate cultures?

SFI professors Rajna Gibson Brandon of the University of Geneva and Alexander F. Wagner of the University of Zurich employ experimental research techniques to determine the role of perceived managerial honesty in investment decisions. Their paper Investing in Managerial Honesty argues that investors form views about CEOs’ honesty based on the CEOs’ previous decisions regarding whether to earn a higher bonus by managing upward the firm’s earnings. Although only legally acceptable practices of earnings management are considered, results show that investors view a CEO who has resisted the temptation as substantially more honest.

Pro-social investors seem to base their investment decisions directly on moral values and are largely insensitive to financial returns. They appear to favor perceived managerial honesty simply because they themselves value honesty, and are willing to accept lower returns in order to invest with a similarly minded CEO.

What do the results mean for the financial sector?

The learning points from this research have implications not only for investors, but also for banks, corporations, and regulators. Investors seem willing to avoid firms they perceive as being run by dishonest managers. Instead, they favor investments in firms run by managers seen as being more honest. This is irrespective of any given investor’s pro-self or pro-social orientation.

Banks should acknowledge the importance and role of managerial honesty when selecting financial assets and creating suitable portfolios for their clients. They should not focus exclusively on financial expectations. Corporations should recognize that managerial honesty may impact a firm’s value. Essentially, the results suggest that firms with CEOs perceived as more honest may enjoy better access to funds and, therefore, a lower cost of capital. The research therefore supports ongoing efforts to make managerial integrity a key consideration when recruiting top management.

Finally, transparent information regarding managerial characteristics is required to enable investors to channel funds to firms they consider more honest. This is where policy makers and regulators have a key role to play in setting the right disclosure requirements.

Investors are classified as «pro-self» or «pro-social». The results show that both types of investors seek the same goal—managerial honesty—but for different motivations. Specifically, the pro-self investors assign greater credibility to future financial returns announcements when such statements are issued by CEOs perceived to be more committed to honesty. The rationale at work here is that such CEOs are expected to announce more reliable information regarding financial returns and thus lower the odds of investors being deceived.

Do investors’ perceptions of managerial honesty impact their investment decisions?

In total, 60 percent of the participants in the experiment chose to invest with CEOs who did not engage in upwards earnings management and thus passed on the opportunity to earn a significantly higher bonus. Participants favored CEOs they perceived to be more committed to honesty, even if this implied lower financial returns. Further, the more a CEO is perceived to treat honesty as a protected value, the less investors tend to be sensitive to the relatively higher future returns claimed by CEOs perceived to be less honest.

Does managerial honesty carry the same meaning for all investors equally? And if not, in which sense do they differ?

This insights draw on the academic paper by Prof. Rajna Gibson Brandon, Dr. Matthias Sohn, Prof. Carmen Tanner, and Prof. Alexander F. Wagner. The full academic paper can be accessed at: http://bit.ly/2vwLhUK