CEO charisma biases financial analysts, can hurt investors, study says

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Projecting the charisma of a newly hired Chief Executive Officer often leads financial analysts to make crucial errors in forecasting the company's future performance, according to a new study in the current issue of *Organization Science*, a journal of the Institute for Operations Research and the Management Sciences (INFORMS).

"In Charisma We Trust: The Effects of CEO Charismatic Visions on Securities Analysts" is by Angelo Fanelli of the HEC School of Management in France, Vilmos F. Misangyi of Pennsylvania State University, and Henry L. Tosi of the University of Florida. The study appears in the current issue of *Organization Science*.

While it is difficult to translate the findings (that a one-standard deviation increase in the use of charismatic language results in approximately a tenth-of-a-point increase in analyst recommendations) directly into an effect on stock prices, previous findings by academic research has shown that an upward revision of one point in analyst recommendations can increase stock prices in the range of 2-3% over the first month following the revision.

At the same time, "analysts covering firms with higher CEO charismatic visions were more prone to misestimating future performance than those following firms with less charismatic CEO visions," the authors explain.

Thus, the use of charismatic language in CEO vision statements can lead investors to make poor decisions about their purchase of securities.

The authors reached their conclusions by analyzing the initial letters to shareholders made by incoming CEO's and, in turn, securities analysts' subsequent recommendations and forecasts.

The authors' research completely supported their first two research hypotheses:

1. that CEO charismatic visions as expressed in their inaugural letters to shareholders persuade individual analysts to make positive recommendations

2. that these charismatic messages further influence a herd effect, with the preponderance of analysts writing favorably about the company

The authors' third hypothesis has important implications for investors and the analyst community. It says that CEO charismatic visions are related to analysts making forecasting errors. The authors' research partially supports this hypothesis, leading them to conclude that in the one-year period following a higher frequency of CEO charismatic communication (CCV), analysts make larger errors in their forecasts, either overestimating or underestimating the firms' performance.

This can affect the price at which securities trade, as well as decisions by individual investors.

In effect, the authors write, investors may sustain losses as a result of analysts succumbing to the charm of charismatic CEOs and doing a less than thorough job examining other significant measures of a company's performance.

The authors found that more skilled analysts were less likely to make

these errors.

They warn that analysts' careers could be damaged by these misjudgments.

"Given that forecast accuracy is crucial to analyst reputation…, our results imply that [CEO charismatic visions] may have negative consequences for analysts' judgment and ultimately for their careers; it appears that analyst should be war of incorporating CCV into their evaluations," the authors write.

In their research, the authors examined a sample of CEO succession events that occurred between 1990 and 1990, identified through the ExecuComp database, within a random sample of 800 U.S. publicly traded corporations within 30 industries. After exclusions, the final sample was 367 CEO succession events. Charismatic vision statements, as identified by the authors, are those which use language that 1) is critical of the status quo, 2) presents goals in ideological and moral overtones rather than in pragmatic terms, and 3) tends to empower stakeholders.

To examine analyst responses to CEO charismatic visions, the authors collected all the recommendations issued by the analysts following each of the 367 firms within a year after the letter's release to shareholders and examined them for uniformity. Analyst recommendation uniformity was measured for each firm as the standard deviation from the consensus recommendation across all analysts following the firm.

To assess analyst error, the authors used forecasts of earnings per share.

The authors examined data from two databases: I/B/E/S and FirstCall.

More information: http://orgsci.journal.informs.org/

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