CEO's fate in hands of external constituents

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A CEO's fate might be in the hands of external constituents, according to a new study from Rice University's Jones Graduate School of Business. The study found that investment analysts and their negative stock ratings can sway a board to dismiss its CEO.

Conventional research has focused on internal factors that contribute to CEO dismissal -- poor firm performance and organization power and politics. But the new study, published by the Strategic Management Journal, turned its attention outward to discover the significant influence investment analysts have on a board of directors' decision on CEO dismissal versus retention.

The study, conducted by Rice's Yan Anthea Zhang with Margarethe Wiersema at the University of California at Irvine, is the first to provide evidence that investment analysts' stock recommendations can influence boards' evaluations of CEOs and decisions on their dismissal.

"As legitimate third-party evaluators of the firm and its leadership, investment analysts provide certification as to the CEO's ability, or lack thereof," said Zhang, Jones School Distinguished Associate Professor of Management. "Most of the boards' assessments of CEOs involve qualitative judgments characterized by uncertainty, so stock ratings of investment analysts help reduce the ambiguity in the evaluation process.

"In addition, investment analysts' stock recommendations are consequential to investors' decisions. Given that a public company is dependent upon the financial markets for access to capital, the board is likely to be aware of and respond to analyst recommendations when they are negative," she said.

For the study, "CEO Dismissal: The Role of Investment Analysts," Wiersema and Zhang used panel data on the S&P 500 companies from 2000 to 2005, a time period in which concerns over shareholder wealth maximization and CEO accountability generated significant pressures and constraints on companies.

They found that negative stock recommendations (lower levels of average analyst ratings, downgrading of the stock and a larger percentage of sell recommendations) resulted in a higher probability of CEO dismissal. The impact of negative stock recommendations was particularly stronger when the firm's prior stock return was relatively lower than its industry peers'.

The study showed that the impact of investment analysts' stock recommendations on CEO dismissal changed over time. The impact became weaker after litigation against some investment analysts in 2002, which damaged the credibility of investment analysts as a professional community.

"The board responded to negative or unfavorable analyst recommendations in their decision to dismiss the firm's CEO only to the extent that analysts were perceived as credible, and thus consequential to investors' decisions," Zhang said.

For each of the 500 companies, Wiersema and Zhang identified whether the firm experienced a CEO turnover in any year during 2000-2005 and whether the turnover was a voluntary turnover or dismissal. Within the six-year time period, they found a total of 239 turnovers, of which almost 30 percent were dismissals.

They examined three measures of investment analyst stock recommendations -- average analyst recommendation, change in average analyst recommendation (upgrading or downgrading) and percentage of sell recommendations -- all calculated from data gathered from the Institutional Brokers Estimate System. They found that for firms that were initially rated as a "buy" or "strong buy," a downgrade had a significant impact. For firms already rated as relatively unfavorable, further downgrades were not significant. For upgrades, there was no significant effect, regardless of the initial average analyst recommendation.

"An upgrade does not materially reduce the probability of CEO dismissal, while a downgrade increases the probability of CEO dismissal significantly," Zhang said. "That is consistent with prior findings that negative information alters investor perceptions more than positive information."

Provided by Rice University

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