

# Research challenges 'stigma effect' for industries with law-breaking companies

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When financial misconduct is discovered, the company caught cooking the books suffers a fall in market value, but so do its industry peers, because the accusation triggers investors' perceptions that other

companies in the industry may have engaged in similar misconduct (stigma effect). Interestingly, however, a few close competitors of the wrongdoer could actually benefit from the scandal by acquiring its disgruntled customers, which could boost their market value (competition effect).

Research by Dovev Lavie (Department of Management and Technology) with Ivana Naumovska (INSEAD), forthcoming in *Administrative Science Quarterly*, finds that the negative [stigma](#) effect increases with greater product market overlap between the accused and non-accused companies, but only up to a point. After that, the positive [competition](#) effect kicks in and counterbalances it, with closest competitors gaining from the accused company's pain.

The challenge? Not all investors can tell who the close competitors are. Industry experts, and sophisticated investors, such as [hedge funds](#) and mutual funds, who rely on a more fine-grained classification of products in the industry, can identify those close competitors and invest in them, while most other investors have only a broad understanding of the industry, and thus mostly react to the stigma and sell their stocks of other companies in the accused company's industry.

Lavie and Naumovska tested their hypotheses with data on 233 publicly traded U.S. firms operating in the software industry in the 1990s. During the period under study, they identify 16 software companies that were subject to enforcement actions by the SEC for financial misrepresentation. Market loss or gain was calculated using cumulative abnormal stock market return (CAR) around the time of accusation.

Whereas the accused company suffered an average CAR of -30.84%, non-accused companies experienced a -1.98% loss. This suggests that "the stigma effect is stronger than the competition effect on average," Prof. Lavie notes. However, the average does not tell the true story, as

the CAR declines with product market overlap up to a point, after which it starts to increase.

To test the idea that value is in the eye of the beholder, alternative product classifications were tested. When using a relatively coarse classification (assigning the companies' products to 54 [market](#) segments), the positive, competition effect on non-accused companies was less evident than when using a more fine-grained classification (464 product classes). In the latter case, the 5.6 closest competitors to the accused [company](#), on average, were able to reap some benefit. "In other words," Professor Lavie says. "The competition effect offsets the stigma effect for a select group of the accused peer's closest competitors." The authors then demonstrate that it is the sophisticated investors that invest in those competitors and are relatively immune to the stigma effect compared to the majority of investors.

How should companies avoid the negative spillover from delinquent companies in their industry? "We suggest that companies should anticipate and respond not only to the competitive actions of their industry peers but also to their unethical behavior, which can affect performance much like competitive actions can," Professors Lavie and Naumovska conclude. "Somewhat counterintuitively, close competitors of an accused peer should underscore the similarity of their products at a fine-grained level, so that the positive spillover ascribed to the competition effect can offset the negative spillover ascribed to the stigma effect. In contrast, firms that do not compete directly with the accused peer would be advised to emphasize the dissimilarity of their products at a coarse level, as this may weaken the stigma effect."

**More information:** Ivana Naumovska, Dovev Lavie. When an Industry Peer is Accused of Financial Misconduct: Stigma Versus Competition Effects on Non-Accused Firms (April 21, 2021). *Administrative Science Quarterly*, Forthcoming, Bocconi University

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