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Full length Research Paper

The market reaction to the appointment of an outside CEO: An empirical investigation

Melita Charitou*, Andreas Patis and Adamos Vlittis

Department of Economics and Finance, University of Nicosia, Cyprus, P. O. Box 24005, 1700 Nicosia, Cyprus.

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The primary objective of this study is to examine whether there is a market reaction around the announcement day of an outside Chief Executive Officer (CEO) appointment. A significant market reaction around the announcement would indicate the strategic importance of a CEO and his/her contribution to future firm prospects. Our dataset consists of 158 US firms over the period 1993 to 2005 that appointed an outside CEO. Using an event study methodology, our results indicated that there exist abnormal stock returns around the appointment day of an outside CEO. The results of this study should be of great importance to organizations and capital market participants, such as investors, analysts, bankers, simply because firms will give more emphasis on the selection criteria of an outside CEO appointment, which subsequently affects shareholders' wealth.

Key words: Abnormal returns, CEO appointment, market reaction.

INTRODUCTION

During the last decade, many corporate collapses took place and the need for proper corporate governance led to the Sarbanes Oxley legislation in 2002. Moreover, the recent global financial crisis led many organizations into financial distress; among these are Lehman Brothers, Bear Stearns and General Motors. CEOs in these companies might have been overly aggressive, taking a large amount of risk leading their companies into financial problems. On the contrary, other companies in which a successful CEO was at the helm, managed to perform better possibly due to the right strategic decisions taken by the CEO.

When CEOs are concerned with their external career opportunities, they tend to make decisions at their current employers that increase their appeal to others (Fama, 1980; Holmstrom, 1982). This could either increase or decrease the value from the current employer's view. Bizjak et al., (1993) stated that concerns about labor market opportunities may affect capital investment, earnings manipulation, risk taking, capital structure, corporate control and money management strategies (Bedchuk et al., 2003; Bedchuk and Grisnstein, 2005; Bower, 2007; Fee et al., 2003).

It is obvious that the CEOs have a key role in determining a firm's strategy and performance. As such, the stakeholders are likely to view CEO selection as an indication of the firm's future. Specifically, for shareholders the succession of a CEO is a signal for future success or future failure (Davidson et al., 2002; Friedman and Singh, 1989). Thus, CEO succession is an important event for any organization. It is no surprise that in the last decade, CEO turnover and succession has become a common subject in U.S corporations (Boeker, 1992; Grube, 1995; Plitch, 2003). This is partly due to the increased demand from institutional investors for optimum managerial practices and the need for CEOs to satisfy the principal (board) and generally the stakeholders, as an agent of the company (Huson et al., 2004; Jensen and Meckling, 1976; Jenter and Kannan, 2005).

In CEO selection decisions, the boards of directors usually face a dilemma on whether to hire an insider or an outsider. According to Agrawal et al. (2006) the majority of CEO successions involved insiders. Obviously, insiders are more favored than outsiders. There are two potential explanations for this phenomenon. First, according to Chan (1996), the preference for insiders is to provide an incentive to insiders to work hard. The firm puts the executives in a promotion contest against each other to prove their managerial abilities. This provides

*Corresponding author. E-mail: charitou.m@unic.ac.cy. Tel: 357-22-841-682.

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incentives for the lower level executives to work hard in their current jobs, which benefits the firm. The board eventually rewards the executive with the highest contribution and abilities with the CEO position. Thus, in a contest between insiders and outsiders and when other factors like educational background, experience and past performance remain the same, firms tend to favor insiders. A second reason for the preference of insiders that is more related to the current study is the adverse selection problem. That is, when there is information asymmetry as to the ability of the potential candidates, the board is more likely, *ceteris paribus*, to have better information about the ability of an insider candidate leading to the preference for insider hires (Kaplan and Minton, 2006; Khurana, 2002).

On the other hand, it seems that the appointment of an outsider as a CEO is more likely when the hiring firm has poor performance. Outsiders are preferred because they bring to the firm knowledge from other organizations, they can more objectively evaluate and challenge the current strategy of the company and incorporate new and fresh ideas in order to take the firm out of financial problems. Finally, the external labor market provides the company a much larger talent pool to choose from and as a consequence, better chances of finding the right person for the job. The challenge for the board of directors is to choose the appropriate candidate for the job. Because of the information asymmetry about the ability of the potential candidates, the board needs to rely on imperfect public signals to make the right choice for the CEO position.

Our dataset consists of 158 US firms over the period 1993 to 2005 that appointed an outside CEO. Using an event study methodology, our results indicated that there exist abnormal stock returns around the appointment day. The study proceeds as follows: It discusses the research problem and further reviews the relevant literature and develops the research hypothesis. In addition, it describes the methodology and the data collection. Lastly, empirical results are discussed and conclusions are presented.

RESEARCH PROBLEM

This paper examines the signals that the market finds most beneficial in choosing an outsider CEO. This paper investigates outsider appointments because the board and the market needs to rely on publicly observable signals in order to assess their ability, in contrast to insiders where the board has much more information about the ability of the insider and this information is intangible and usually unobservable to the public.

To this end, this study adopts an empirical approach, focusing on share price behavior surrounding announced changes in the top ranking executive position. Systematic evidence of shareholder wealth effects surrounding chief executive changes, would lend credence to arguments about the value relevance of the strategic function in the firm, from the top managerial perspective. Also, they would provide some initial understanding about the chief executive officer position and would highlight the need for further research in the area.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Given the importance of CEO selection and succession in a firm's future prospects, the primary objective of this study is to examine the investors' reaction at the announcement date of an outsider CEO selection. The most related research in the literature is focused on the dynamics of the market of outside directorships. Generally, these articles suggest that the market rewards managers from firms that perform above the average (Kaplan and Reishus, 1990; Brickley et al., 1999). Shen and Canella (2003) found a significant positive wealth effect for outside succession. These findings are consistent with a prior study of Davidson et al. (2001), which suggests that shareholders favor outside successions. Motivated by the limited empirical research on the outsider CEO appointment, this study examines the abnormal returns around the announcement day of an outside CEO change (Weishback, 1988; Warner et al., 1988; Parrino, 1997; Rosenstein and Wyatt, 1990).

There are diverse expectations about the market reaction to a CEO appointment. One possibility is that a firm voluntarily making such a change seeks to obtain the benefits of a redirection in its strategic leadership expecting performance improvements as a result. To some extent, if mismanagement of the strategy, vision mission and objectives contributed to financial problems for the firm, a change in leadership is expected to reverse this trend by improving the strategies in the firm. Consequently, this will help to accelerate the firm's performance recovery in the future. Investors will embrace such improvements into their expectations about the firm's future cash flows, which will ultimately be reflected on investors' positive assessment of the news of the new chief executive appointment. This would interpret into a positive share price response on the day of announcement of the CEO's appointment (Denis and Denis, 1995; Bower, 2007).

On the other hand, a change in CEO is not without risks, given that it is typically associated with a change in the firm's strategic direction. The most probable response of the incoming CEO is to question the previous firm's strategy and performance. In general, the appointment of CEOs is likely to signal both potential benefits and costs for the appointing firms. In the light of this discussion, the stock market reaction to the announcement of a new CEO appointment is an open empirical question. Motivated by the ambiguous first order effect of a CEO

Table 1. Time distribution of the CEO announcements. In this table we present the time distribution of the 158 CEO announcements over the period 1993-2005.

Year	Number of events	% Sample
1993	7	4.43
1994	6	3.80
1995	5	3.16
1996	8	5.06
1997	8	5.06
1998	9	5.70
1999	13	8.23
2000	16	10.13
2001	16	10.13
2002	11	6.96
2003	22	13.92
2004	18	11.39
2005	19	12.03
Total	158	100.00

appointment on firm value, the main objective of this study is to identify if there is a direct relationship between the announcement of an outside CEO appointment and stockholders' wealth.

As it was mentioned earlier, when a firm decides to change its CEO it is partly due to the poor performance of the firm in terms of earnings or stock performance or the retirement of the existing CEO. Based on prior research, it is expected that the stockholders will react positively at the announcement date when a firm hires an outside CEO. The aforementioned discussion leads us to the following hypothesis:

H1: The market reaction to the announcement of the CEO appointment is expected to be on average positive.

RESEARCH METHODOLOGY

Event study

An event study methodology is employed to examine empirically the research hypothesis proposed in this study. The period over which the security prices will be examined are the days before and after the announcement and the day of the announcement. This period of examination is also called the event window. The event window captures the price effects of announcements after the stock market closes on the announcement day. The impact of the event in relation with the stock prices is measured using the abnormal return. The abnormal return (ARit) is the actual return of the security over the event window minus the normal return of the firm over the event window. The normal return (Rit) of the firm is approximated using the market model with the equally weighted index proxying the market rate of return (Rmt). To estimate the model, a 255 –day estimation period is used that begins 300 days before the event day, on t=-300 and ends 45 days before the event day, on t=-45.

For firm i and date t the abnormal return is,

$$AR_{it} = R_{it} - (\alpha_i + \beta_i R_{mt}) \qquad (1)$$

Where:

a and b are constant and beta coefficient respectively, estimated for a 255 day estimation period, that begins 300 days before the event day, on t = -300 and ends 45 days before the event day, on t = -45.

Daily abnormal returns are averaged over the event window to yield cumulative abnormal returns,

$$CAR_i(\tau_1\tau_2) : CAR_i(\tau_1\tau_2) = \sum_{\tau=\tau_1}^{\tau_2} AR_{it} \qquad (2)$$

where the event window in this study is measured over 4 days around the announcement day, that begins 2 days before the event date (t = -2) and ends one day after the event day (t = 1).

Sample selection

In order to test our research hypothesis, we identified all CEO turnovers and specifically all CEO outside hires from a set of publicly traded firms. The sample is composed of firms listed in S and P 500 and S and P MidCap 400 covering a twelve-year period, from 1993 to 2005. During this period, we identified 158 outside CEO appointments. We also controlled for confounding events such as declaration of dividends, mergers and acquisitions and other executive appointments during the event window. Following the identification of CEO turnovers, the Lexis/Nexis database was used to find the hiring announcement for each CEO and classified them into inside and outside hires. Lexis-Nexis includes, in an electronic form, articles published by a huge number of newspapers in US and can be considered as a reliable source in event studies. Market data for this study were collected from the Center of Research in Security Prices database.

Table 1 presents the distribution of the 158 firm announcements through time. The highest number of announcement occurred in 2003 (n=22; 13.92% of the sample) and the lowest in 1995 (n=5: 3.16% of the sample). It is noticeable that there is an upward trend of CEO turnovers through the years, with a spike in 2000 onwards. Probably, this may be explained by the various scandals during the time period leading to the SOX act in 2002. Particularly in 2001, the Enron collapsed due to accounting fraud and in 2002 the dot com bubble led the WorldCom Company to file for Chapter 11 bankruptcy protection due to earnings manipulation which was the biggest bankruptcy in US history at that time. The year 2002 was a turning point for corporate governance. At that point, the US model of corporate governance had lost most of its appeal and institutional investors were disappointed from the existing corporate governance mechanisms. Sarbanes Oxley Act, also known as SOX, was approved in 2002 and the legislation was necessary and has played a useful role in restoring public confidence in the nation's capital market, by among other things, strengthening corporate accounting controls.

Table 2 shows CEO announcements by 2-digit industry classification. It is noteworthy that the greatest percentage (12.03%) of the announcements took place at the Business Services sector. Also, there are a great number of announcements at the 30 to 39 2-digit industry classifications. Specifically, 53 announcements are identified which weight 33.5% of the sample. These kinds of firms can be considered as heavy-duty industries and are affected to a greater extent by the economic cycles.

In order to be able to conduct our empirical analysis, our financial

Table 2. Industry distribution of the 158 CEO announcements. In this table we present the Industry distribution of the 158 CEO announcements over the period 1993-2005.

2-digit SIC	Industry description	Number of announcements	% of Sample
10	Metal mining	1	0.63
13	Oil and gas extraction	4	2.53
16	Heavy non-building construction	1	0.63
20	Food and kindred products	5	3.16
23	Apparel and other textile products	1	0.63
24	Lumber and wood products	2	1.27
26	Paper and allied products	3	1.90
27	Printing and publishing	2	1.27
28	Chemicals and allied products	13	8.23
30	Rubber and miscellaneous plastic products	2	1.27
33	Primary metal industries	2	1.27
34	Fabricated metal products	4	2.53
35	Industrial, machinery and equipment	16	10.13
36	Electrical, other electrical equipment	13	8.23
37	Transportation equipment	5	3.16
38	Measuring and analyzing equipment	10	6.33
39	Miscellaneous manufacturing	1	0.63
44	Water transportation	1	0.63
48	Communications	2	1.27
49	Electric, gas, sanitary services	14	8.86
50	Durable goods-wholesale	1	0.63
51	Nondurable goods-wholesale	1	0.63
52	Building material, hardware and gardening stores	1	0.63
53	General merchandise stores	3	1.90
55	Automotive dealers and service stations	2	1.27
56	Apparel and accessory stores	3	1.90
57	Home furniture and equipment stores	2	1.27
58	Eating and drinking places	1	0.63
59	Miscellaneous retail	4	2.53
60	Depository Institutions	4	2.53
62	Security and commodity brokers	1	0.63
63	Insurance carriers	4	2.53
67	Holding and other investment offices	1	0.63
70	Hotels	1	0.63
72	Personal services	1	0.63
73	Business services	19	12.03
80	Health services	1	0.63
82	Educational services	1	0.63
87	Engineering, accounting, mgt. services	4	2.53
99	Other	1	0.63
Total		158	100.00

and market information for all firms used in this study, were collected from the reports prepared by the firms under investigation and from proxy statements.

EMPIRICAL RESULTS

In the present study, we hypothesized that we expect a market reaction around the announcement day of an outside Chief Executive Officer (CEO) appointment. A significant market reaction around the announcement would indicate the strategic importance of a CEO and his/her contribution to future firm prospects. In order to test the aforementioned hypothesis, we employed an event methodology. Table 3 presents our empirical

Table 3. Excess returns around the announcement of an outside CEO appointment. This table present excess returns around the announcement of an outside CEO appointment during the period 1993-2005. The event-period excess returns are the residual returns from a 255-trading day market model. CARs are the cumulative abnormal returns.

Cumulative excess returns	Mean CARs (%)
Day -2	-0.15
Day -1	0.33
Day 0	1.06**
Day -1	1.36***
Day -2, Day 0, Day +1	2.26***

***, **, * Indicate levels of significance for 1, 5 and 10%, respectively.

results, the period over which the security prices were examined are the days before and after the announcement and the day of the announcement. This event window captures the price effects of announcements after the stock market closes on the announcement day. The impact of the event in relation with the stock prices was measured using the abnormal return. The abnormal return is the actual return of the security over the event window minus the normal return of the firm over the event window.

Specifically, results in Table 3 present abnormal returns for firms announcing a CEO appointment around the announcement day. Consistent with our hypothesis, results suggest a positive market response to the announcement of an outsider succession. Results show that there is 2.26% mean abnormal return in the (-2, 1) event window, which is statistically significant at the 1% level under the parametric t-test and a 1.36% mean cumulative abnormal return one day after the announcement, that is statistically significant at the 1% level using the parametric t-test. At day 0, there is an abnormal return of 1.06%, which is statistically significant at the 5% level. Day -1 and day -2 abnormal returns are 0.33% and -0.15% respectively, of which none is statistically significant.

Therefore, it appears that shareholders interpret at least on average, that outsider CEO appointments will have a positive effect on future firm value, leading to a positive market reaction on the announcement day. In simple words, a CEO announcement on average increases the cumulative mean stock price returns at 2.26%, two days before to one day after the announcement. The results support the semi strong form of the efficient market hypothesis that information is publicly available. This hypothesis states that, current share prices reflect all current publicly available information about the company, in addition to historic share price information. Therefore fundamental analysis will not enable investors to earn consistently above average returns, under the framework of this form of efficiency.

The conclusion for the support of the efficient market hypothesis can be extracted from the abnormal returns. At day 2 there are negative abnormal returns of -0.15%. At day 1 there are positive returns of 0.33% but someone can assume that they are not so significant compared with the day 0 and day 1. At day 0 the returns increase at a rate of 1.06% and at day 1 the rate reaches the 1.36%. A possible explanation for the increase in day1 is that investors after the announcement need some time to study, evaluate the hired CEO and then take the appropriate action.

Overall, the results presented in Table 3 support our hypothesis and suggest that the market reaction on the announcement of an outsider CEO appointment will be on average positive.

Conclusions

The primary objective of this study was to examine whether there is a market reaction around the announcement day of an outside CEO appointment. To test our primary hypothesis we employed an event study methodology and investigated the stock price performance of 158 listed US firms announcing outside CEO appointments between 1993 and 2005. The event window was set two days before the announcement and one day after the announcement. Consistent with our hypothesis, our empirical results indicated that there exist positive abnormal returns around the announcement of an outside CEO appointment. These results suggest that new outsider CEO appointments can be considered as beneficial to investors.

Given the recent increase in CEO turnovers and the relatively little empirical research on the subject, the study contributes to the literature by providing direct evidence on the importance of a CEO appointment. The results of this study should be of great importance to capital market participants, especially during the recent global financial crisis, simply because firms should give more emphasis on the selection criteria of an outside CEO appointment since the right selection affects shareholders' wealth positively.

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