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Do managers time the market? Evidence from open-market share repurchases

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Abstract

A contentious debate exists over whether executives possess market timing skills when announcing certain corporate transactions. Pseudo-market timing, however, has recently emerged as an important alternative hypothesis as to why the appearance of timing might be evident when, in fact, none exists. We reconsider this debate in the context of share repurchases. Consistent with prior studies, we also report evidence of abnormal stock performance following buyback announcements. Pseudo-market timing, however, does not appear to be a viable explanation. Our results are more consistent with the notion that managers possess timing ability, at least in the context of share repurchases.
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1. Introduction

One of the more contentious ideas in the finance literature is the extent to which corporate managers have the ability to time the market when executing important corporate

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transactions. Following the seminal study of Ritter (1991), many papers such as Loughran and Ritter (1995) report poor long-run stock performance after firms issue equity. These studies conclude that managers seem to time the stock market by taking advantage of "windows of opportunity" and issuing mis-priced equity to investors with overly optimistic expectations. Purnanandam and Swaminathan (2004) support this view by documenting that IPO firms have price multiples that are high relative to their industry peers. This apparent timing ability is not restricted to pure equity issues. In an issuance-like transaction, Loughran and Vijh (1997) show that acquiring firms earn negative long-run abnormal returns if the deal is financed with new stock. Rau and Vermaelen (1998) show that this negative drift is accentuated in growth firms who issue equity to finance a takeover.

Conversely, Ikenberry et al. (1995) and Ikenberry et al. (2000) find that firms which announce their intention to engage in the opposite transaction by initiating a share repurchase program tend to experience positive long-run abnormal stock performance. Studies regarding other corporate decisions, such as stock splits (e.g., Ikenberry and Ramnath, 2002) and debt offerings (e.g., Spiess and Affleck-Graves, 1999) report long-term abnormal return patterns that are seemingly indicative of managerial timing ability.

This idea of managerial timing is not inconsistent with statements we see in the popular press when companies increase or shrink their equity base.[1] Surveys of managers also support this view of timing. Graham and Harvey (2001) show that two-thirds of the CFOs they surveyed admit that the extent to which their stock is mis-priced is an important factor in issuing equity. In another widely cited survey of high-level executives, Brav et al. (2005) report that over 80% of corporations initiate stock repurchase programs when their stock is "a good value relative to other investments." In short, managers directly and indirectly indicate an ability to identify mis-pricing. Many executives, when announcing corporate financing decisions, seem to predicate many of their actions on this capability.

Yet this view of the "informed manager" is not universal. A growing literature challenges the empirical evidence on managerial timing by raising important questions that generally fall into one of two key categories. The first relates to empirical estimation issues or problems. These include concerns over appropriate benchmarks and how to measure abnormal performance and its significance. For example, Fama (1998) and Eckbo et al. (2000) argue that the results in some empirical studies which focus on long-horizon returns may not be robust due to the use of incorrect or flawed methodologies.[2] Papers by Brav and Gompers (1997), Brav et al. (2000) and Mitchell and Stafford (2000) all support this

[1] As an example, consider the comments of Harvey Sanders, the CEO of the men's sportsware company Nautica Enterprises, on May 18, 2000 who said, when announcing a $23 million share repurchase program, "This action demonstrates our confidence in Nautica's future and our continued commitment to improving shareholder value".

[2] Fama (1998), for example, focuses attention on the spin-off literature where Cusatis et al. (1993) find significantly positive long-term abnormal returns of spin-off firms. He suggests that the relatively low t-statistics of three-year buy-and-hold abnormal returns, which assume independence across observations, may not hold if adjustments were made for cross-sectional dependence. Later studies using more appealing methodologies, such as McConnell et al. (2001) and Veld and Veld-Merkoulova (2004), find either no, or at least weaker, evidence of long-term abnormal performance after spin-offs. Moreover, in their study on the long-run performance of seasoned equity offering firms, Eckbo et al. (2000) argue that the underperformance of equity issuers is not evident when a conditional asset pricing model is used to calculate abnormal returns.

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