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Impact of Leverage and Managerial Skills on Shareholders' Return

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Abstract

The recent financial crisis that saw an increase in the risk premium and shareholders' return around the world is partly caused by the management use of excessive leverage. This paper investigates the effect of leverage and managerial skills on shareholders' return. Our regression analysis that accounts for managerial skill factors reveals that leverage has a positive relationship with shareholders' return. Similarly, managerial skills have a positive relationship with shareholders' return. Based on the findings, the study suggests that leverage and managerial skills may be priced in equity valuation. We develop an index measure of managerial skills and use the upper-echelon theory of the management literature to explain how managerial skills relate to shareholders' return.

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1. Introduction

The global increase in the risk premium and shareholders' return during the recent financial crisis is partly attributed to the top management use of excessive leverage. Since the use of high leverage increases financial risk, shareholders' would demand a higher return to compensate them for the added financial risk.

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Over the years, finance researchers have identified reliable factors such as leverage, tax, price-to-book ratio and size as some of the variables that affect the shareholders' return. Nonetheless, managerial skill factor has been frequently omitted because it is unobservable and difficult to measure which explains why these variables are frequently omitted in return model. Pandey, 2005, and Jacobson, 1990, argue that failure to account for unobservable firm-specific factors in a return model would lead to omitted variable bias. Moreover, the inferences we make based on a model that does not account for these unobservable firms-specific factors would be incorrect. Despite the difficulty of dealing with unobservable factors that affect shareholders' return, studies in this area which concern with the problem created by omitted variable bias, have used techniques designed to control for the influence of unobservable firm-specific factors in a return model (Pandey, 2005 and Jacobson, 1990). Specifically, the role of unobservable firm-specific factors such as managerial skills has been ignored in the literature, but managerial skills could have a strong influence on the shareholders' return. Do leverage and managerial skills affect shareholders' return in Malaysia?

In order to investigate the effects of leverage and managerial skills on shareholders' return in Malaysia, we select the top 400 listed firms as our sample framework. We focus on listed firms because they provide direct setting for us to empirically investigate how leverage and managerial skills affect shareholders' return within the Modigliani and Miller's, (1958 and 1963) risk-return relationship framework. Listed firms provide a good setting because valuation is attached to listed firm stock.

In Malaysia, there are cases of firms that have financial distress problems and financial practices that do not justify continuous trading. This has prompted Bursa Malaysia to introduce Practice Note No. 4/2001[PN4] and Practice Note No. 17/2005 [PN17] in order to provide a comprehensive plan to help listed firms with signs of financial distress to improve their operating conditions (Alifiah *et al*., 2011). The use of high leverage leads to the financial distress problem, and we may attribute it to a failure on the part of top management to maintain sustainable leverage level. Consistent with risk-return relationship, shareholders demand higher returns to compensate them for added financial risk caused by the management use of high leverage.

We hope this study can fill in the gap in the executive leadership and in Malaysia firm's asset valuation and capital structure literature through systemic assessment of relationship between top management team's characteristics and shareholders' return. It is well established in the upper-echelon perspective that the maximization of shareholders' return is a reflection of top management skills. Thus, investigating the effect of leverage and managerial skills on shareholders' return adds new insight to the relationship between return and leverage from Malaysia perspective.

The rest of the paper is organized as follows: section two reviews relevant literature, section three describes method and data, section four discusses the results and section five provides concluding remarks.

2. Literature review

Upper-echelon theory draws from organizational behavior and management science literatures to argue that demographic attributes such as education level and years of experience of top management influence their strategic decision (Hambrick and Mason, 1984). Furthermore, upper-echelon theorists suggest that a firm's top management is a critical resource for its success because of the significant influence the top management has on firms' strategic decisions and success (Escriba-Esteve, 2009; Barney, 1991 and Hambrick and Mason, 1984). The underlying assumption in upper echelon theory is that demographic attributes such as educational level and years of experience serve as surrogates for cognitive ability of top managers. Top management managers with high level of education and experience make high quality decisions because they have the cognitive ability to execute complex strategic decision (Escriba-Esteve, 2009).

Maximization of shareholders' return is a strategic decision that top management faces, and better educated managers at top management are more confident of their strategic decision. This is because they are better positioned to analyze the outcome of their strategic choices. Similarly, we expect top management to

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