



CEO risk preferences and dividend policy decisions



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ABSTRACT

This study examines whether risk aversion-inducing CEO compensation motivates managers to pay more dividends regardless of investor preferences. Using inside debt (i.e., pensions and deferred compensation) and the sensitivity of CEO equity compensation to stock price changes (i.e., high CEO delta), as proxies of CEO risk aversion, we document that inside debt induces CEOs to pay dividends while convex CEO compensation decreases dividend payout.

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1. Introduction

In this study, we examine whether the risk preferences of chief executive officers (CEOs) are linked to dividend policy, since they can affect the riskiness of corporate policies.³ Using inside debt (i.e., pensions and deferred compensation) and the sensitivity of CEO equity compensation to stock price (i.e., delta) as proxies of CEO risk aversion, we examine whether risk aversion-inducing CEO compensation motivates managers to pay more dividends regardless of the market's preferences (Core and Guay, 1999; Jensen and Meckling, 1976; Sundaram and Yermack, 2007). This is likely for two reasons. First, we consider higher payouts a conservative policy as opposed to investing in value-increasing projects (DeAngelo et al., 2006; Grullon et al., 2002) which involve risk-taking. Therefore, CEOs with high inside debt should be inclined to pay excess cash out as dividends (or buy back stocks) rather than investing in projects, which may increase firm risk and thus endanger the value of their inside debt.⁴ Second, to pursue investment opportunities (i.e., gambles), high-delta CEOs must give up more certain gains, decreasing the utility that they derive from investment opportunities (Kahneman and Tversky, 1979). On the other hand, equity compensation that is sensitive to stock return volatility (i.e., convex compensation or high vega) encourages CEOs to invest in value-increasing projects (Core and Guay, 1999). We expect CEOs with convex compensation to decrease payouts since they are more likely to invest firm resources in value-increasing projects.

However, Sundaram and Yermack (2007) postulate that CEOs with more inside debt may tend to decrease dividend payouts to shareholders. Providing empirical support for this concept, White (2012, p. 2) argues that CEOs with high inside debt “seek to reinvest firm income to preserve the long-term viability of the firm and their future pension benefits.” Conflicting views about the riskiness of

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³ See Core et al. (2003) for a comprehensive survey of CEO compensation.

⁴ CEOs may also hold cash; however, due to investor activism and rights, there is a limit to it. Another concern may be that since CEOs with high inside debt act like creditors, they may be unwilling to pay dividends due to liquidity constraints. We discuss these in detail in the literature review.

dividend-paying firms exist even outside the academic world.⁵ We contribute to this line of the literature by examining the effect of CEO risk preferences on payout policy. In particular, we account for CEOs' deferred compensation (a major component of inside debt) and test the effect of inside debt on the propensity to pay, which are overlooked in previous literature (White, 2012).

Because inside debt data are available since 2006, we test our hypotheses in the period from 2006 through 2011, with more than 2000 firm-year observations. We estimate the effect of CEO risk preferences on the propensity to pay dividends via logistic regressions. Each regression accounts for industry and year fixed effects. Lending support to our hypotheses, we find that CEOs with high inside debt or delta (i.e., CEOs with lower risk tolerance) have a higher propensity to pay dividends, whereas CEOs with high vega (i.e., CEOs with high risk tolerance) have a lower propensity to pay dividends.

Our findings are robust to a battery of additional tests. First, we examine whether the relationship between inside-debt and the propensity to pay dividends is non-linear. This is because the wealth transfer view suggests that creditors dislike dividends, which may drain firm liquidity. If so, managers with significantly high inside debt may be reluctant to pay dividends since CEOs with inside debt might act like creditors. As such, the relationship between inside debt and the propensity to pay dividends may be non-linear. We test this possibility using dummy variables capturing the level of CEOs' inside debt (i.e., low, mid, and high) and comparing the dividend policy decisions of CEOs with low inside debt with that of others. Our results indicate that when CEO inside debt is measured via CEO relative leverage, there is no evidence of non-linearity. This suggests that CEOs whose personal leverage is comparable to that of the firm are more likely to pay dividends, regardless of firm characteristics or other CEO compensation incentives.

In the second robustness test, we check whether our results are sensitive to endogeneity bias. Our main concern is that some firm characteristics may be among the determinants of CEO compensation, causing an endogeneity bias in our results (Core and Guay, 1999). To address this, we deconstruct CEO risk preference proxies into "expected" and "excess." Following Shen and Zhang (2013), we first run a set of ordinary least squares (OLS) regressions, where the dependent variables are CEO variables (e.g., inside debt, vega, delta, equity) and the independent variables are firm variables (e.g., the debt/equity ratio, the market/book ratio). We save the residuals of these regressions as excess CEO variables that are not related to the firm characteristics. Using these excess variables as the CEO risk preference variables, we replicate the entire logistic regression analysis, which (at least partially) allows the endogeneity problem to be resolved. Even though the endogeneity robust results are less significant, there is still evidence to support our hypotheses.

Our third robustness check follows Grullon et al. (2011) who introduce alternative definitions of payouts. Because firms can pay dividends and issue equity at the same time, or buy back shares instead of paying dividends, these authors argue that, for unbiased results, it is necessary to examine net payouts (e.g., dividends minus equity issuance) as opposed to whether a firm pays cash dividends at time t . Based on Grullon et al. (2011), we construct three alternative dependent variables capturing whether the firm's net payouts to shareholders are positive. Even with the alternative definitions of payouts that incorporate stock buybacks or the change in the value of treasury stock, our results still support the central hypothesis of our paper: risk-averse CEOs are more likely to pass earnings to shareholders via cash dividends or stock buybacks, whereas risk-seeking CEOs are more likely to retain earnings or issue more equity.

In our fourth robustness test, we examine the effect of CEO risk preferences on dividend policy changes such as dividend initiations, omissions, etc. This is because our main analysis may be biased, as some firms may have started or stopped paying dividends before the CEO took office. If so, examining dividend policy changes (e.g., initiations, omissions, etc.) should ensure that the dividend policy is affected by the current CEO's risk preferences, and thus alleviate a possible endogeneity problem. Consistent with our prior findings, we find that conservative CEOs are more likely to initiate or increase dividends, whereas risk-seeking CEOs are less likely to increase or initiate dividends.

In the fifth robustness tests, we replicate our original analysis in the period from 1995 through 2008. The advantage of this analysis is that it includes 2.5 times more observations than our original dataset. Further, it excludes the post-financial crisis era, which could have caused a bias in our prior results due to the pessimistic environment. Most importantly, this dataset allows us to test our hypothesis in a period that is mostly characterized by high sentiment because according to catering theory, market sentiment (measured by the average market/book ratio difference between payers and non-payers) determines the propensity to pay dividends. Thus our findings may be sample-specific due to market conditions. In this analysis, we find that CEOs with high delta or non-convex equity compensations have a higher propensity to pay dividends than CEOs with convex equity compensations. Hence, our results alleviate some of the sensitivity concerns with respect to the selection of a specific sample period.

In our sixth and final robustness test, we examine whether our findings are robust to market conditions in a more direct way. To do so, in the spirit of Baker and Wurgler (2004), we introduce the *relative dividend premium* (RDP) measure to our analysis; RDP is the average market-to-book ratio of dividend paying firms minus that of firm i .⁶ According to the catering theory, when the RDP is

⁵ For example, the article entitled "Dividend-Paying Stocks Are Not 'Bond Equivalents'" by the Financial Lexicon on Seeking Alpha addresses the general perception that dividend-paying firms are being compared to bonds due to their low risk (see <http://seekingalpha.com/article/1132851-dividend-paying-stocks-are-not-bond-equivalents>). Even though the article does not present a counterargument to the general perception regarding the low risk of dividend-paying firms, it considers the comparison of dividend-paying firms to bonds an exaggeration. Another article published on forbes.com, titled "Paying Dividends," presents a life cycle-oriented argument and highlights the idea that dividends are reliable cash flows (see <http://www.forbes.com/sites/larahoffmans/2012/12/06/paying-dividends-ken-fisher>). The article adds, however, that a "dividend doesn't signal sure safety." Finally, a very interesting proposition is seen on cnbc.com in the article "6 Climbing High-Yield Dividend-Paying Stocks," which presents a completely different perspective to the already puzzling story of dividends (see <http://www.cnbc.com/id/100331092>): The author argues that "dividend-paying company executives understand they must stay aggressive each quarter or risk being forced to cut the dividend (and upset investors)," which is completely contrary to the public belief of dividend-paying firms being less risky.

⁶ Note that the RDP is derived based on the dividend premium of Baker and Wurgler (2004), defined as the average market-to-book ratio of dividend paying firms minus that of the non-paying firms.

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