Do Directorship Returns Affect CEO Turnover?

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Summary

• Do directors use stock returns experienced at other directorship firms to make CEO retention decisions at the current firm?
• A one-standard-deviation increase in directorship returns is associated with 11-19% increase in the probability of forced turnover.
• The effect is stronger when the experience is more recent, and when CEO ability is harder or costlier to evaluate.
• These findings are consistent with boards using availability heuristics to form beliefs about the ability gap between incumbent and replacement CEOs.

Main Results

Dependent variable is forced turnover (Parrino (1997))

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<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Directorship ret</strong></td>
<td>0.046*</td>
<td>(0.026)</td>
<td></td>
</tr>
<tr>
<td><strong>Directorship ret[t-2]</strong></td>
<td>0.058***</td>
<td>(0.019)</td>
<td></td>
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<tr>
<td><strong>Directorship ret[t-3]</strong></td>
<td>-0.013</td>
<td>(0.022)</td>
<td></td>
</tr>
<tr>
<td><strong>Directorship ret[t]</strong></td>
<td>0.034**</td>
<td>(0.011)</td>
<td></td>
</tr>
<tr>
<td>Controls</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Year FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Firm FE</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Adj-R-sq</td>
<td>0.064</td>
<td>0.065</td>
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<tr>
<td>Obs</td>
<td>25037</td>
<td>25037</td>
<td>21757</td>
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</tbody>
</table>

• Positive relation between Directorship ret and Forced turnover
• The effect is driven by more excess performance experienced over the past three years (Directorship ret[t-2])
• Results are robust to alternative measures of excess performance (e.g., using industry-adjust ROA as benchmark)

Economic Magnitude

**Directorship ret[t-3]** ↑ 1 std. ⇒ Pr(Forced) ↑ 0.44 pp, 14.7% ↑ over unconditional Pr(Forced).
Industry returns ↑ 1 std. ⇒ Pr(Forced) ↑ 0.46 pp
Firm stock returns ↓ 1 std. ⇒ Pr(Forced) ↑ 2 pp

Post Turnover Firm Performance

• Relying on availability heuristics to make retention decision leads to sub-optimal CEO replacement decisions
• High, Medium, and Low exp are firms with Directorship ret[t-2] in the top, 2nd or 3rd, and bottom quartile at Year 0, respectively.

Hypothesis Development

Availability Heuristics: People estimate the frequency of an event by the ease with which instances come to mind (Tversky and Kahneman (1974))

Main Hypothesis: Boards with directors that have experienced high stock returns at other firms are more likely to replace the incumbent CEO at the current firm.

• A director who experienced high (poor) stock returns at other directorship firms find it easy (challenging) to recall instances of observing other high-quality CEOs.
• Therefore, she believes the odds of finding a better replacement CEO than the incumbent CEO is high (low)

Unique predictions of availability heuristics

• Research in psychology shows that people use availability heuristics when the cost of exerting effort is high and when there is more uncertainty
• The effect is concentrated in instances where the boards’ cost of exerting effort is high and when the board is more uncertain about incumbent CEO’s ability

Contribution

• Boards infer the chance of hiring a replacement CEO better than the incumbent CEO using experienced performance at other directorship firms, and this behavior, on average, leads to sub-optimal CEO turnover policy
• My findings highlight novel situations in which directors use their personal experiences: when the boards’ cost of exerting effort is high and when the board is more uncertain about the incumbent CEO’s ability, they rely on heuristics to make one of the most important corporate decisions - CEO retention.