

# The Market Reaction to Votes of Confidence for Embattled CEOs

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## Abstract

Investors rely heavily on a CEO's ability to execute effective strategy and deliver shareholder value. When companies falter, many investors question whether the blame rests on the firm's CEO. This paper examines what happens when boards rally around their besieged CEOs by formally taking a vote of confidence. We find that there is a significant negative market reaction to the vote event. After the vote, we find that shorting activity rapidly diminishes, stock underperformance slowly dissipates, and profitability underperformance narrows. These patterns seem to indicate that such votes of confidence were eventually proven correct.

**Keywords:** Vote of Confidence; Market Reaction; Short Interest; Leadership

## 1. Introduction

This paper investigates the results of the decision by the board to support current leadership. In some cases, when a firm stumbles, the board may decide that the best candidate for improvement is actually the current CEO. Sometimes directors feel that the key problem is external rather than internal, and that the current CEO best understands the nature of the problem, and therefore offers the best chance for leading the firm back into profitability and growth (MacTaggart, 2012). In cases where the board of directors supports the CEO, the board will make public its opinion by staging a "vote of confidence" in management; that is, the board makes a public declaration of its intent to keep working with the current executives to return the company to profitability.

Votes of confidence events raise many interesting questions. How do investors tend to interpret the signal of a vote of confidence? Are directors generally right when they hold a vote of confidence to stay the course with current leadership? Does operational performance improve compared to peers or not? How does market sentiment as change with votes of confidence? We address these questions through an analysis of various pricing data and profitability measurements that surround corporate votes of confidence.

Overall, we examined the data to determine whether vote of confidence firms: (i) experience any abnormal stock price reaction to the news of the vote; (ii) experience improving market sentiment relative to their competitors after the vote; (iii) experience improved stock performance relative to their competitors after the vote; and (iv) experience improved operational performance relative to their competitors after the vote. Our research is the first empirical paper, to our knowledge, to examine any of these four issues as related to votes of confidence.

## 2. Literature Review

There is an ongoing debate about whether top management really matters or not, particularly for large firms (Bloom, et. al., 2012). Recently Frick (2016) and Bender (2016) have argued that, in fact, having the right management team in place makes a big difference. We tackle this question from the angle of examining periods of significant challenge for companies, where the struggle to compete is at the point that many shareholders are demanding the ouster of the firm's CEO.

What happens to senior leadership when things go poorly for a firm? Should the board of directors be patient and trust current leadership to turn things around, or should new leadership be brought in? The board of director's choice to maintain management or replace it during times of distressed profitability is critical to investors. It has been found by Weisbach (1988) that, in times of financial stress, the announcement of managerial turnover results in positive returns for shareholders. This result was confirmed by Bonnier and Bruner (1989).

According to MacTaggart (2012), votes of confidence, like votes of no-confidence, tend to hinge on a few key drivers: (i) arrogance or failure to communicate, (ii) resistance to change, (iii) failure to pursue effective

strategies, and (iv) egregious actions. In the sample of firms examined in this study, firms tend to cluster in the categories of “failure to pursue effective strategies” (e.g., Proctor and Gamble’s declining revenue and margins) or the “egregious actions” (e.g., British Petroleum after the Gulf oil spill).

### 3. Data and Methodology

We have identified 59 different firms that have experienced confidence votes during the period 1993-2013 as reported in the *The Wall Street Journal*. Of these 59 companies, 36 were publicly traded with available pricing and performance data, comprising the subject group to be studied. Using the methodology of Loughran, et. al. (1997) and Boyer, et. al. (2010), a matched-pair control group was generated by identifying close competitors of the subject firms from the same industries which were closest in size based on market capitalization and product overlap.

Bloomberg Professional Service was used to obtain daily share price data, daily short interest coverage data, and quarterly operational performance measures of return on assets (ROA) and return on equity (ROE) data. For each vote of confidence event, daily stock price data was collected for the 3 years (750 trading days) before and 3 years (750 trading days) after the announcements. Daily short interest data was calculated for the 3 years (730 trading days) before and 3 years after (750 trading days) after the announcement events. ROA and ROE data was obtained for 9 quarters before and after the vote announcement events.

To compute the “abnormal” daily returns we employ standard event-study methodology used by Brown and Warner (1985), Lamoureux and Poon (1987), and many others. Based on the usual Gauss-Markov assumptions, significant tests on the linear error term from period  $t$  determine where abnormal returns appear, we have

$$r_{it} = \alpha_i + \beta_i r_{mt} + \varepsilon_{it} \quad (\text{Eq. 1})$$

where

- $r_{it}$  = the arithmetic estimated return of security  $i$  in period  $t$ ,
- $\alpha_i$  and  $\beta_i$  = the time-invariant linear OLS intercept and slope estimators, respectively,
- $r_{mt}$  = the arithmetic return for the S&P500 index in period  $t$ , and
- $\varepsilon_{it}$  = the error term for security  $i$  in period  $t$ .

Bloomberg returns are used to estimate the  $\alpha_i$  and  $\beta_i$ ,  $i = 1 \dots N$ , over a period of 120 days, beginning 250 days prior to the event, for each confidence vote. The abnormal return is designated as the difference in the estimated daily return (Equation 1) from the actual daily return.

The tests were conducted on the variables defined in Table 1.

Table 1: Variable Notation for Hypothesis Testing

Notation	Definition
$SIR_{i,t/u}$	The average short interest ratio of firm $i$ between times $t$ and $u$
$\Delta SIR_{i,t/u,v/w}$	The change in the short interest ratio for firm $i$ between times $t$ and $u$
$ar_{i,t}$	The average daily stock abnormal returns of firm $i$ in time $t$
$r_{i,t/u}$	The average daily stock returns of firm $i$ between times $t$ and $u$
$ROA_{i,t}$	The ROA of firm $i$ in quarter $t$
$ROE_{i,t}$	The ROE of firm $i$ in quarter $t$

**3.1 Hypothesis 1:** Subject firms experience no abnormal returns when announcing their vote of confidence.

We seek to gage the reaction of investors in the marketplace to see if they are positive or negative toward the news that the board plans to retain current embattled leadership. Often when firms struggle with poor operational performance and especially poor stock price performance, outside investor pressure mounts to try something different. At that point the board of directors must make a critical decision about the retention of the CEO. Stock market reaction to the announcement of the vote of confidence is a clear signal whether the shareholders on average agree or disagree with that vote and to what extent they feel it matters. Therefore, we test the presence of unusual daily returns using the t-test.

For all firms  $I$  in time  $t$ , the abnormal returns are assessed where:

$$H_0 : ar_{i,t} = 0$$

$$H_1 : ar_{i,t} \neq 0$$

**3.2 Hypothesis 2:** The change in voting firms’ short interest ratios is similar to the change in competitor firms’ short interest ratios.

If the vote of confidence is the correct vote, then investor confidence should rally, as approximated by a decline in the short interest ratios (SIR), compared to peers. Short interest ratios are a proxy for market sentiment; they are measured as the degree of shorting for a security relative to its average trading volume. Alternatively, a movement the other way in which short interest ratios do not improve (SIR increase) would indicate that the confidence vote was not correct and did not inspire optimism in shareholders. If shareholders do not feel that the

vote matters anyway, then the change for subject firms' short interest ratios will be indistinguishable from the change in competitors' short interest ratios. Therefore, we test the difference in changes in short interest ratios using the t-test.

For all firms  $i$  and  $j$ , where  $j$  is the competitor firm associated with a subject firm  $i$ , between times  $t$  to  $u$ , the change in short interest ratios can be compared where:

$$H_0 : \Delta SIR_{i,t/u} = \Delta SIR_{j,t/u}$$

$$H_1 : \Delta SIR_{i,t/u} \neq \Delta SIR_{j,t/u}$$

**3.3 Hypothesis 3:** Vote of confidence firms have comparable daily stock returns before the vote and after the vote, relative to competitors.

If the vote of confidence has no impact on stock price returns, then the parameter estimates for the stock price returns of subject firms should be equal to or indistinguishable from the stock price returns of competitor firms. We expected that stock returns for voting subject firms would be lower than those of their competitors before the vote, but that subject firms' equities would experience equal or greater returns than competitor firms' stocks after the subject firms' votes. If the daily returns for the voting firms is greater than competitors after the vote, then this would signal that the board's vote was seen as correct in the subsequent periods. Therefore, we test the difference in daily returns using the t-test.

For all firms  $i$  and  $j$ , where  $j$  is the competitor firm associated with a subject firm  $i$ , between times  $t$  and  $u$ , the average daily returns are compared where:

$$H_0 : r_{i,t/u} = r_{j,t/u}$$

$$H_1 : r_{i,t/u} \neq r_{j,t/u}$$

**3.4 Hypothesis 4:** Vote of confidence firms return to comparable profitability after the vote of confidence, relative to competitors.

If a vote of confidence predicts a firm's return to comparable profitability, then the parameter estimates for the subject firms' ROA and ROE in fiscal quarters after the vote (Q +1, Q +5, and Q +9) will be indistinguishable from the parameter estimates for the competitor firms' ROA and ROE in the same fiscal quarters. Failing to reject any of the null hypotheses above would imply that a vote of confidence tends to precede a return to normal profitability that occurs by the time the corresponding fiscal quarter has concluded. Rejecting any of the null hypotheses, on the other hand, would signify that the vote of confidence does not predict a return to profitability by the conclusion of that fiscal quarter. Therefore, we test the difference in ROA and ROE using the t-test.

For all firms  $i$  and  $j$ , where  $j$  is the competitor firm associated with a subject firm  $i$ , for quarter  $t = -9, -5, -1, +1, +5$  and  $+9$ , the quarterly performance measures are compared where:

a)  $H_0 : ROA_{i,t} = ROA_{j,t}$

$$H_1 : ROA_{i,t} \neq ROA_{j,t}$$

b)  $H_0 : ROE_{i,t} = ROE_{j,t}$

$$H_1 : ROE_{i,t} \neq ROE_{j,t}$$

## 4. Results

**4.1 Hypothesis 1:** Subject firms experience no abnormal returns when announcing their vote of confidence.

For event days -2, -1, and 0, we reject the null hypothesis of no abnormal daily stock returns. Table 2 shows results verifying this analysis of abnormal daily returns. There is a significant, negative reaction to the announcement of the vote of confidence made by the board of directors on the day of the vote and the two prior days leading up to the vote. We can interpret this to mean that the initial reaction of shareholders is not positive as word of the vote of confidence start to leak out to the marketplace.

Table 2: Abnormal Daily Returns

Event Trading Day	Daily Return (Subjects)	T-Test Statistic
-2	(0.00852)	(1.93603)**
-1	(0.0075)	(1.70409)**
0	(0.00729)	(1.65483)*
+1	(0.00359)	(0.81665)

Indicates significance at the 1% level (\*\*\*), 5% level (\*\*), and the 10% level (\*).

As a robustness check, we also compared the cumulative returns for the 7 days surrounding the announcement event (-3 through +3). Cumulative returns for the 7-day window for subject firms was 3.5% less than the cumulative returns for the matched peer firms ( $p = 0.019$ ).

**4.2 Hypothesis 2:** The change in subject firms' short interest ratios is similar to the change in competitor firms' short interest ratios.

The changes in average short interest ratios between the earlier and later time periods for the subject firms and

competitor firms, the test statistics, and the sample sizes for each test are given in Table 3. The null hypothesis is rejected for the 1 and 2 years surrounding the vote of confidence, indicating that the vote of confidence influences shorting activity.

Table 3: Change in Short Interest Ratios Comparison

Time Period	$\Delta$ SIR (Subjects)	$\Delta$ SIR (Competitors)	T-Test Statistic
-3 to +3	(0.2296843)	1.1883347	(1.1667221)
-2 to +2	(0.5080400)	1.2606432	(1.4989887)*
-1 to +1	(0.7358907)	1.0277439	(1.9432810)**

Indicates significance at the 1% level (\*\*\*), 5% level (\*\*), and the 10% level (\*).

Considering the two-year period surrounding a vote of confidence (-2 to +2), it appears that the short interest ratio for vote firms drops significantly relative to competitor firms. Subject firms' short interest ratios *decrease*, on average, by about 0.508 days of average daily volume (ADV), whereas the competitor firms' short interest ratios *increased*, on average, by about 1.26 days of ADV. [In a separate test, we note that in the 2 years leading up to the vote (-2 to 0), subject firms experienced *higher* average short interest ratios (by 0.96 days) than competitors; whereas in the 2 years following the vote (0 to +2), subject firms experienced *lower* average short interest ratios (by 0.83 days) than competitors.]

4.3 Hypothesis 3: Vote of confidence firms have comparable daily stock returns before the vote and after the vote, relative to competitors.

Average daily returns comparisons for the subjects and competitors and the test statistics are given in Table 4. Vote of confidence firms have significantly lower stock returns relative to their competitors *before* the vote occurs. Specifically, when considering the 3 years before a vote of confidence, subject firms have average daily stock returns that are statistically significantly lower than their competitors' returns. And we note that these pre-vote returns are on average negative for the subject firms.

Table 4: Daily Returns Comparison

Time Period	Average Returns (Subjects)	Average Returns (Competitors)	T-Test Statistic
-3/0	(0.0000004433)	0.0003628919	(1.5828030)*
-2/0	(0.0002257272)	0.0002527312	(1.7010996)**
-1/0	(0.0008688789)	0.0004803343	(3.3442287)**
0/1	0.0062127613	0.0012195685	1.0123084
0/2	0.0035237170	0.0007777252	1.0951298
0/3	0.0005815954	0.0005325948	0.1353036

Indicates significance at the 1% level (\*\*\*), 5% level (\*\*), and the 10% level (\*).

These lower average returns experienced by shareholders of the subject firms explains in part why the vote was forced in the first place. Competitors were adding value while the subject firms were destroying value for shareholders. This may be tolerated for a brief period due to normal cycles and variability in the markets, but three years of persistent underperformance would build pressure to either (i) replace the CEO outright, or (ii) question the CEO suitability. The fact that stock performance returned to normal compared to peers after the vote seems to vindicate the decision of the board, at least in part.

4.4 Hypothesis 4: Vote of confidence firms return to comparable profitability after the vote of confidence, relative to competitors.

The average ROA and ROE for subjects and competitors and the test statistics on the differences are given in Table 5 and Table 6. The null hypothesis is supported eventually, but takes some passage of time.

Table 5: ROA Comparisons

Time Period	Average ROA (Subjects)	Average ROA (Competitors)	T-Test Statistic
Q -9	0.04829	0.05758	(0.50353)
Q -5	0.04234	0.04721	(0.14666)
Q -1	0.01424	0.04651	(2.0313)**
Q +1	0.01159	0.04302	(2.14134)**
Q +5	0.02098	0.05007	(1.12449)
Q +9	0.01678	0.036003	(0.64700)

Indicates significance at the 1% level (\*\*\*), 5% level (\*\*), and the 10% level (\*).

Table 6: ROE Comparisons

Time Period	Average ROE (Subjects)	Average ROE (Competitors)	T-Test Statistic
Q -9	0.14943	0.13162	0.45539
Q -5	0.05844	0.14054	(1.00367)
Q -1	0.02130	0.11897	(2.31201)**
Q +1	0.00689	0.10989	(2.51862)***
Q +5	0.01644	0.19633	(3.72074)***
Q +9	0.04739	0.13162	(1.21206)

Indicates significance at the 1% level (\*\*\*), 5% level (\*\*), and the 10% level (\*).

This data reveals that a growing operational gap developed in the periods preceding the vote of confidence peaks in the quarter immediately before (Q -1) and after (Q +1) the vote. The ROE lag continues into the 5th quarter after the vote (Q +5). After that, the underperformance of the subject firms persists but narrows to a statistically insignificant level.

## 5. Conclusion and Further Research

In examining the event of firms holding a vote of confidence on their leadership, we draw several conclusions. First, shareholders see the need for a vote of confidence in negative terms. This is demonstrated in a negative stock price reaction to the announcement of a vote of confidence. Second, we observe that, relative to peers, voting firms eventually see an easing of shorting activity. This may be due to a strategy among shorting investors that they take their shorting profits off the table before any turnaround plan is enacted. Third, shareholders experience the worst of the effect in the couple of years leading up to the vote, but share performance soon returns to normal after the vote is taken. So the vote itself is in reaction to and subsequent to share underperformance, but the vote does not lead as an indicator to future share price performance. Fourth, we see that firms requiring a vote of confidence underperform operationally for up to 5 quarters after the vote before closing the performance gap to a significant degree.

Further empirical research is warranted around the topic of votes of confidence. For instance, it would be interesting to compare relative performance of firms who retained their leadership long after the confidence vote to those who eventually experienced an eventual leadership change despite the vote. Further research could also examine factors leading to termination votes versus votes of confidence, and the subsequent performance outcomes. Our research can also be expanded by examining cases on confidence votes outside the U.S. markets.

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