

CEOs and Stock Market Performance in the Textile Apparel Industry

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ABSTRACT

Six firms in the textile apparel industry are used in a classroom activity that examines the relationship between the CEO's power and the firm's stock market performance. Students use SEC Edgar DEF 14A filings to obtain measures of the CEO's power and compare them to stock returns and volatility for the six firms. Students discuss whether their observations are consistent with findings reported in recent academic studies as well as possible explanations for differences. The six firms are Nike, Under Armour, Columbia Sportswear, The Gap, Lululemon Athletica, and V.F. Corporation.

INTRODUCTION

Typically within the first week of class, the undergraduate core corporate finance course introduces students to the potential for conflicts of interest between the firm's shareholders and its management (the "agency problem"). For example, the topic is introduced in the first chapter of Ross, Westerfield, and Jordan (2015) and Berk, DeMarzo, and Harford (2015). Students may conclude that concentrating too much power in the hands of the CEO is bad for shareholders.

Intriguingly, recent research documents a positive relationship between the power held by the firm's CEO and the firm's stock return. Consistent with stock ownership's incentive effects, Lilienfeld-Toal and Ruenzi (2014) find that firms have larger positive abnormal returns on average when the CEO owns a high percentage of the shares. Perhaps more interestingly, returns are highest when the CEO's power ("managerial discretion") is also high. Fahlenbrach, Minton, and Pan (2011) find that when retiring CEOs are more powerful, they are more likely to remain on the firm's board of directors ("lingering CEOs"); and the firm's performance benefits.

The stock returns of firms with powerful CEOs may also be more volatile, however. Adams, Almeida, and Ferreira (2005) examine CEO decision-making power in terms of power over the board of directors and the firm's other top executives. They find that firms with more powerful CEOs experience more variance in their stock returns. They conclude that more powerful CEOs are less likely to have to compromise on major decisions and, as a result, extreme decisions – bad and good – are more likely. In the extreme, Malmendier and Tate (2009) conclude that

CEOs who achieve “Superstar CEO” status may become distracted and the firm’s stock may subsequently underperform.

Six firms in the textile apparel industry provide an excellent sample for a classroom activity that introduces students to this academic literature. The six firms are Nike, Under Armour, Columbia Sportswear, The Gap, Lululemon Athletica, and V.F. Corporation. The CEO’s power and percentage of stock ownership varies widely from firm to firm. Some of the CEOs are founders. In some firms, CEOs have multiple titles (e.g. they also serve as the Chairman of the Board). The firms include several CEO turnovers in the past five years. There are also several “lingering CEOs” and arguably at least one “Superstar CEO”.

All of the data used in the activity are publicly available. Stock price data are from finance.yahoo.com. The CEO power measures are obtained from SEC Edgar DEF 14A filings. The activity requires little in the way of prerequisites and can be used in the first few weeks of an introductory corporate finance course. The following sections of the paper describe the learning activity, offer suggestions for how the activity can be shortened, and present extensions of the activity for use in a course on securities analysis or portfolio management.

THE LEARNING ACTIVITY

Prior to class, students are provided with Appendices I and II and asked to read both before coming to class. At the beginning of class, students are given two Excel files that provides the templates (without the data) for the CEO power measures (Appendix III) and stock market variables (Appendix IV) they will obtain. Appendices III and IV also provide instructions for collecting the information. The students work through the instructions for Nike while the instructor demonstrates. (Alternatively, the instructor can let the students work on their own while circulating to answer any questions.) Students are then divided into 5 groups. Each group is responsible for collecting the information for one of the other 5 companies (Under Armour, Columbia Sportswear, The Gap, Lululemon Athletica, and V.F. Corporation).

When each group has collected the information for their company, they provide the instructor with their information so that it can be entered into the template. The instructor then provides the Excel spreadsheet with the information for Nike plus the other 5 firms to all of the students. The instructor leads a discussion that allows students to compare the CEO power measures and stock market performance for the six firms. Students conclude their observations are sometimes, but not always, consistent with the findings of recent academic studies. Possible explanations for the differences are discussed. Suggestions for instructors for questions and answers for leading the discussion are provided in Appendix V.

SUGGESTIONS FOR SHORTENING THE ACTIVITY

In the interest of time, stock price information can be obtained by the instructor for each of the six firms and provided to the students. To further speed up the activity, the instructor can provide the Appendix IV returns and volatility measures to the students as a summary sheet.

EXTENSIONS FOR SECURITIES ANALYSIS OR PORTFOLIO MANAGEMENT

This paper, including the appendices, can be given to students as an example for the textile apparel industry. It can be used as a framework for analyzing CEO power for the students' firms of interest and their competitors.

REFERENCES

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Appendix I: CEO Power and Stock Market Performance.

As you know, shareholders are the owners of the firm, and managers are the agents hired to work in the interest of the shareholders. This creates the potential for conflicts of interest (the “agency problem”). For example, the firm’s management and shareholders may have different preferences for short-term profits versus long-term growth, the riskiness of projects, or actions that impact the company’s employees. You may have concluded that concentrating too much power in the hands of the CEO is bad for shareholders.

Intriguingly, research shows firms with the most powerful CEOs can have the highest stock returns; but the returns may be more volatile. The table below summarizes the relationships between CEO power and stock market performance we will examine for six firms in the textile apparel industry. The firms are Nike, Under Armour, Columbia Sportswear, The Gap, Lululemon Athletica, and V.F. Corporation.

We will obtain stock price data from finance.yahoo.com and use SEC Edgar DEF 14A filings to determine the CEO power measures (see Appendix II). Before our next class, please examine the table below and read Appendix II. Also, please go to the six companies’ websites and familiarize yourselves with their brands and products. You may be surprised by some of the items these companies make!

Source:	The Relationship between CEO power and stock market performance:	The CEO power measures we will use:
Lilienfeld-Toal and Ruenzi (2014)	Firms have larger positive abnormal returns on average when the CEO owns a high percentage of the shares. Returns are highest when the CEO’s power is also high.	The CEO is one of the firm’s founders. (We will also examine the percentage of stock the CEO owns.)
Adams, Almeida, and Ferreira (2005)	Stock returns are more volatile when CEOs have more power over the board of directors and the firm’s other top executives. Thus, they are less likely to have to compromise and <i>extreme</i> decisions – bad and good – are more likely.	The CEO is also the Chairman of the Board and/or President; the CEO is the firm’s only executive on the board; or the CEO is one of the firm’s founders.
Fahlenbrach, Minton, and Pan (2011)	Retiring CEOs that are more powerful are more likely to serve on the firm’s board of directors after they step down as CEO. Companies benefit from having these CEOs on the board.	One of the firm’s directors was formerly a CEO of the firm.
Malmendier and Tate (2009)	When CEOs achieve “Superstar” status, they can become distracted. The stock’s price subsequently underperforms.	The CEO has very high compensation, has received many awards, and attracts press coverage.

Appendix II: The Form DEF 14A.

The U.S. Securities and Exchange Commission (the “SEC”) enforces various federal securities laws. For example, all companies that issue stock to the public for listing on the New York Stock Exchange or NASDAQ are required to file various reports with the SEC. Filing requirements include annual reports (Form 10-K), quarterly reports (Form 10-Q), and an annual proxy document (Form DEF 14A).

Most of the information for our examination of CEO power can be obtained from the company’s Form DEF 14A filings. “DEF” is the abbreviation for “definitive.” The requirement to file it is found in Section 14(a) of the Securities Exchange Act of 1934. Hence, the filing is called a “DEF 14A”. The SEC makes all filings available to the public on its EDGAR website.

The Form DEF 14A filing is intended to provide the company’s stock owners (“shareholders”) information about the how the firm they have invested in is being managed. The Form DEF 14A filing includes information about the company’s top management and board of the directors, their compensation, and their ownership of the company’s stock. The filing also communicates which issues are to be voted on by the shareholders and the details for voting.

Appendix III: CEO Power Measures.

Instructions:

- 1) Go to SEC EDGAR website <https://www.sec.gov/edgar/searchedgar/companysearch.html>
- 2) Type the company's ticker in the "Fast Search" box. For example, Nike's ticker is **NKE**. Then hit the "enter" key and SEC EDGAR will display Nike's filings.
- 3) We want to see just the company's DEF 14A filings, so type **DEF 14A** in the "filing type" box. Then hit the "enter" key and SEC EDGAR will display only Nike's DEF 14A filings.
- 4) Find the document whose filing date matches that shown in the CEO Power Measures template for the company. For example, for Nike, we will use 2015-07-27. Click on the "Documents" button in the "Format" column for that filing date. SEC Edgar will display a list of all the documents that the company filed for its DEF 14A. We are interested in the first document in the list, labeled the DEF 14A. Click on the document (red font) to open it. The filing indicates the name of the CEO, usually the year in which the CEO became the CEO of the company, the other positions or titles the CEO holds (e.g., Chairman of the Board and/or President), whether the CEO is one of the company's founders, the name of the Chairman of the Board (possibly different than the CEO), whether the CEO is the only one of the company's executives to serve currently on the board of directors, and whether there are any of the company's former CEOs on the board. Search the document using the phrase "beneficial ownership" to find the table of percentage of the company's shares owned by the CEO. Using the DEF 14A, complete the CEO Power Measures template for Nike. (Hint: you can use Google to search using the CEO's name and the company's name to get of sense of whether the CEO attracts a lot of media attention and has received honors and awards, such as "CEO of the Year.")

Appendix III: CEO Power Measures (continued).

CEO Power Measures Template.

Company	Nike	The Gap	Lululemon Athletica	Columbia Sportswear	Under Armour	V.F. Corporation
Ticker	NKE	GPS	LULU	COLM	UA	VFC
Date of DEF 14A Filing	7/27/2015	4/7/2015	4/21/2015	4/8/2015	3/13/2015	3/19/2015
<u>CEO Power Measures</u>						
CEO's name	Mark G. Parker	Arthur Peck	Laurent Potdevin	Timothy P. Boyle	Kevin A. Plank	Eric C. Wiseman
In what year did the CEO become the CEO?	2006	2015	2014	1988	1996	2008
CEO's beneficial ownership as % of shares outstanding	0.4%	< 0.1%	< 0.1%	39.5%	16.8% (and 66.9% of voting shares)	0.7%
Chairman of the Board of Directors' name	Philip H. Knight	Robert J. Fischer	Michael Casey & David Mussafer	Gertrude Boyle	Kevin A. Plank	Eric C. Wiseman
Is the CEO also the Chairman of the Board of Directors?	No	No	No	No	Yes	Yes
Is the CEO also the President?	Yes	No	No	No, but was until Mar. 2015.	No	Yes
Is the CEO the only one of the company's executives on the board of directors?	Yes	Yes	Yes	Yes	Yes	Yes
Is the CEO one of the company's founders?	No	No	No	No, but the founder was the Chair of the BOD's father and CEO's grandfather.	Yes	No
Is there a "lingering CEO"?	Yes. Knight was the CEO until 2005. Knight was one of the founders of Nike.	Yes: Robert Fischer	No	No	No	Not in 2015, but Mackey McDonald, a former CEO, was Chair of the BOD until 2014.
Is the CEO a "Superstar CEO"?	Probably meets the criteria.	Probably does not meet the criteria.	Probably does not meet the criteria.	Probably does not meet the criteria.	Probably meets the criteria.	Probably does not meet the criteria.

Appendix IV: Stock Market Variables.

Instructions:

- 1) Go to <http://finance.yahoo.com/> and type the company's ticker in the "Quote Lookup" or "Search Finance" boxes. A Summary page of market information will appear.
- 2) Click on "Historical Prices" in the left-hand column. Our analysis is for an end date of March 31, 2016. Enter that date for your end date (and use the default start date). Select the "monthly" frequency prices. Then click on "Get Prices." When the prices are displayed, you should see information for the stock's opening price, high price, low price, close price, average volume, and "adj close" for each month. Although the dates display the first trading date of each month, the information are actually for the entire month. For example, the data in the row that says March 1, 2016 are actually for all of that month through March 31, 2016. The "adj close" column provides adjustments to the end-of-month closing price backward in time to reflect dividends paid to the shareholders. We want to calculate the total return to shareholders for various periods of time, so we will use the price data in the "adj close" column. At the bottom of the screen, you will see an option to "Download to Spreadsheet." Click on this and follow the instructions to save the historical price data to a spreadsheet. Using the "adj close" right-hand column of data in the spreadsheet, you can calculate returns for various periods of time.
- 3) To calculate the total return for any period, divide the end-of-period "adj close" by the the start-of-period "adj close", then subtract 1. For example, for Nike, the one-month return as of the end of March 2016 equals the adjusted close price of 61.65 divided by the adjusted close price of 61.43 as of the end of February 2016, minus 1, which equals 0.003, or 0.3%. The one-year return as of the end March 2016 is calculated using the end of March 2015 adjusted close rather than the end of February 2016 price. The one-year return is 24.2%. Calculate the total returns needed to complete the total return cells in the Stock Market Variables template.
- 4) We need to obtain a measure of the volatility or variance of returns for our companies. We will use the standard deviation of one-month total returns as our measure of volatility. Create a column that calculates the one-month total return for each month for the past 5 years. Using Excel's sample standard deviation formula, you can calculate the sample standard deviation for the most recent one-year period (i.e., calculate the standard deviation of the one-month returns for the most recent 12-month period), the most recent two-year period, etc. For example, the one-year sample standard deviation of monthly total returns for Nike is 0.0467, or 4.67%. Calculate the total returns needed to complete the total return cells in the Stock Market Variables template.

Stock Market Variables Template. (BELOW IS APPROXIMATE THROUGH MIDDAY March 30, 2016)

	NKE	GPS	LULU	COLM	UA	VFC
total return (1 year)	24.2%	-31.7%	6.2%	-1.1%	1.7%	-13.2%
total return (2 year)	70.7%	-24.5%	29.3%	47.6%	43.3%	7.5%
total return (5 year)	247.5%	41.5%	52.7%	115.3%	382.9%	187.1%
sample std. dev. (1 year)	0.0467	0.0670	0.0991	0.1057	0.0745	0.0459
sample std. dev. (2 year)	0.0469	0.0688	0.0990	0.1090	0.0807	0.0506
sample std. dev. (5 year)	0.0562	0.0858	0.1152	0.0900	0.0858	0.0548

Appendix V: Suggestions for leading the discussion.

Below are some suggestions for questions (with answers in bold) for leading the discussions.

- 1) Based on the research of Lilienfeld-Toal and Ruenzi (2014), which companies do you expect to have the highest returns? Why?
UA. UA's and COLM's CEOs have much higher stock ownership. UA's CEO founded the firm. (COLM's CEO's grandfather founded the firm. But it is unclear what the research says for CEO's grandfather being the founder.)
- 2) Based on the research of Adams, Almeida, and Ferreira (2005), which companies do you expect to have the most volatile returns? Why?
For all 6 firms, the CEO is the only executive on the board of directors ("BOD"). For 2 of the firms, UA and VFC, the CEO is also the Chairman of the BOD. UA's CEO founded the firm. UA should have the highest volatility of stock returns.
- 3) Based on the research of Fahlenbrach, Minton, and Pan (2011), which companies do you expect to have the highest returns? Why?
NKE and GPS have lingering CEOs and should have the highest returns.
- 4) Based on the research of Malmendier and Tate (2009), which companies do you expect to have the *lowest* returns? Why?
The CEOs of NKE and UA have probably achieved Superstar CEO status. They may have become distracted.
- 5) Does the time period you use for your analysis make a difference (for example one year versus five years of stock price information)? Why?
Yes. For example, NKE has the highest 1-year and 2-year returns, but UA has the highest 5-year return.
- 6) Why is it unfair to use the current CEO's information for the Gap if you use five years of stock price information?
The CEO has only been their CEO for 1 year.

- 7) For which other company would it be unfair to use the current CEO's information using the last 5 years of stock returns and volatility?
LULU.
- 8) Are your observations consistent with your expectations for questions 1 through 4 above?
- **Q. 1: Yes if we use 5-year returns. UA has the highest 5-year return. But no if we use 1-year or 2-year returns. NKE's returns are higher.**
 - **Q. 2: No. UA's volatility is not the highest for the 1-year, 2-year, or 5-year periods.**
 - **Q. 3: Yes if we use 1-year or 2-year returns for NKE. No for GPS.**
 - **Q. 4: Possibly for UA (but not for NKE). UA's returns are highest for the 5-year period, but are middle of the pack for the recent 1-year period.**
- 9) What are some possible explanations for why your observations fail to agree with your expectations?
- **The research in Appendix I was conducted using large samples of companies and reports findings on average. The research does not claim to be true for all cases. We have looked at a small sample of only 6 companies.**
 - **The research in Appendix I finds other factors that we have not yet considered also contribute to stock market performance.**
 - **Examples of additional factors that affect stock prices are investors' perceptions of the company's growth prospects, its competitors' strategies, and whether the company's corporate governance is weak or strong.**