Discussion of Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility

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1. Introduction

Bushee and Noe examine the impact of firms’ corporate disclosure practices on the composition of institutional ownership and stock return volatility. The paper’s objective is to triangulate two prior research findings: (i) improved corporate disclosure results in higher levels of institutional ownership (Healy, Hutton, and Palepu [1999]) and (ii) institutional ownership is positively associated with stock return volatility (Sias [1996]). Healy, Hutton, and Palepu [1999] argue that one of the benefits from improved disclosure is stock intermediation by attracting institutional investors. Sias [1996] suggests that attracting institutional investors may have the undesirable consequence of increasing stock return volatility. Bushee and Noe extend this literature by documenting that return volatility is influenced by transient institutions that appear to increase their holdings subsequent to disclosure changes. I structure my discussion of this study primarily around the issues discussed at the conference.

2. Theoretical Link between Disclosure Practices and Return Volatility

The paper argues that there is both a direct and an indirect effect (through institutional investors) of disclosure practices on stock return volatility. Much of the discussion during the conference centered on two issues. First, why is return volatility an appropriate dependent variable?

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In other words, what does volatility capture and why should an increase in volatility be undesirable for managers and investors? Second, what is the theoretical relationship between disclosure practices and volatility?

Volatility represents fluctuations in stock prices and, ideally, one would expect return volatility to be determined by (unexpected) news about fundamentals.¹ Stock return volatility captures the total risk of equity and, hence, firms with higher volatility are expected to be more risky. Increases in volatility could potentially lead to higher cost of equity capital, because investors will demand higher returns to compensate for the increased risk. This presumes that investors demand higher returns for assuming both systematic and unsystematic risk. In addition to increased cost of equity, it is plausible that the cost of debt might increase. Thus, for cost of capital reasons managers may find return volatility undesirable.

However, one could make a counterargument for why managers may prefer volatility. If managers’ compensation is based on stock options, then managers will have incentives to opportunistically manage disclosure practices.² Increases in return volatility would improve the value of the stock options held by managers, provided that increases in short-run stock return volatility imply increases in implied volatility that affect option values. The benefit to managers also depends on their horizon in terms of exercising those options. While this might make the stock-based compensation both ineffective and costly, the existence of incentives for managers to prefer volatility in such instances cannot be denied.

Conference participants were concerned about the lack of theory that supports the direct effect of disclosure practices on volatility. Return volatility is expected to change over time and is influenced by factors such as leverage and frequency of information arrivals (see Black [1986]). Improvement in disclosure practices would imply better dissemination of fundamental economic information about the firm, in terms of timeliness, frequency, and quality. Thus, improved disclosure practices could drive volatility higher by increasing the rate of information arrival. On the other hand, improved disclosures imply lower information asymmetry and, as a consequence, price impact of trades is lessened. This is because economic information about the firm is provided on a timely basis so that the magnitude of periodic surprises, e.g., surprises in quarterly earnings disclosure, is lower. This would result in lower future volatility. Thus, the direct effect of disclosure on volatility is not obvious.

The authors find that increasing disclosures has the effect of increasing return volatility indirectly through changes in transient institutional ownership. In equilibrium, we would not observe rational managers changing

¹ Stock prices could also reflect irrational investor sentiments and changes in such sentiments could also make stock prices more variable (see Froot, Perold, and Stein [1992]).

² Recent work by Aboody and Kasznik [forthcoming] suggests that managers make opportunistic voluntary disclosure decisions to maximize their stock option compensation.
their disclosure practices if such disclosure changes result only in costs due to increased volatility. Thus, there must be some benefits that accrue to the firm from changing disclosure practices. The paper is silent about the cost/benefit trade-offs from improved disclosures because the paper assumes that disclosure practices arise exogenously. An examination of the cost/benefit trade-offs of changing disclosure practices would require an equilibrium model of institution and investor behavior in relation to changes in disclosure practices. Such an endeavor is beyond the scope of this study.

3. Endogeneity

Conference participants raised the issue of endogeneity of disclosure practices and institutional ownership. The analysis in the study assumes the two decision variables are exogenously determined. It is plausible that changes in institutional ownership and changes in disclosure practices are endogenous, and it is even likely that they are simultaneously determined. An analysis of cross-sectional determinants of disclosure practices has been considered in prior research (Lang and Lundholm [1993]). Therefore, a simultaneous equations approach would be more appropriate to avoid biased and inconsistent parameter estimates and to facilitate precise interpretation of the results.

Another important factor that does not receive adequate attention in the study is analyst following. The authors do include analyst following as an additional variable in their analysis but it is treated as exogenous as well. Analysts’ decisions to follow firms, institutional investors’ decisions to buy stocks, and firms’ decisions to choose a level of disclosure are interrelated (among other things) through information asymmetry considerations. Simultaneity between institutional ownership and analyst following has been considered by prior research (O’Brien and Bhushan [1990]). Furthermore, research by Healy, Hutton, and Palepu [1999] finds that increases in disclosure ratings are associated with increases in analyst coverage. Thus, the importance of treating these variables as endogenous in understanding the effect of disclosure and institutional ownership on return volatility need not be overemphasized. Needless to say, this would increase the number of equations in the system and complicate the analysis. Furthermore, an attempt to address the endogeneity issue is fraught with its own set of problems, such as identifying an appropriate set of instrumental variables that determine disclosure practices.

4. Other Issues

The study uses the overall score provided by AIMR as the measure of disclosure practice. AIMR provides disclosure scores across three dimension: annual information, quarterly information, and investor relations activities. While the authors provide some preliminary evidence on the
importance of these dimensions for institutional ownership behavior, it would be a worthwhile endeavor to identify the specific aspects of changes in firms’ disclosure practices that contribute to volatility and changes in the composition of institutional ownership.

One potential omitted variable in the analysis is the composition of managerial ownership. Research by Bushman and Indjejikian [1995] suggests that public disclosure that reduces a manager’s private information advantage can actually increase his/her trading profits. Thus, if managers opportunistically change disclosure practices, we could envision managers changing their ownership position subsequent to a disclosure policy change to profit from trading. Including changes in insider ownership as an additional variable would help control for another potential source of increased volatility to changes in disclosure practices.

Another issue considered by participants was whether the increase in volatility subsequent to changes in disclosure practices documented in the study represented market mispricing and, thus, an exploitable arbitrage opportunity. While this could certainly be characterized as a form of mispricing, it does not appear to be an easily exploitable opportunity for two reasons. First, it would be difficult to identify the timing of the disclosure change based on which a trading strategy could be implemented. Second, the effect of short-run volatility on firm value is not apparent. Thus, it is unclear ex ante how riskless hedge portfolios could be formed to exploit the mispricing.

Participants also commented on the issue of classification of institutions into transient, dedicated, and quasi-indexer institutions that is central to the differential predictions for the relation between institutional ownership and volatility. The information on institutional ownership is obtained from 13-F filings. 13-F reports contain ownership information at the fund “family” level that usually contains funds with varying investment objectives and, hence, there is a potential for misclassifying firms. The evidence that transient owners do not change their positions when managers reduce disclosures also suggests the presence of measurement error in classifying firms. If anything, we should expect transient institutional owners who are particularly focused on liquidity to sell their positions when managers reduce disclosures.

5. Concluding Remarks

The preceding discussion has focused on the difficulties associated with understanding the relation between disclosure practices, institutional ownership, and volatility, especially because of lack of theoretical guidance on the relations. But, this in no way should serve to undermine the contribution of the study. Bushee and Noe document an important empirical result, i.e., improving disclosure practices may have some unintended consequences such as increasing short-term volatility. This evidence adds to the growing body of literature that examines the role of
institutional owners in financial markets. The results in the study have particular implications for some recent work in the finance literature that has documented a significant positive trend in firm-level stock return variance over the years (e.g., Campbell et al. [2000]). While there are several issues unresolved in our understanding of the equilibrium behavior of institutional investors in response to changes in disclosure practices, the study provides impetus for further research to resolve those issues.

REFERENCES


