Research Proposal

An important aspect of any investment portfolio involves diversification. Diversification may be defined as investing in a wide variety of asset classes within a portfolio in order to reduce risk and maximize returns. If a portfolio is well diversified, a loss on some investments will be offset by the stability or gains of other investments. Markowitz (1952) shows the rational investor will diversify her portfolio in a mean-variance maximizing manner.

In recent decades, many managers and executives have begun receiving company stock and stock options as a portion of their pay. As of 1995, stock options became the largest performance based incentive compensation received by CEO’s, with 2/3 of all CEO’s receiving stock options and the value of such options representing about 1/3 of total CEO compensation (Yermack, 1996). Due to the recent growth associated with stock options, executives who have exercised such options should encounter a diversification problem, since a large portion of their portfolio is made up of their own firm’s stock. In this situation, it would be difficult for managers to sell stock legally and within the bounds of contracting constraints without sending a negative signal to the market.

Lorie and Niederhoffer (1968) have concluded that insiders earn significant abnormal profits by trading the securities of their own firms. Jeng, Metrick, and Zeckhuser (1999) have acknowledged that most studies have found adverse unusual returns for stocks that are intensely sold by insiders. Seyhyn (1992) has collected data showing that, during the 100 days following the insider trading day, stock prices declined abnormally by 1.7% following sales. A similar occurrence has been noted during the 100 days prior to an insider trading day, with stock prices rising abnormally by 2.5% preceding the sale of stock. This suggests that insider’s sell stock prior to the release of negative information, and wait to sale stock until after positive information has been announced.

The selling of company stock is one way for managers to diversify their holdings. An additional way they may diversify is through the issuance of dividends. Research has been conducted indicating that the introduction of executive stock options leads to lower dividends (Lambert, Lanen & Larcker, 1989). Further research points out that managers holding a large number of stock options tend to substitute stock repurchases for dividends (Jolls, 1995), resulting in lower dividend payments. Fenn and Liang (2001) have found that stock options do not encourage larger total payouts, but that they change the composition of existing payouts, which suggests that stock options could help to explain the rise in repurchases at the expense of dividends. Managers who hold stock options have incentive to increase stock repurchases and decrease dividends because repurchases increase the value of the underlying stock, while dividends decrease the value.

It is important to note that these findings apply to situations where CEO's have been offered stock options, but have not actually exercised those options. Lambert, Lanen, and Larcker (1989) point out that stock options may not affect dividend policy immediately, because options are exercisable over a period of time, usually up to 10 years. Once a manager exercises the option and takes ownership of the stock, there may be a different effect on dividends. White (1996) indicates that dividend payments are linked to managements’ stock ownership, and that top managers who are also shareholders are less averse to dividends than managers who do not have direct access to the cash distributed as dividends. Therefore, a reasonable assumption is that, while management stock options lead to a decrease in dividend payments, management stock ownership may lead to an increase in dividends.

Fama and French (2001) show that the number of firms who pay dividends peaked in 1978, but have steadily fallen from that time until 1999, when their study was complete. Since then, Julio & Ikenberry (2004) have shown that dividend payments are on the rebound. They suggest several reasons that may contribute to this change, none of which directly address diversification.

This line of thought leads to the following hypotheses: (1) Managers will sell stock less often and in smaller amounts when they have small holdings in company stock, and consequently do not have a diversification problem as a result of management stock ownership. (2) Managers with greater power over dividend policy will sell stock less often and in smaller amounts than managers who have little power over dividend policy. This is because dividend payments will give these managers a way to diversify their portfolio without selling stock. (3) Managers are more likely to exercise stock options and retain the shares just prior to the ex-dividend date. The ex-dividend date is the day on which all shares that are either bought or sold no longer have the right to the most recently declared dividend. Therefore, managers will exercise stock options before this date in order to receive the accompanying dividend payment.

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