SPECTRA MARKETS

Thursday, February 17, 2022

am
FX

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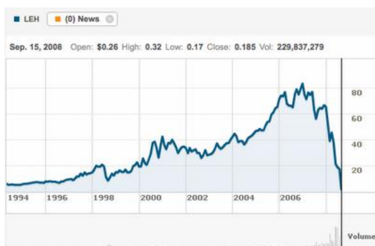
Enron


Lehman Brothers

Current Views

Bullish EURGBP
Long 18MAR 0.8550 EURGBP digital call at 24% (spot ref. 0.8426)

Bullish AUDCAD
Long 22FEB 0.91 AUDCAD call
Cost 26bps, spot ref 0.9050

Quitters

Today, I go off topic. No global macro.

People frequently ask me "What are the best blogs? What are the best books?" and I am currently preparing a big am/FX on that very topic. Generally, though, my answers are pretty boring. I read much of the same stuff everyone else reads. I just read a lot of it! When I find something new and different, that is potentially more interesting.

For example: I recently started reading "The Bear Cave" by Edwin Dorsey. I do not know Edwin, but I like his letter; it's out of my wheelhouse, but still tangentially related and interesting. He writes bearish notes about problems at specific companies and tracks activist short campaigns, notable resignations, and other company-negative stuff. He frequently gets shout-outs on Bloomberg and his calls can move individual stocks. One recent article highlighted serious safety issues at the gaming platform Roblox. The timing of that article was good/lucky as Roblox stock got destroyed on earnings yesterday.

His Twitter profile is "Exposing bad companies. Class of 2020." That's a good summation! He's a young guy with energy and passion. Here's an article about him in Institutional Investor and here's a list of other research products recommended by The Bear Cave. I have no relationship with The Bear Cave, financial or otherwise.

Three memories

Each week in The Bear Cave, Edwin has a heading: Recent Resignations (notable executive departures disclosed in the past week). Executive departures resonate strongly with me as a red flag indicator because 1) they are logically huge red flags and 2) I have three flashbulb memories of key executive departures that signaled imminent disaster:

1. **June 2008, Erin Callan is fired**
   I was on paternity leave, walking through Central Park, pushing my 4-year-old son in the orange Bugaboo stroller, eight days after the birth of my second son. My Blackberry rang and I wanted to be a good Dad and not answer it, so I didn't. Then it rang again. And again. It was a buddy of mine calling to tell me:

   "Dude, Callan just resigned or got fired or something. It's over."

   There was no single moment that signaled the end of Lehman but the bad earnings and CFO departure the week of June 9th were certainly close.

   This story is amazing in hindsight:
   NYT, June 17, 2008: At Lehman, Chief Exudes Confidence

2. **[August 2001, Jeff Skilling resigns.]**
   Background from wiki: On March 28, 2001, PBS's Frontline interviewed Skilling, where he claimed for Enron "We are the good guys. We are on the side of angels."

   On April 17, 2001, Skilling made what became an infamous comment during a conference call with financial analysts. In response to fund manager Richard Grubman saying, "You know, you are the only financial institution that can't produce a balance sheet or cash flow statement with their earnings", Skilling replied: "Thank you very much, we appreciate that... asshole."

   Skilling unexpectedly resigned on August 14 of that year, citing personal reasons, and he soon sold large amounts of his shares in the corporation. Then-chairman Kenneth Lay, who previously served as CEO for 15 years, returned as CEO until the company filed for bankruptcy protection during December 2001. When brought in front of congressional committees, Skilling stated that he had "no knowledge" of the complicated scandal that would eventually result in Enron's bankruptcy.

   In 2006, he was convicted of federal felony charges relating to Enron's collapse and eventually sentenced to 24 years in prison.

3. **March 1996, Michael de Guzman "falls out of a helicopter"**
   I have never felt richer than I felt on the day I got my first performance bonus. I was already making what felt like incomprehensibly insane money as I had just scraped through four years of university on part-time and summer jobs, Kraft Dinner, $100 monthly checks from my mom and dad and two slowly (then suddenly) ballooning credit cards. Then plunk: my first bonus was $20,000. I had just won the lottery! There was only one thing to do with all that money: go all-in on the most exciting investment story I had ever seen!

   I put it all in Bre-X, a speculative gold mining company that had taken the world by storm. The Calgary company was saying it had found the largest gold mine in the world; the stock was en fuego. It was the biggest story in Canadian financial markets at the time and one of the biggest ever.

   Then, on March 19, 1997, a very troubling headline. "Bre-X geologist Michael de Guzman falls to his death from a helicopter in Borneo". Certainly a non-standard executive departure. And a sad and memorable one. It turned out he actually jumped on purpose. The whole Bre-X story unraveled quickly after. It was all a fraud.

The Financial Post

Canada's Business Voice — Thursday, March 27, 1997 — $1.00

Disaster for Bre-X

Investment community reels on news that Busang, heralded as one of the biggest gold finds in history, may contain no mineable gold

BY PAUL BAGNELL AND SANDRA RUBIN
The Financial Post

Canadian markets were stunned yesterday by news that the Busang gold find in Indonesia — long touted as one of the biggest in history — may contain no mineable gold at all.

Bre-X Minerals Ltd., the small Alberta company that discovered Busang, said yesterday there is a "strong possibility" its estimates of the discovery's wealth have been "overstated because of invalid samples and assaying."

Freeport-McMoRan Copper & Gold Inc., the U.S. mining giant that won a high-stakes contest to become Busang's developer, said yesterday it has found only "insignificant" traces of gold at Busang II and III.

Freeport said it would not continue its participation in Busang unless economically viable gold deposits are found. By the end of the business day, there were reports the company has already said it wants out of the venture.

Neither Bre-X nor Freeport would elaborate on these shocking state-

Tracking the Bre-X story

How could it happen?
Junior shares hammered
Funds price Bre-X as low as $2
Nightmares of the past: pages 8,9
Market Eye: page 24

exploration John Felderhof confidently predicted that Busang could yield 200 million ounces of gold.

Bre-X president David Walsh said at the time he had full confidence in Felderhof's projections.

Bre-X's latest official estimate, is

David Walsh (far left) had expressed full confidence in Busang, while Jim Bob Moffett used extensive Indonesian connections to gain a slice of the play.

it in the Busang II zone.

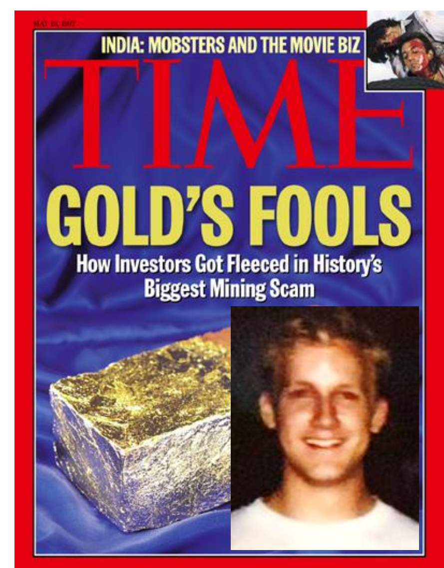
Either figure would make it the

Yesterday, market players reeled from the news that there may be no

future will now be on Wall Street — 3

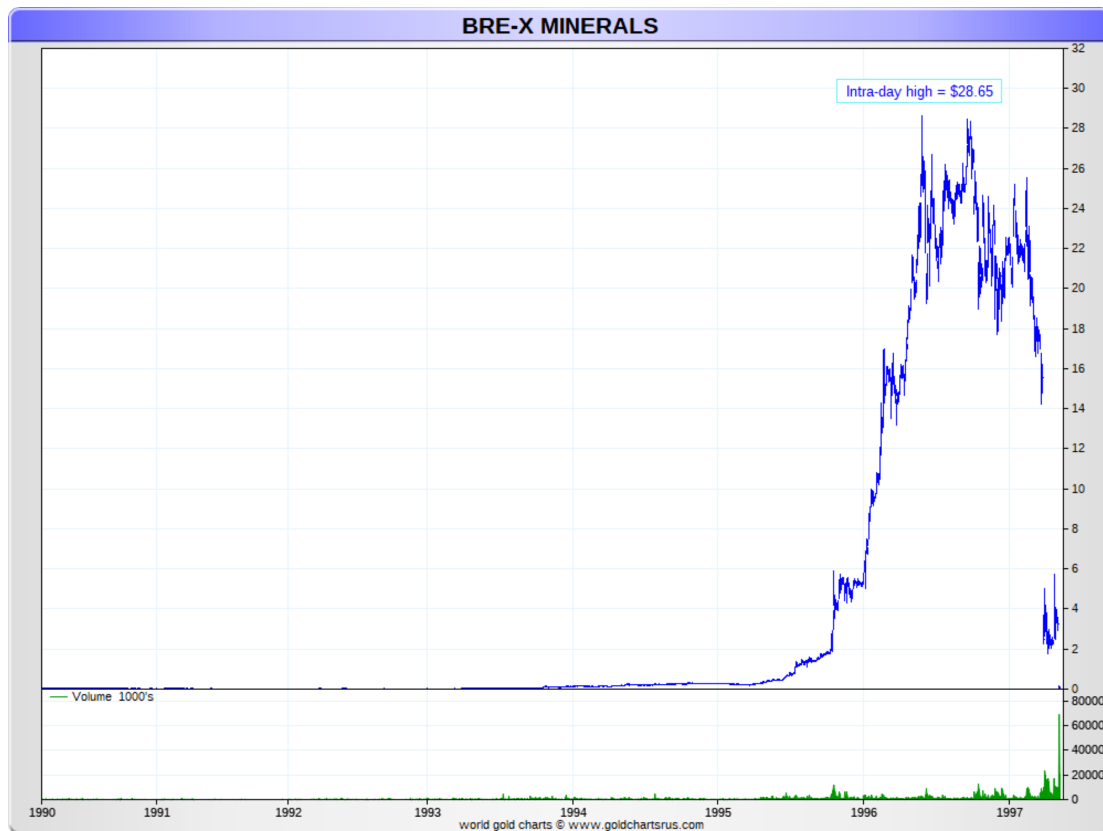
shares — forced deal — must sell four malls to pension — feud. — 3

surprise quarter profit — of WordPerfect — withstand onslaught — Microsoft. — 5



[And…. It's gone].

Full story here: https://en.wikipedia.org/wiki/Bre-X



http://www.goldchartsrus.com/chartstemp/BubbleComparisonBRE-X.php

Anyone who has been in finance for more than a few years most likely has personal experience or strong memories of executive departures. Theranos, Enron, or others There is anecdotal logic to a fear trade when a company executive (or two, or three!) resigns out of nowhere. Of course, there are counterexamples too, and it's not always a red flag. When Tesla CFO Jason Wheeler left in February 2017, that was not a sell signal!

Fun memory: When I worked at Citi, when someone resigned, the entire trading floor would clap them off to celebrate their good work. One hilarious guy I worked with (TJ) would always yell "Quitter!" over the applause. LOL. The best of these clap-offs (and TJ didn't yell "quitter" for this one) was when the maintenance / janitor man for our floor, who had worked there for 30 years, retired. People lost their minds clapping for him as he walked out. He was clearly touched. I may or may not have cried a little tiny bit.

I love anecdotal stuff in markets, but only when it's supported by empirical evidence. That is why I did the work to confirm The Magazine Cover Indicator and that's why I like to go deep in the numerical weeds of Excel almost every day. My question today is: Do executive departures predict poor equity performance going forward? Common sense says "yes" but common sense is sometimes wrong. Articles such as this one from the WSJ are full of examples but lack empirical data.

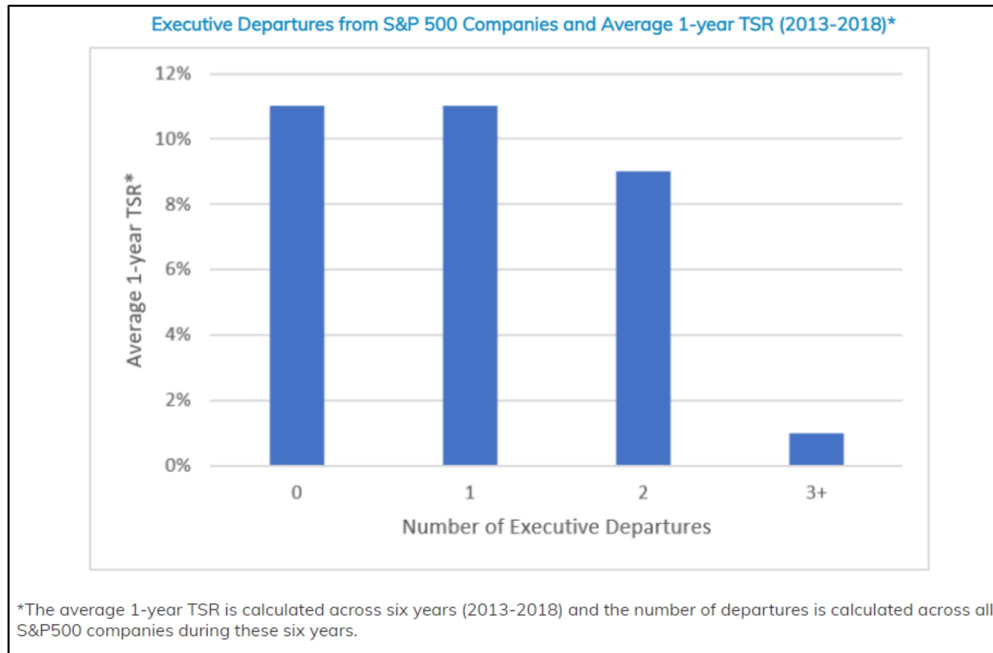
I found research that supports the hypothesis, but most studies simply support the more obvious conclusion that senior executive departures are unambiguously bearish on the day of announcement. If you know of any research that shows stock performance AFTER the announcement effect, please send them over. Thanks!

The empirical evidence supports the following conclusions:

1. There is conclusive evidence that executive departures are, on average, bad for the stock on announcement day.
2. More than one departure in a short period is significantly worse than a single departure.
3. Negative effects on stock prices and company performance can persist for up to two years but very little research has gone into separating the announcement effect from the follow-through impact of executive departures.

Here are some highlights of the research that I found.

A quick one pager from cglytics looks at just six years pf data. but seems logical. Their conclusion is that multiple departures are a red flag while a single departure is not. Makes sense.



https://cglytics.com/the-effect-of-executive-departures-on-company-performance/

Do Independent Director Departures Predict Future Bad Events?
Fahlenbach, Low, and Stultz (2017)

My summary: They use a control group (random director deaths) to conclude that surprise director departures are viewed as, and are empirically, bad news for immediate and future equity performance. The methodology here looks solid.

Abstract: Following surprise independent director departures, affected firms have worse stock and operating performance, are more likely to restate earnings, face shareholder litigation, suffer from an extreme negative return event, and make worse mergers and acquisitions. The announcement returns to surprise director departures are negative, suggesting that the market infers bad news from surprise departures. We use exogenous variation in independent director departures triggered by director deaths to test whether surprise independent director departures cause these negative outcomes or whether an anticipation of negative outcomes is responsible for the surprise director departure. Our evidence is more consistent with the latter.

The Impact of CEO Turnover on Equity Volatility
Clayton, Hartzell, Rosenberg (2003)

Abstract: A change in executive leadership is a significant event in the life of a firm. This study investigates an important consequence of a CEO turnover: a change in equity volatility. We develop three hypotheses about how changes in CEO might affect stock price volatility and test these hypotheses using a sample of 872 CEO turnovers over the 1979-95 period. We find that volatility increases following a CEO turnover, even when the CEO leaves voluntarily and is replaced by someone from inside the firm. Forced turnovers increase volatility more than voluntary turnovers - a finding consistent with the view that forced departures imply a higher probability of large strategy changes.

My summary: CEO changes increase stock volatility. Higher volatility is generally associated with lower returns and lower Sharpe ratios, but the paper does not cover returns, just vol. Here is the money chart:

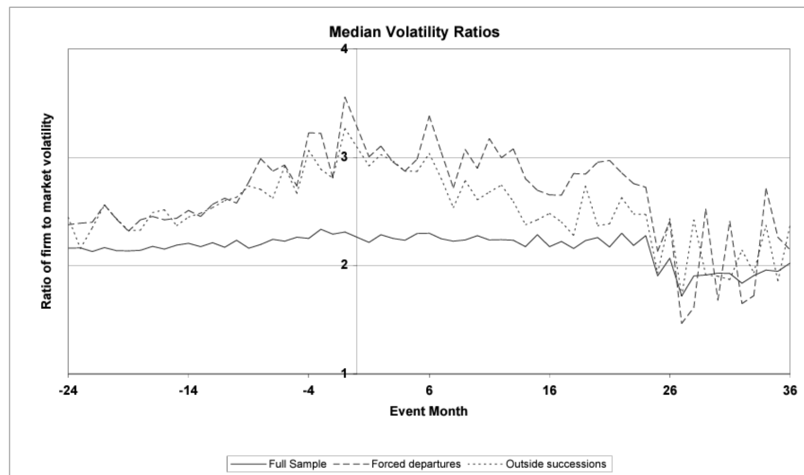


Fig. 1: Median ratios of firm volatility to market volatility around CEO turnover. Volatility is calculated as the daily standard deviation of returns over the event month. The firm to market volatility ratio uses the CRSP value-weighted index as the market proxy. The median ratio is calculated across events for each event month. Forced turnovers are defined as those turnovers where a WSJ announcement indicates the CEO was forced out or fired, or where the CEO was under the age of 60 and did not leave for health reasons or to go to another firm. An outside succession is defined as a change in CEO where the new CEO has been with the firm for less than one year at the date of the announcement.

Shareholder Wealth Effects of CEO Departures: Evidence from the UK
Dedman and Lin (2001)

My summary: Negative stock returns on announcement day and company return on assets remains below industry benchmark for two more years after a CEO departure.

Abstract: The market reacts negatively to announcements of top executive departures, especially when the CEO is dismissed or leaves to take up another job. Share price reactions to the disclosure of top executive departure are significantly affected by the financial risk of the firm and whether the board announces a replacement CEO.

CFO Gaps: Determinants and Impact on the Corporate Information Environment
Chen, Li, and Lin (2022)

My summary: Firms with CFO gaps tend to have larger earnings surprises and more restatement of earnings. The paper makes no conclusions on equity performance per se but does show that bid-ask for companies with CFO departures is 2.5% wider than for companies with a CFO. The paper is more like “companies without CFOs are more volatile” than “CFO departures are bad” but the logic overlaps somewhat.

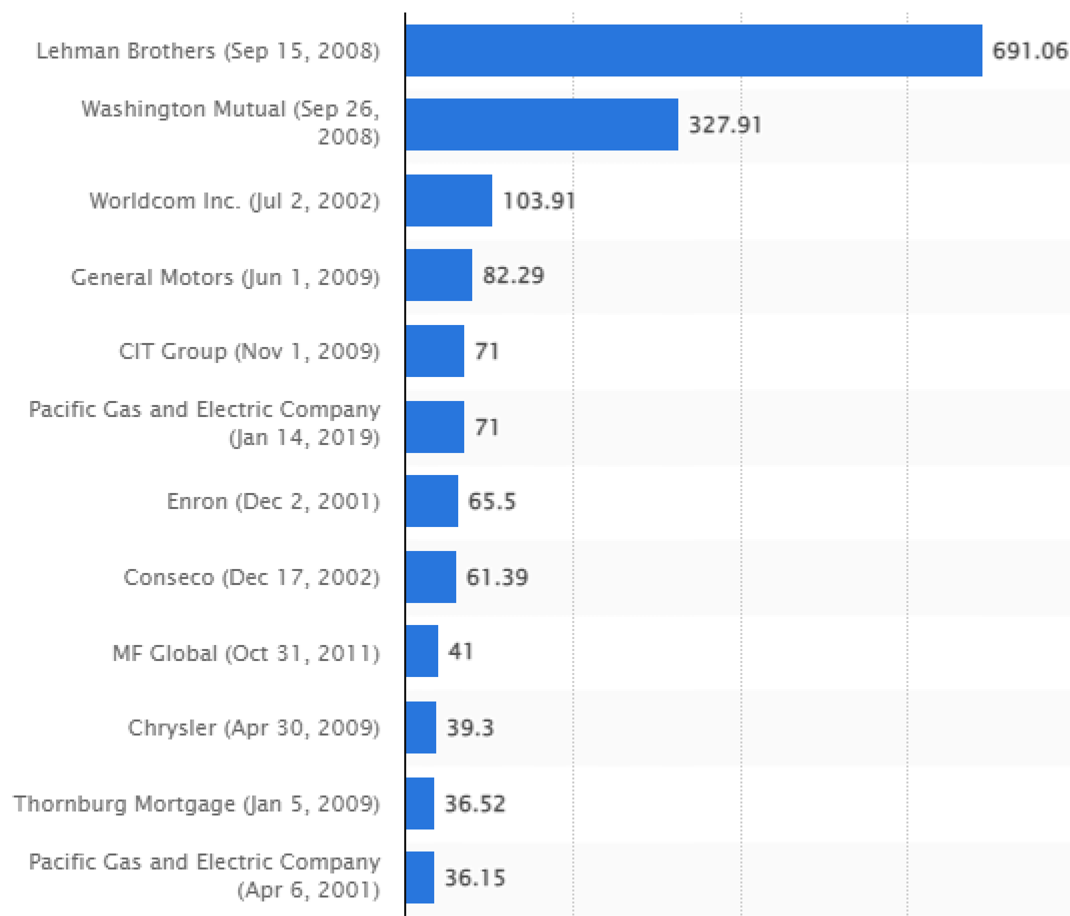
Abstract: A CFO gap arises when the CFO position is left vacant for a period between the departure of the old CFO and the appointment of a new CFO. CFO gaps are more likely for firms that face more labor market search frictions and with financial reporting and performance issues and are less likely for firms with succession plans and with greater growth opportunities. CFO gaps are associated with significantly negative changes in firms’ voluntary disclosure frequency and analysts’ forecast quality.

End of detour

Thank you for reading today’s detour. Back to regularly scheduled programming tomorrow.

Have an excellent day.

good luck ⇅ be nimble


The largest bankruptcies in US history
by assets
Lehman Brothers (Sep 15, 2008)
691.06
Washington Mutual (Sep 26, 2008)
327.91
Worldcom Inc. (Jul 2, 2002)
103.91
General Motors (Jun 1, 2009)
82.29
CIT Group (Nov 1, 2009)
71
Pacific Gas and Electric Company (Jan 14, 2019)
71
Enron (Dec 2, 2001)
65.5
Conseco (Dec 17, 2002)
61.39
MF Global (Oct 31, 2011)
41
Chrysler (Apr 30, 2009)
39.3
Thornburg Mortgage (Jan 5, 2009)
36.52
Pacific Gas and Electric Company (Apr 6, 2001)
36.15

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