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Management as a Proxy for Firm Quality

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Abstract : There is no agreed-upon definition of firm quality. While profitability and stock performance often qualify as popular proxies of quality, in this project, we aim to identify quality without relying on a firm's financial statements or stock returns as selection criteria. Instead, we use firm-level data on management practices across small to medium-sized U.S. manufacturing firms from the World Management Survey (WMS) to measure firm quality. Each firm in the WMS dataset is assigned a mean management score from 0 to 5, with higher scores identifying better-managed firms. This management score serves as our proxy for firm quality and is the sole criteria we use to separate firms into portfolios comprised of high-quality and low-quality firms. We define high-quality (low-quality) firms as those firms with a management score of one standard deviation above (below) the mean. To study whether this proxy for firm quality can identify better-performing firms, we link this data to Compustat and The Center for Research in Security Prices (CRSP) to obtain firm-level data on financial performance and monthly stock returns, respectively. We find that from 1999 to 2019 (our sample data period), firms in the high-quality portfolio are consistently more profitable — higher operating profitability and return on equity compared to low-quality firms. In addition, high-quality firms also exhibit a lower risk of bankruptcy — a higher Altman Z-score. Next, we test whether the stocks of the firms in the high-quality portfolio earn superior risk-adjusted excess returns. We regress the monthly excess returns on each portfolio on the Fama-French 3-factor, 4-factor, and 5-factor models, the betting-against-beta factor, and the quality-minus-junk factor. We find no statistically significant differences in excess returns between both portfolios, suggesting that stocks of high-quality (well managed) firms do not earn superior risk-adjusted returns compared to low-quality (poorly managed) firms. In short, our proxy for firm quality, the WMS management score, can identify firms with superior financial performance (higher profitability and reduced risk of bankruptcy). However, our management proxy cannot identify stocks that earn superior risk-adjusted returns, suggesting no statistically significant relationship between managerial quality and stock performance.

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