

MANAGERIAL OVERCONFIDENCE AND FINANCIAL DECISIONS - A LITERATURE REVIEW

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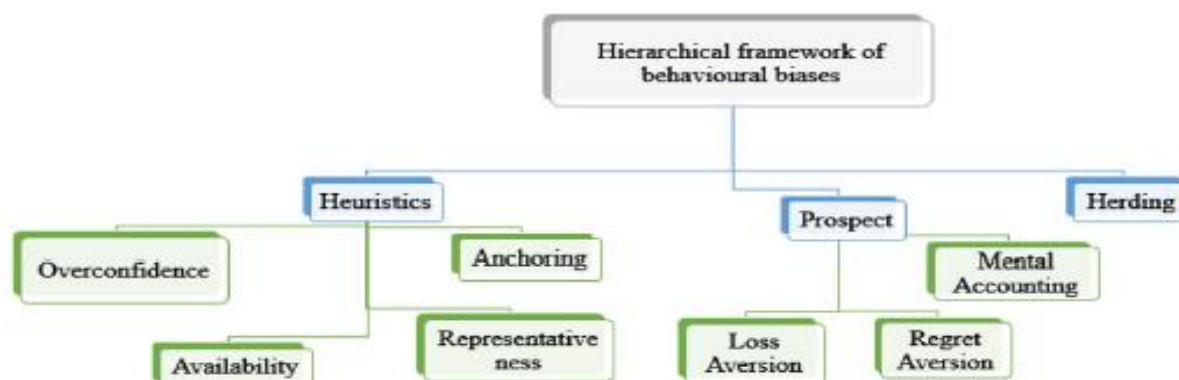
Abstract

Human behaviour is diverse and complex and unfortunately, it is not always governed exclusively by rationality. Most financial models and theories assume that an individuals' financial decision making process is rational. Literature shows evidence of recurring patterns of irrationality in the way people as well as managers take decisions especially under uncertainty. "Behavioural Finance combines behavioural and cognitive psychological theory, with conventional financial economic thinking to provide explanations for why people make irrational financial decisions" (Phung, 2002). The field of behavioural finance rests on the premise that financial behaviour and consequently decision making, may be affected by certain psychological factors (Kahneman & Tversky (1979), Nemeth (2012), Ricciardi & Simon (2000), Thaler et al. (1997). These psychological factors called heuristics and biases. Behavioural Finance studies the prevalence of heuristics and biases in judgement and decision making. The overconfidence bias is one of the most prevalent Judgment Bias. "It is observed when people's subjective confidence in their own ability is greater than their objective (actual) performance" (Pallier, et al., 2002). In the past decade, several scholars have researched have reviewed behavioural heuristics and biases (Kumar & Goyal, 2015); (Costa & Carvalho, 2016); Paule-Vianez et al. (2020)) Though these prevailing assessments offer valuable discernments, nevertheless a complete assessment covering managerial overconfidence bias is still amiss. The author endeavours to bridge this gap by considering the impact of managerial overconfidence on the three basic financial decisions of investing, financing as well as dividend policy. It also covers the impact of managerial overconfidence on other allied areas of finance.

Key Words: Corporate Governance, CEO Overconfidence, Heuristics, Overconfidence Bias, Behavioural Finance

INTRODUCTION

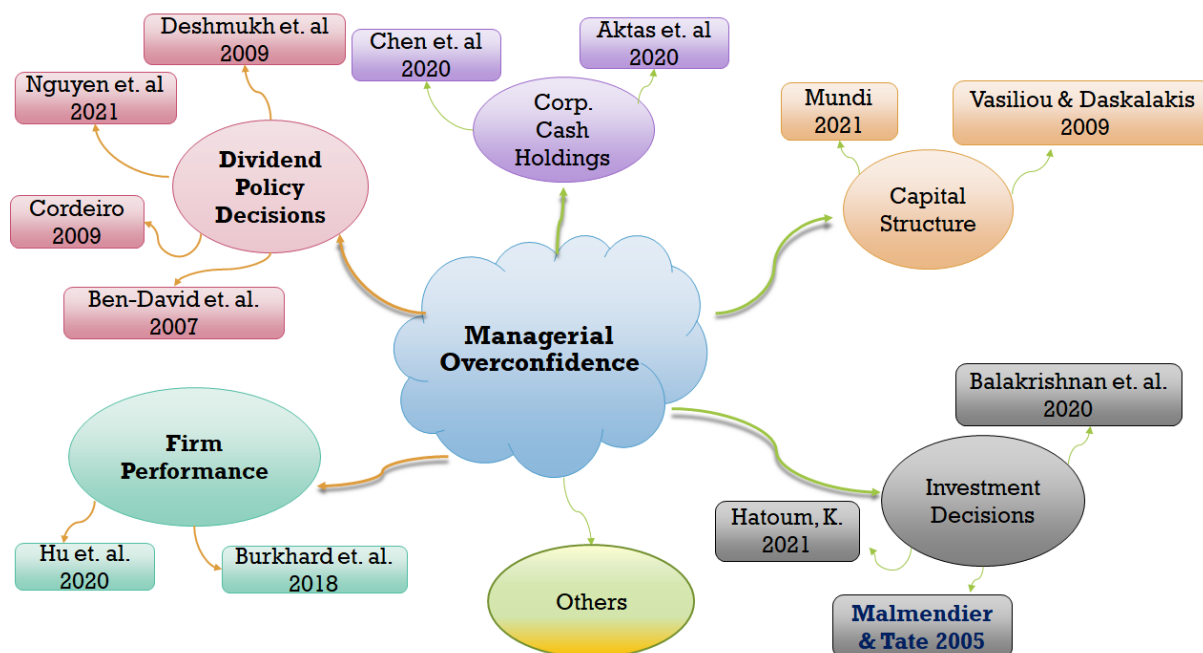
Behavioural Finance entwines behavioural and cognitive psychological theory, with traditional financial economic rational to elucidate for why individuals take irrational financial decisions (Phung, 2002). The field of behavioural finance rests on the premise that financial behavior and consequently decision making, may be affected by certain psychological factors (Kahneman & Tversky (1979), Nemeth (2012), Ricciardi & Simon (2000), Thaler et al. (1997)) and investment decisions must appreciate and adjust for the same. These psychological elements are called heuristics and biases. When decision makers are challenged with voluminous and complex data, they are unable to take optimal decisions as presumed by the standard finance theory. Instead, they are prone to biases and bank on limited number of cognitive strategies or heuristics that oversimplify complex decisions. Much of the behavioural finance literature is focused on individual psychology, particularly the use of heuristics and various biases in judgement and decision making. One such bias is the Overconfidence Bias. Jain et al. (2021) suggest that behavioural biases are an essential area of research in the field of corporate behavioural finance.



Source 1: Jain, J., et al. (2021).

Overconfidence

In a most elementary way, overconfidence may be pronounced as, “unjustified faith on intuitive reasoning resulting from cognitive and judgment skills” (Pompian, 2012). Consequently, overconfidence makes people too confident in their knowledge and abilities (Ludwig & Nafziger, 2011), they also become ignorant of the decisional risks (Kumar and Goyal 2015). Merkle and Weber (2011) purport that overconfidence is, “not just obvious but essentially a consequence of a psychological bias”. The overconfidence bias is extensively researched in Psychology ever since the 1960’s (Habib & Hossain, 2013). This concept was initially termed by Oskamp (1965) in his work called “overconfidence in case-study judgments. According to Peón et al. (2016)”, “overconfidence can be expressed in the estimates about a person’s own performance, in the estimates about performance in relation to that of others, and in the over application of estimates about future uncertainties”. The overconfidence bias has been validated in psychology, and managers are every so often found to be disproportionately overconfident (Hackbarth, 2002). The existence of overconfidence bias leads people to think of their judgements as being ‘better than average’ (Weinstein, 1982).



Source 2: Infographic by the author
Overconfidence and the Financing Decision

The financing decision of either using borrowed funds or that of equity is continuously deliberated by firms as it affects the firm’s performance. Literature shows that managerial overconfidence has an influence on the type of financing utilised. Overconfidence bias alters the composition of a firms capital (Bertrand & Schoar (2006); Chen et al. (2014); Lemmon (2008)). Behavioural corporate finance scholars have documented that, “for a given level of investment needs, the sensitivity of investment cash flows is much higher for overconfident CEO than a rational CEO” (Malmendier & Tate, 2005). Research done by Campbell et al. ((2009)) and Chen et al. (2014) suggest that overconfidence among CEO’s is palpable. Schrand and Zechman (2012) purport that financial misreporting is observed due to overconfidence amongst managers. Tan (2017) examined that overconfident CEO’s picked more debt than equity and He et al. (2019) proposed that over-investment is prominent in state-owned companies with overconfident CEO’s.

Overconfidence and Investment Decision

Investment or capital budgeting decision is the route by which businesses define how to capitalise their investment. This involves decisions to invest in new ventures, review the extent of capital already invested in current ventures, apportion and allot money across departments, and acquisition of other companies. In principle, the capital budgeting method delineates the size of a company’s existent assets, which then generate cash flows that eventually decide its profitability, significance, and feasibility. Scrutinising the part managerial overconfidence plays in influencing corporate investments decisions is crucial to appreciate the causes of inept corporate investment decisions ensuing “numerous corporate investment defaults and bankruptcies” (Hatoum, 2021). Malmendier & Tate (2005) argue that managerial overconfidence may account for corporate investment misrepresentations, asserting that overconfident managers are inclined to misjudge the yields of their investment. Literature proposes that biased CEO’s overinvest their company’s free cash-flows, venture in too more mergers than necessary, establish more companies and new ventures, and hold onto unsuccessful investment strategies longer than necessary. Ben-David et al. (2013) interviewed senior finance executives, the

majority of whom were CFOs, and find that, “firms with mis-calibrated or optimistic executives invest more and have more debt, on average”.

Overconfidence and Dividend Decision

The deviation in dividends over time and across businesses is one of the chief unsolved conundrums in the relics of corporate finance, in spite of an extensive theoretical and empirical literature. Standard finance theory suggests that managers with an overconfident conviction in their company's future have a preference of ploughing back profits instead of distributing dividends to investors. Several scholars have linked managerial biases and dividends by adopting the Malmendier and Tate (2005) proxies for overconfidence. Managers are treated as overconfident if they do not diversify their portfolio by disinvesting executive options or if they laud themselves in the media. Cordeiro (2009) finds support for the hypothesis that managers who are optimistic about their firms' cash flows are less likely to pay dividends. Deshmukh et al. (2013) reveals that, “the level of dividend pay-out is lower in firms managed by overconfident managers”. The authors further examine market perceptions by scrutinising the stock price deviations to broadcasts of dividend changes and find that the extent of the positive stock price response to broadcasts of dividend increases is greater in companies in which there is more uncertainty about the degree of manager's overconfidence. Ben-David et al. (2007) propose that overconfident managers invest more in specific acquisitions, take on more leverage and are less probable to pay dividends. Dinh Nguyen et al. (2021) opine that managerial overconfidence has a positive influence on Dividend Payout and Yield of Vietnamese firms.

CONCLUSION

Since the mid-to-late 2000's, *behavioural corporate finance* has presented innumerable proofs that managers are bound by biases that impact corporate results in copious ways, and continues in every stage in the career cycle of a managers. The theoretical and empirical proofs isolate the inadequacies of convectional debates for why managers are rational decision makers. Originally, researchers in the field of finance only accepted the probability that individual investors may be influenced by psychological predispositions. By verifying biased decision making of managers and other c-suit executives, behavioural corporate finance has magnified the significance and repercussions of psychological factors in financial frameworks. Notwithstanding these significant developments, the area of behavioural corporate finance is still nascent, and several essential problems linger unrequited. Three major queries merit emphasis: in the context of managerial selection: What part can “testing” for biases play in decreasing biased managerial decision-making? Do biases relate with other, possible performance-augmenting persona traits? Do employers mis-value certain characteristics? In the context of managerial decision-making, prospective research questions include: Which other biases and heuristics affect corporate outcomes? What is the comparative significance of diverse managerial biases across corporate policies? In the context of dismissal of a manager: How do board members' biases impact firms and corporate governance efficacy? A fundamental task for the corporate behavioural finance area is to furnish an all-inclusive “behavioural approach,” which ratifies that all stakeholders involved are conceivably bound by biases.

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