Секция «Корпоративные финансы: наука, теория и практика»

Overconfident CEOs and payout policy choice

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The choice of payout policy is one of the most widely investigated topics in the corporate finance. The classic theories explaining the variation in the payout policy did not consider that agents in the financial markets were not always fully rational. That is why the new approach called “behavioral explanation” was developed. This approach aimed to find the evidence that the manager’s and/or investor’s behavior affected the payout policy choice.

The existing studies that were conducted on the sample of the US companies during 2000’s found that the CEO’s overconfidence might significantly affect the payout policy choice. For example, if the CEO is overconfident and holds its executive options until the expiration, he or she will pay fewer dividends [Hirshleifer et al., 2012; Deshmukh et al., 2013]. However, such behavior may stimulate managers to repurchase stocks, as they tend to think that the company’s shares are undervalued [Fenn, Liang, 2001]. So the effect on the total payout may be mixed.

The aim of this paper is to investigate the relation between the CEO’s overconfidence and payout policy choice in the United States. The research contributes to the existing literature in the following directions: we propose some new specifications of the manager’s overconfidence; we test the influence of the overconfidence not only on the level of payout, but also on the decision to initiate payouts; finally, we test the ability of corporate governance to eliminate the adverse effects of CEO’s overconfidence.

In this paper we aimed to test the following hypotheses:

1. The **higher** the level of overconfidence of the CEO, the **higher** the **level** of payout in the form of repurchased. This proposition is based on the assumption that overconfident CEO treats the company’s shares as undervalued and tends to repurchase them [Fenn, Liang, 2001];
2. The **higher** the level of overconfidence of the CEO, the **higher** the probability of **initiating the repurchase** [Fenn, Liang, 2001];
3. The size of the Board of Directors makes the relation between overconfidence and payout policy choice **insignificant** [Sharma, 2011; Bhabra et al., 2015].

To measure Overconfidence we use two specifications: the ratio of value of exercisable executive options to the value of all executive options; and the ratio of exercised executive options to the value of exercisable executive options at the beginning of the year.

The research was conducted on the sample of 671 non-financial and non-utilities companies from the S&P1500 Index for the period of 2007-2016. The data was obtained from the S&P Capital IQ database. After testing the hypotheses 1 and 2 we derived the subsample of the “good quality” Board of Directors companies. We propose the index of quality which includes the board size; the number of independent directors and female directors; CEO duality; and the number of board meetings. We did so to estimate the impact of the board quality on the negative effects of manager’s behavior.

We managed to find that the level of exercisable options has significant positive influence on both the total payout and repurchases. It means that the more confident CEO repurchases more. However, the level of exercised executive options has no significant effect on the dependent variables.

Moreover, the level of exercisable options has a significant positive effect on the decision to repurchase. It means that more confident managers are more likely to initiate repurchases.

Unfortunately, we did not find any evidence that the board quality eliminates the impact of CEOs behavior on the payout policy.

Further research is needed to prove such interrelations in other markets; to test other specifications of the overconfidence; to test this interrelation for the CFO's behavior; to find other ways to reduce the above mentioned negative effects of CEO's behavior.

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