European Financial Management / Volume 11, Issue 5 / pp. 649-659

Does Overconfidence Affect Corporate Investment? CEO Overconfidence Measures Revisited

Ulrike Malmendier, Geoffrey Tate

First published: 08 November 2005
https://doi.org/10.1111/j.1354-7798.2005.00302.x

PDF

Abstract

This article presents the growing research area of Behavioural Corporate Finance in the context of one specific example: distortions in corporate investment due to CEO overconfidence. We first review the relevant psychology and experimental evidence on overconfidence. We then summarise the results of Malmendier and Tate (2005a) on the impact of overconfidence on corporate investment. We present supplementary evidence on the relationship between CEOs' press portrayals and overconfident investment decisions. This alternative approach to measuring overconfidence, developed in Malmendier and Tate (2005b), relies on the perception of outsiders rather than the CEO's own actions. The robustness of the results across such diverse proxies jointly corroborates previous findings and suggests new avenues to measuring executive overconfidence.

References

Alicke, M. D., 'Global self-evaluation as determined by the desirability and controllability of trait adjectives', *Journal of Personality and Social Psychology*, Vol. **49**, 1985, pp. 1621–30.

Web of Science® | Google Scholar

Alicke, M. D., Klotz, M. L., Breitenbecher, D. L., Yurak, T. J., *et al*., 'Personal contact, individuation, and the

Baker, M. and Wurgler, J., 'The equity share in new issues and aggregate stock returns', *Journal of Finance*, Vol. **55**, 2000, pp. 2219–57.

Web of Science® | Google Scholar

Baker, M. and Wurgler, J., 'Market timing and capital structure', *Journal of Finance*, Vol. **57**, 2002, pp. 1–32.

PubMed | Web of Science® | Google Scholar

Baker, M., Ruback, R. and Wurgler, J., 'Behavioral corporate finance: a survey', in E. Eckbo (ed.), *The Handbook of Corporate Finance: Empirical Corporate Finance*(New York: Elsevier/North Holland, forthcoming).

Google Scholar

Bazerman, M. H., *Judgment in Managerial Decision Making*, 5th ed. (Hoboken NJ: John Wiley & Sons, 2002.

Google Scholar

Becker, G., *The Economics of Discrimination*(Chicago: University of Chicago Press, 1957.

Google Scholar

Bergman, N. and Jenter, D., 'Employee sentiment and stock option compensation', *Working Paper* (MIT, 2005.

Google Scholar

Camerer, C. and Lovallo, D., 'Overconfidence and excess entry: an experimental approach', *American Economic Review*, Vol. **89**, no. 1, 1999, pp. 306–18.

Web of Science® | Google Scholar

Camerer, C. and Malmendier, U., 'Behavioral economics of organizations', in P. Diamond and H. Vartiainen(eds), *Economic Institutions and Behavioral Economics*, (Princeton NJ: Princeton University Press, Yrjö Jahnsson Foundation, forthcoming).

Web of Science® Google Scholar

DellaVigna, S. and Malmendier, U., 'Contract design and self-control: theory and evidence', *Quarterly Journal of Economics*, Vol. **119**, no. 2, 2004, pp. 353–402.

Web of Science® Google Scholar

Feather, N. T. and Simon, J. G., 'Attribution of responsibility and valence of outcome in relation to initial confidence and success and failure of self and other', *Journal of Personality & Social Psychology*, Vol. **18**, no. 2, 1971, pp. 173–88.

Web of Science® Google Scholar

Fischhoff, B., Slovic, P. and Lichtenstein, S., 'Knowing with certainty', *Journal of Experimental Psychology: Human Perception and Performance*, Vol. **3**, 1977, pp. 552–64.

Web of Science® Google Scholar

Gabaix, X. and Laibson, D., 'Shrouded attributes, consumer myopia, and information suppression in competitive markets', *Working Paper* (MIT, 2005.

Google Scholar

Gervais, S., Heaton, J. B. and Odean, T., 'Overconfidence, investment policy and stock options', *Working Paper* (Duke University, 2003.

Google Scholar

Goel, A. M. and Thakor, A., 'Rationality, overconfidence and leadership', *Working Paper* No. 00-022 (University of Michigan Business School Faculty, 2000.

Google Scholar

Graham, J., 'How big are the tax benefits of debt?' *Journal of Finance*, Vol. **55**, 2000, pp. 1901–42.

Hall, B. and Murphy, K. J., 'Stock options for undiversified executives', *Journal of Accounting and Economics*, Vol. **33**, 2002, pp. 3–42.

Web of Science® | Google Scholar

Heaton, J. B., 'Managerial optimism and corporate finance', *Financial Management*, Vol. **31**, 2002, pp. 33–45.

Web of Science® | Google Scholar

Hey, J. D., 'The economics of optimism and pessimism', *Kyklos*, Vol. **37**, no. 2, 1984, pp. 181–205.

Web of Science® | Google Scholar

Kruger, J., 'Lake Wobegon be gone! The 'below-average effect' and the egocentric nature of comparative ability judgments', *Journal of Personality and Social Psychology*, Vol. **77**, no. 2, 1999, pp. 221–32.

CAS | PubMed | Web of Science® | Google Scholar

Kunda, Z., 'Motivated inference: self-serving generation and evaluation of causal theories', *Journal of Personality and Social Psychology*, Vol. **53**, 1987, pp. 636–47.

Web of Science® | Google Scholar

Landier, A. and Thesmar, D., 'Enterpreneurial optimism and financial contracting', *Working Paper* (NYU, 2004.

Google Scholar

Langer, E. J., 'The illusion of control', *Journal of Personality and Social Psychology*, Vol. **32**, 1975, pp. 311–28.

CAS | Web of Science® | Google Scholar

Larwood, L. and Whittaker, W., 'Managerial myopia: self-serving biases in organizational planning', *Journal of Applied Psychology*, Vol. **62**, 1977, pp. 194–98.

Google Scholar

Malmendier, U., Tate, G. and Yan, J., ‘Corporate financial policies with overconfident CEOs’, Working Paper, (Stanford University, 2005.

Google Scholar

March, J. and Shapira, Z., ‘Managerial perspectives on risk and risk taking’, *Management Science*, Vol. **33**, no. 11, 1987, pp. 1404–19.

Web of Science® | Google Scholar

Milburn, M. A., ‘Sources of bias in the prediction of future events’, *Organizational Behavior and Human Performance*, Vol. **21**, 1978, pp. 17–26.

Web of Science® | Google Scholar

Miller, D. T. and Ross, M., ‘Self-serving biases in the attribution of causality: fact or fiction?’ *Psychological Bulletin*, Vol. **82**, no. 2, 1975, pp. 213–25.

Web of Science® | Google Scholar

Moore, P. G., The manager's struggle with uncertainty’, *Journal of The Royal Statistical Society Series A*, Vol. **149**, 1977, pp. 129–65.

Web of Science® | Google Scholar

Moore, D. A. and Kim, T. G., ‘Myopic social prediction and the solo comparison effect’, *Journal of Personality and Social Psychology*, Vol. **85**, no. 6, 2003, pp. 1121–35.

PubMed | Web of Science® | Google Scholar

Myers, S. and Majluf, N., ‘Corporate financing and investment decisions when firms have information that investors do not have’, *Journal of Financial Economics*, Vol. **13**, 1984, pp. 187–221.

Shyam-Sunder, L. and Myers, S. C., 'Testing static tradeoff against pecking order models of capital structure', *Journal of Financial Economics*, Vol. **51**, 1999, pp. 219–44.

Web of Science® Google Scholar

Stigler, G. J., 'The economies of scale', *Journal of Law and Economics*, Vol. **1**, 1958, pp. 54–71.

Web of Science® Google Scholar

Svenson, O., 'Are we all less risky and more skillful than our fellow drivers?' *Acta Psychologica*, Vol. **47**, 1981, pp. 143–48.

Web of Science® Google Scholar

Van den Steen, E., 'Organizational beliefs and managerial vision', *Journal of Law, Economics, and Organization*, Vol. **21**, no. 1, Spring 2005, pp. 256–83.

Web of Science® Google Scholar

Weinstein, N. D., 'Unrealistic optimism about future life events', *Journal of Personality and Social Psychology*, Vol. **39**, 1980, pp. 806–20.

Web of Science® Google Scholar

Weinstein, N. D. and Klein, W. M., 'Resistance of personal risk perceptions to debiasing interventions', in T. Gilovich, D. Griffin and D. Kahneman (eds), *Heuristics and Biases: the Psychology of Intuitive Judgment*(Cambridge: Cambridge University Press, 2002, pp. 313–23.

Google Scholar

Yermack, D., 'Do corporations award CEO stock options effectively?' *Journal of Financial Economics*, Vol. **39**, nos. 2–3, 1995, pp. 237–69.