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Risk Management

Feeling Confident?

A new study shows that companies may pay the price for the "animal spirits" of their CFOs.

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CFOs might be worried about the economy, but when it comes to themselves, they are generally an optimistic bunch.

John Maynard Keynes once wrote, "Individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits." The British economist observed that successful businessmen tend to embrace a "naive optimism" and must put aside the thought of ultimate loss, just as healthy men put aside the thought of death.

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Apparently CFOs have taken this sentiment to heart, possibly to a fault. A new working paper by Itzhak Ben-David of the University of Chicago and John Graham and Campbell Harvey of Duke University, finds that a majority of finance chiefs are overconfident in their abilities to make judgments and that they make risky financial decisions as a result.

The authors surveyed 7,000 CFOs during a six-year span, asking them to make predictions on stock-market returns and to divulge how certain they felt about their picks. Using the S&P 500 index, CFOs forecasts were correct just 38 percent of the time, although most of the soothsayers felt very sure of themselves when selecting.

Such "miscalibrations" are natural, as people on balance tend to be overconfident. The effect is magnified, however, for corporate executives because they have experience taking risks that tend to work out. "Top executives should be expected to be overconfident because promotion in corporations is typically based on past performance," the authors write. "Overconfident managers underestimate risk and therefore take actions with excessive risk."

So Keynes called it correctly, but confidence has its limits. The authors find that overconfidence among CFOs comes with certain tendencies, and potentially costs. Firms with overconfident finance chiefs, they say, use lower discount rates when valuing cash flows, invest more, use more debt, and are less likely to pay dividends compared to those with more humble CFOs. What is more, they also have a greater tendency to repurchase shares and to use more long-term debt rather than short-term.

For an overconfident manager, corporate decisions are seen through the lens that winning is the rule. "Investment projects seem safer than they really are," the authors say. As a result, projects are assigned a higher net present value and given a low discount rate. When making financing choices, cocky CFOs might incorrectly price the firm's securities, as they assume the market is undervaluing the company's worth. This also explains the appeal of repurchases, due to the belief that outsiders fail to understand the worth of the shares.

The best medicine for CFOs might be to know whether they are overconfident and to factor that into their decisions. After all, shy executives with an aversion to risk probably won't keep their jobs much longer than their maverick counterparts.

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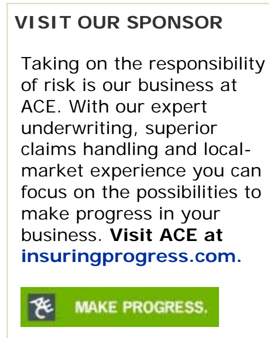

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