Does overconfidence affect payout policy choice?

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Abstract
A great number of research papers has been dedicated to the payout policy so far. However, most of them have not considered the fact that managers are not always fully rational while making their decisions. These decisions can be negatively influenced by the behavioral characteristics of managers. Overconfidence and risk preferences are good examples of such characteristics. They can have negative effects not only on the managers’ decisions but also, as the consequence, on the shareholders’ wealth. To eliminate these adverse effects and to protect the interests of shareholders the Board of Directors may be established in the company.

This paper aims to find the evidence of impact of CEO’s overconfidence on the decisions about payout. Using the sample of 671 US companies, author investigates the effects of CEO’s overconfidence on dividends and repurchases and on the probability of payout initiations in both forms.

This research contributes to the existing literature by testing several measures of overconfidence; by investigating the impact of overconfidence on the probability of payout initiations; by analyzing the ability of corporate governance to eliminate negative effects of CEO’s behavior on the strategic decisions.

The results have confirmed the hypothesis that overconfident CEO tends to increase payout in the form of repurchases because such manager considers company’s stocks as undervalued. Such CEO more likely initiates repurchases if it has not been done already. The same is true for the total payout ratios. However, the results are sensitive to the way overconfidence is measured.

The author also shows that these findings do not hold for the companies that have more than 8 members in the Board of Directors. It is assumed that corporate governance is more efficient in such companies and is able to protect shareholders from the negative effects of managers’ behavior.

Keywords: payout policy; behavioral finance; overconfidence; corporate governance

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