
CORPORATE GOVERNANCE AND BEHAVIORAL FINANCE: FROM MANAGERIAL BIASES TO IRRATIONAL INVESTORS

HERCIU Mihaela

Lucian Blaga University of Sibiu, Romania

OGREAN Claudia

Lucian Blaga University of Sibiu, Romania

Abstract:

Corporate governance is concerned about the ways in which investors assure themselves of getting a return on their investment, on one hand, and is focus on motivating managers to increase the company profit, on the other hand (the agency theory). Corporate governance emerges from the interaction between managers and investors. Managers are often more likely to invest the extra cash-flow or profit than to return it to shareholders. But, both managers and investors are lees then fully rational. Sometimes their behavior is based on cognitive psychology. In this context, we are dealing with two problems: managerial biases and irrational investors. Managerial biases focus on the illusion of optimism and overconfidence. Instead, irrational investors can produce overreaction to something and under-reaction to other thing. By this paper we try to emphasize that both managerial biases and irrational investors will affect corporate governance and furthermore will drive to company distress (even bankruptcy) if decisions are more based on cognitive psychology than on rational information.

Key words: *behavioral finance, corporate governance, irrational investors, managerial biases, agency theory*

1. Introduction

Corporate governance and corporate finance are about managers, investors and shareholders. Sometimes, they act in an irrational way based on their own perception or on their own biases. Managers may be too optimistic when assessing the profitability of their investment, investors may have an irrational behavior that can produce a mispricing and shareholders are too optimistic about the value of their share and are confronting with disposition effect. Also, the corporate governance is influenced by two different approaches: (1) “when the primary source of irrationality is

on the investors' side, economic efficiency requires insulating managers from the short-term share price pressures, which may result from managerial stock options, the market for corporate control, or an insufficient amount of liquidity that forces the firm to return regularly to the capital market"; (2) "when the primary source of irrationality is on the managers' side, managerial responsiveness to market signals and limited managerial discretion are called for" (Tirole, 2006).

2. Corporate governance and behavioral finance

Corporate governance emerges from the interaction between managers and investors. This implies an agency theory perspective in order to balance and manage the conflict of interest between the two parts (Nicholson and Kiel, 2003). More than that, managers have to find different ways to maximize the wealth of the shareholders because this represents the goals of businesses, on one hand, and shareholders have to find ways to motivate managers to reach their goals, on the other hand.

In order to manage this kind of conflict, in nowadays, corporate governance is based on behavioral finance that according to Pompian (2011) "examines behavior or biases of individual investors that distinguish them from the rational actors envisioned in classical economic theory".

But, according to Ritter (2003) "behavioral finance has two building blocks: cognitive psychology – that refers to how people think, and the limits to arbitrage – that refers to predicting in what circumstances arbitrage forces will be effective, and when they will not be". Ritter also proposed, based on previous literature research, some patterns for cognitive psychology: heuristics (rules of thumb); overconfidence (optimism); mental accounting (separate decisions instead of combining them); framing (how a concept is presented to individuals matters); representativeness (underweighting long-term averages); conservatism (to be slow to pick up on the changes); disposition effect (to avoid realizing paper losses and seek to realize paper gains).

In the study *Market efficiency, long-term returns, and behavioral finance* that was published in *Journal of Financial Economics*, Eugene Fama (1998) has approached the problem of behavioral models based on overreaction or underreaction. He has considered two models: BSV (Barberis, Shleifer, and Vishny) and DSH (Daniel, Hirshleifer, and Subrahmanyam) in order to explain some investor's behaviors.

The first model, BSV (named by Fama after initials of the authors surname), was published by Barberis, Shleifer, and Vishny (1998). Firstly, the model is motivated by a variety of psychological evidence, and in particular by the idea that people pay too much attention to the strength of the evidence they are presented with and too little attention to its statistical weight when they make forecasts (they overreact). Secondly, the model is also related to conservatism; people react slowly in the face of evidence (they underreact). Authors have supposed "that corporate announcements such as those of earnings represent information that is of low strength but significant statistical weight. This assumption has yielded the prediction that stock prices underreact to

earnings announcements and similar events”. Also, the authors have further assumed that “consistent patterns of news, such as series of good earnings announcements, represent information that is of high strength and low weight. This assumption has yielded a prediction that stock prices overreact to consistent patterns of good or bad news.”

The second model, DSH (named by Fama after initials of the authors surname), was published by Daniel, Hirshleifer, and Subrahmanyam (2001), but Fama had the first unpublished version since 1997. This model takes into consideration both informed and uninformed investors. “The uninformed are not subject to judgment biases. But stock prices are determined by the informed investors, and they are subject to two biases, overconfidence and biased self-attribution. Informed investors (overconfident) receive a private signal, instead uninformed investors do not receive a private signal and it is fully rational informed arbitrageurs”.

3. Managerial biases and irrational investors

In general, managers have the intention to overestimate their activity in a specific field or in a company and often, when they forecast the revenues, income, cash-flows, and other financial indicators they are overconfident on these results. But, according to Heaton (2002) “the managerial optimism model generates several new additional testable predictions as well:

- ✓ First, managerial optimism predicts the existence of biased cash flow forecasts.
- ✓ Second, managerial optimism predicts pecking order capital structure preferences.
- ✓ Third, managerial optimism predicts efforts to hedge corporate cash flow, even in the absence of significant asymmetric information, by generating a false, but perceived wedge between the internal and external cost of funds.
- ✓ Fourth, managerial optimism predicts takeover resistance”.

In Malmendier and Tate (2005) opinion “if CEOs are too optimistic about the value they can generate, then stock and options are not helpful in improving corporate decision-making. Overconfident CEOs do not need incentives to maximize the market value of the firm’s equity – that is what they believe they are doing already. Options could even push them towards risk-loving behavior and investments which are riskier (and lower NPV) than shareholders prefer, especially given that the CEOs already overestimates the expected value of those gambles”.

Managerial behavior is very complex and different from manager to manager. Some of them are aware about the importance of shareholders in a company, while others are more preoccupied to satisfy the needs of all stakeholders (employees, suppliers, costumer, and community) including shareholders; but to satisfy these needs you have to give up on an important part of profit – then the shareholders are not very excited. The managerial behavior is based also on psychological factors like believes, expectations, biases.

In managerial biases “the main themes are that individuals do not always form beliefs logically, nor do they convert a given set of beliefs into decisions in a consistent and rational manner” (Baker and Wurgler, 2011). In the context of managerial decision, Malcom and Wurgler (2011) have investigated some biases and nonstandard preferences, such as:

- ✓ Limited governance: making rational decision in favor of investors,
- ✓ Bounded rationality: sometimes you have to respect financial rules of thumb,
- ✓ Optimism, overconfidence and hubris of the managers that are suffer from self-importance and which involves more risk-taking
- ✓ Reference dependence: comparison with overconfidence that sometimes became a benchmark.

In the literature, the approaches of investors or managers behavior are often mixed. But, a recent study emphasized that “biases creep into the investment process at two important stages: first, when forming estimates, and second, biases find their way into the investment decision” (Goldman Sachs Research).

Figure 1 sows eight features for both estimate and investment decision that are in interrelations: anchoring/herding; confirmation bias/loss aversion; framing/mental accounts; more is more fallacy; overconfidence/overoptimism; availability bias/recency bias; substitution/hindsight bias; halo effect/causal thinking.

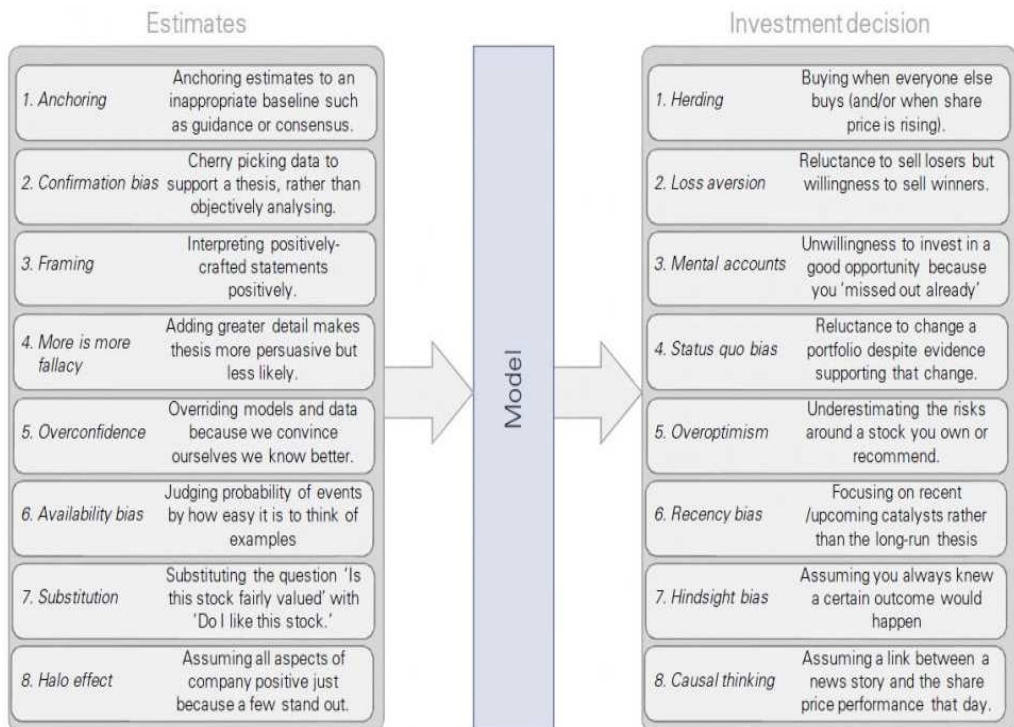


Figure 1: Biases into the investment process (Goldman Sachs Research, Kahneman “Thinking, fast and slow”, Montier “Behavioral investigating: a practitioners guide to applying behavioral finance”)

It is a different situation when is take into consideration the investor behavior. An investor acts more irrational and can produce overreaction to something and underreaction to other thing. The psychological factors are more present in an investment decision. If the investor behavior is related to economic cycle then we must considered two inflexion points – peak one and bottom one and some cognitive/behavioral attributes of investor. The two inflexion points represent the market peak or point of maximum risk and the market bottom or point of lowest risk. From the optimism point to market peak (on the ascendant side) investor feels gradually excitement, thrill even euphoria; after the market peak (on the descendant side) investor feels anxiety, denial, fear, depression, panic, capitulation and at the bottom line despondency. From the point of lowest risk feelings are very confused from desperation to hope and relief up to the optimism point again.

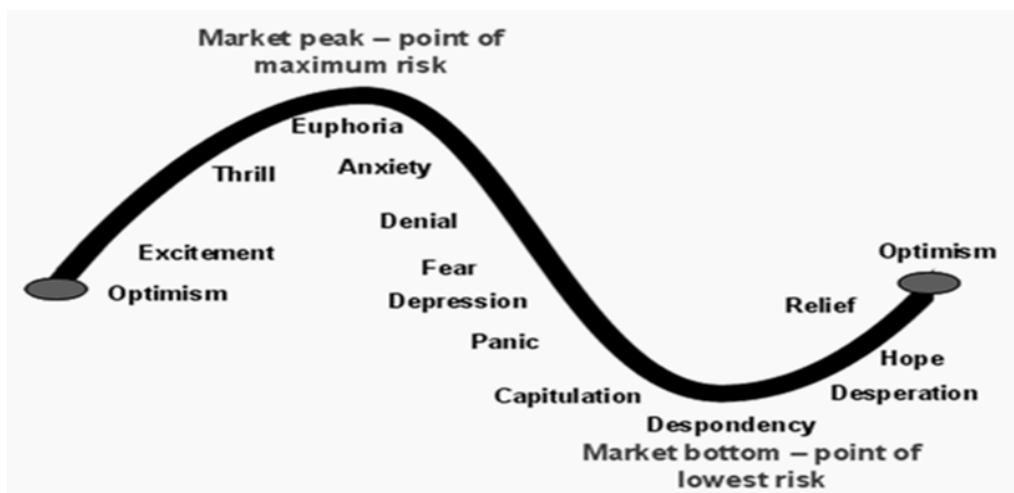


Figure 2: Investor Behavior through the Economic Cycle (Russell Investments and <http://www.divergingmarkets.com/category/asia/>)

Investor behavior will be more irrational if the optimism point is not the same – and often is different, depends on the trend. If the trend is ascendant the optimism point will go up to the market peak from the previous cycle; but, if the trend is descendant the optimism point will go down to the market bottom from the previous cycle or worse. In investor behavior expectations are some of the key factors for an irrational behavior. According to Fama (1998), “in forming expectations, investors give too much weight to the past performance of firms and too little to the fact that performance tends to mean-revert.”

In particular, investor psychology is influenced by behavioral biases. Even if an investor is very well informed may not be enough. A great investor has to feel the market and put information together in order to create synergy. Sometimes an irrational behavior is good, when you act different and gain more than others instead of herding

instinct. But, in many cases an irrational behavior will cost much more than it expected because feelings are more powerful than reason, many is better than few.

For example, an investor wants to buy a specific share but at the beginning he is contempt and has some doubts and suspicions. But on the market the price of the share is raising and even if the investor is cautious he becomes confident when the price of the share grows gradually. In the confidence stage/phase the investor decides to buy the share and after that he is very enthusiastic about that. The price of the share is growing. The investor is becoming greedy. This point is the maximum value/price of the share (but the investor does not know that). In a short time the price is going down. So, the investor is indifferent in this phase because if he sells the share he will still gain but he decides to not sell. After that is too late to. The anxiety of losing money develops a lot of feeling from dismissal and denial to fear and panic; the investor refuses to sell because he loses a lot of money (Figure 3).



Figure 3: The Investor Psychology Cycle (RMB Unit Trusts and <http://www.investmentpostcards.com/2008/08/29/investor-psychology-cycle-%E2%80%93-are-we-there-yet/>)

In general, investors have two kinds of regrets: omission regrets (when appears an opportunity and it is not exploited) and commission regret (when appears an opportunity, follows the opportunities but you are too greedy to sell at the optimum level). Managerial biases and irrational behavior of investor are important cognitive attributes that could affect the corporate governance and that are parts of behavioral finance.

4. Conclusions

Corporate governance is dealing first of all with behavioral finance and has to solve the problem of agency theory. Managers are often more likely to invest the extra cash-flow or profit than to return it to shareholders. But, both managers and investors are less than fully rational. Sometimes their behavior is based on cognitive psychology

that will affect corporate governance at the bottom line. As Morck (2008) emphasized “effective corporate governance reforms must weaken this reflexive subservience. (...) Corporate governance reforms that envision independent directors (dissenting peers), non-executive chairs (alternative authority figures), and fully independent audit committees (absent authority figures) aspire to a similar effect on corporate boards – the initiation of real debate to expose poor strategies before they become fatal”. Even so, with limited governance and bounded rationality, managers or CEOs will make decisions and take risks based on own their perception and believes.

Biases and irrational behaviors are present at every level. All managers, investors, shareholders act at one time irrational. But, maybe is time for this kind of behavior because prudence will not put you in the fast track to success (or fail).

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