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The effect of managerial overconfidence on the market timing ability and post-buyback performance of open market repurchases

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ABSTRACT

This paper investigates whether managerial overconfidence has an adverse impact on the market timing ability and post-buyback performance of open market repurchases, and whether corporate governance can mitigate the adverse impact in Taiwan. We find that managerial overconfidence raises the repurchase cost implying an adverse impact on the market timing ability of share repurchases. The repurchasing firms with overconfident managers experience poorer short-run announcement return and long-run stock performance than those without overconfident managers because of the poorer market timing ability and the higher repurchase cost. However, corporate governance mitigates the adverse impacts of managerial overconfidence on the market timing ability and post-buyback performance of repurchases.

1. Introduction

Open market repurchases (OMRs) is discretionary and flexible leading to a core issue of financial strategy and corporate governance. The decision and timing flexibility of OMRs influence the value

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of a firm. Brockman and Chung (2001) find that managers can buy back shares at lower prices via private information, indicating that managers have market timing ability of OMRs. Bozanic (2010) suggests that the amount of share repurchase is negatively related to the stock return of the previous month but is positively related to the return of the following three months implying managers' timing ability of OMRs. De Cesari, Espenlaub, Khurshed, and Simkovic (2012) also find that the repurchase price of a certain stock is generally lower than the average closing price of the current month. Ben-Rephael, Oded, and Wohl (2014) find that small firms have the market timing ability of OMRs. With the market timing ability of OMRs, managers repurchase shares at lower prices to increase firm value and shareholders' wealth.

In this paper, we investigate the market timing ability and post-buyback performance of OMRs from the perspective of behavioral finance. This study is other than the previous studies related to the timing ability of OMRs, which mostly assume that managers are rational (Bozanic, 2010; De Cesari et al., 2012; Ben-Rephael et al., 2014, and among others). Instead, we focus on the adverse impact of managerial overconfidence on the market timing ability and post-buyback performance of OMRs. We further examine how to mitigate the adverse impact through corporate governance.

Miller and Ross (1975) and Alicke (1985) argue that overconfident managers tend to exaggerate their capabilities, attribute success to their own capabilities, and attribute failure to bad luck or other factors. Roll (1986) proposes the hubris hypothesis that managers engage in M&A activities because of their overconfidence. According to Heaton (2002), overconfident managers believe that the capital market underestimates their firm value and thus reject external financing. Heaton suggests that the financing preference of overconfident managers is consistent with the pecking order theory. Ben-David, Graham, and Harvey (2007) argue that overconfident managers overestimate the future cash flows and underestimate the investment risks of investment projects, resulting in over-investment. Malmendier and Tate (2008) propose that overconfident managers pay excessively high prices for mergers because they overestimate their abilities. Consequently, overconfident managers tend to believe that the stock price of the firm is underestimated by the market and they have strong motivations to repurchase shares. Andriosopoulos, Andriosopoulos, and Hoque (2013) suggest that managerial overconfidence increases the execution rate of OMRs.

Overconfident managers tend to use more internal funds and debt financing than equity financing. Ben-David et al. (2007) and Malmendier, Tate, and Yan (2011) show that firms with overconfident managers have higher leverage and lower equity issuance, raising the degree of financial constraint. Chen and Wang (2012) find that financially constrained firms experience poor stock performance and operating performance after OMRs because OMRs deteriorate the financial risk and liquidity of financially constrained firms. Moreover, overconfident managers tend to overestimate future earnings and thus overbid to repurchase. We argue that OMRs driven by managerial overconfidence raise the repurchase cost, diminish the market timing ability, and hurt the value of the firm.

OMRs raise firms' liquidity risk due to the reduction in cash position or the increase in debt financing (Jensen, 1986; Stephens & Weisbach, 1998; Dittmar, 2000; Hovakimian, 2004). The increased liquidity risk, thus, raises the external financing costs (Chen & Wang, 2012). The liquidity risk due to OMRs also hurts firm's competitive strength and profitability (Froot, Scharfstein, & Stein, 1993; Chevalier & Scharfstein, 1996; Campello, 2003; Almeida, Campello, & Weisbach, 2004). The liquidity risk resulting from OMRs will be even higher with overconfident managers' poor market timing abilities leading to worse stock performance after OMRs. Consequently, we argue that managerial overconfidence hurts the post-buyback stock performance of OMRs because of managers' poor market timing ability.

How to ease the adverse impact of managerial overconfidence on OMRs is the other issue of this paper. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000b) indicate that corporate governance reduces the managers' incentives to expropriate shareholders. The board structure and ownership structure are important governance mechanisms. Yermack (1996) and Eisenberg, Sundgren, and Wells (1998) point out that a smaller board of directors is more efficient in monitoring the management. Klein (2002) and Xie, Davidson, and DaDalt (2003) find that board independence improves corporate governance. Dechow, Sloan, and Sweeney (1996) argue that outside blockholders can lessen the possibility of manipulating earnings. Lins (2003) finds that outside blockholders can raise the value of firms in an emerging market, especially for firms with poorer investor protection. La Porta,