Journal of Behavioral and Experimental Finance 3 (2014) 11–21

Contents lists available at ScienceDirect

Journal of Behavioral and Experimental Finance

journal homepage: www.elsevier.com/locate/jbef

Full length article

The effect of CEO overconfidence on turnover abnormal returns

Neslihan Yilmaz [a,*], Michael A. Mazzeo [b]

[a] *Department of Management, Bogazici University, Turkey*
[b] *Department of Accounting and Finance, Oakland University, United States*

ARTICLE INFO

Article history:
Received 20 March 2014
Received in revised form 1 July 2014
Accepted 9 July 2014
Available online 17 July 2014

Keywords:
CEO overconfidence
Management turnover
Executive options

ABSTRACT

This paper investigates the effect of managerial overconfidence on the market reaction to a CEO change within the firm. Some studies provide empirical evidence that irrational managers may engage in actions that can be detrimental to firm value while others suggest that an overconfident manager can increase firm value. We control for different turnover, governance and firm characteristics, and analyze the abnormal returns of S&P 500 firms in the event of a CEO turnover. We find that when an overconfident CEO is appointed to the firm there is a significant negative impact on firm's stock price. Our results support the arguments against overconfident CEOs due to the possible future actions of the CEO that may decrease firm value.

1. Introduction

Recent behavioral studies examine the relationship between less than fully rational managerial behavior and firm's actions. This research explores how the actions of managers with biased self-assessment affect firm's financial policies, investment, and mergers and acquisitions decisions. Studies show that overconfident managers engage in overinvestment and make value destroying acquisitions whereas others argue that it might be desirable for a firm to hire an overconfident manager as he can result in greater innovative success of the firm.[1] Yet, we do not know much about how the market reacts to the appointment of overconfident CEOs. In particular, the link between CEO overconfidence and the firm's abnormal stock returns in the event of a CEO turnover is yet to be examined.

We study the turnover of a sample of CEOs employed by S&P 500 firms from 1996 to 2006. We calculate the firm's abnormal returns when a CEO turnover is announced within the firm and analyze whether CEO overconfidence has any impact on the market reaction to the appointment news. Our proxy for overconfidence is from Malmendier and Tate (2005) who use CEO option holdings data to measure CEO overconfidence and consider overconfidence as the persistent failure of the manager to reduce his exposure to company-specific risk. We use an event study methodology to calculate turnover abnormal returns and find that the overconfidence of the incoming CEO has a significant impact; when an overconfident CEO is appointed to the firm there is a significant negative impact on the firm's stock price. Moreover, this negative effect seems to persist; the firm's industry-adjusted stock market performance for the year following the turnover event is significantly lower when the successor CEO is overconfident.

The findings of this paper contribute to the behavioral corporate finance literature. Beginning with Roll (1986), studies examine the role of managerial irrationality in corporate finance. In general findings suggest that overconfident managers may be detrimental to firm value

* Correspondence to: Department of Management, Bogazici University, 34342 Istanbul, Turkey. Tel.: +90 212 359 6511; fax: +90 212 287 7851.
E-mail address: neslihan.yilmaz@boun.edu.tr (N. Yilmaz).

1 Papers in the literature include, among others, Ben-David et al. (2007), Malmendier and Tate (2008), Englmaier (2004), Gervais et al. (2011) and Hirshleifer et al. (2012).

http://dx.doi.org/10.1016/j.jbef.2014.07.001
2214-6350/

(e.g., Ben-David et al., 2007, Malmendier and Tate, 2008). However, some studies argue that it might be desirable for a firm to hire an overconfident manager as he can increase firm value (e.g., Englmaier, 2004, Gervais et al., 2011 and Hirshleifer et al., 2012). This study complements the literature by measuring the biased managerial beliefs and their implications for turnover abnormal returns in order to shed light on how overconfident CEOs are perceived in the market. This paper also adds to the research on managerial turnover. Many studies consider the stock price reaction to turnover news and analyze the effects of different controls such as firm, governance and turnover characteristics.[2] This paper complements the literature by examining the effect of CEO overconfidence on the stock price reaction to turnover news by observing abnormal returns where CEO overconfidence is public information (Malmendier and Tate, 2005).

The paper is organized as follows. Section 2 presents the related literature and hypotheses. Section 3 describes the data. Section 4 presents the empirical results. We present our conclusions in Section 5.

2. Related literature and hypotheses development

2.1. CEO turnover

Top executive turnover is one of the important events in a firm as the CEO plays a crucial role in setting and implementing the strategy and actions of the firm (Bertrand and Schoar, 2003). Accordingly, executive succession has long been a subject of interest among researchers. One of the main findings is that the likelihood of management turnover is negatively related to firm performance (Weisbach, 1988, Denis and Denis, 1995, Huson et al., 2004, Kaplan and Minton, 2012). However, there are mixed results on the stock price reactions to turnover news which is generally analyzed through the calculation of firm's abnormal stock returns around the CEO turnover announcement. Some studies report significantly positive reactions to turnover news. For example, Weisbach (1988) looks at the effect of board composition on CEO resignations for stocks traded in the New York Stock Exchange (NYSE) between 1977 and 1980. Using a logit model, the author observes a stronger relationship between prior firm performance and the probability of resignation for outsider-dominated boards, and significantly positive abnormal stock returns for outsider-dominated and mixed boards. Huson et al. (2004) study turnovers between 1971 and 1995, and find that turnover follows a period of deteriorating firm operating performance. Firm performance improves after the turnover especially for forced turnovers, therefore, the abnormal stock returns are significantly positive. Similarly, Salas (2010) examines CEO changes between 1972 and 1982, and shows that if the CEO is entrenched, tenure exceeds 10 years and firm performance over the last three years are negative, the market reaction to turnover news is positive.

In contrast, Beatty and Zajac (1987), who consider executive changes between 1979 and 1980, show that CEO changes are associated with a reduction in firm value especially for unexpected changes. Lee and James (2007) study the period between 1990 and 2000, and examine the appointment of female executives (including CEO, CFO, COO, President and Executive Vice President). They find that the investor reactions to the CEO announcements are more negative for female and outsider CEOs. Others like Reinganum (1985) look at CEO turnovers during 1978 and 1979, do not observe significant price changes. The author shows that only when an outsider successor is appointed to a small firm, the abnormal returns are significantly positive. Friedman and Singh (1989) use surveys to gather information from firms experiencing turnover such as the nature of the turnover (forced versus voluntary) and successor's origin (insider versus outsider) in addition to the publicly available data sources like Wall Street Journal. The authors find that stock price reaction to turnover news is heterogeneous; the market reacts positively to board-initiated succession announcements when the firm's prior performance is poor, however, the market reaction is negative when the CEO dies or becomes disabled.

Some recent studies look at the effect of CEO irrationality on turnover behavior. Campbell et al. (2011) examine US data between 1992 and 2002, and use an option-based measure to proxy for optimism. The authors find that CEOs with relatively low or high optimism face a higher probability of forced turnover specifically for outsider-dominated boards. The authors follow the argument by Goel and Thakor (2008); overconfident managers sometimes make value-destroying investments but a risk averse CEO's overconfidence has a nonmonotonic positive effect on firm value since it offsets some of the manager's risk aversion. Choi et al. (2013) uses international data, the Fortune Global 500 list, and show that there is a higher likelihood of a dismissal for overconfident CEOs. The dismissal of the overconfident CEO is associated with improved market performance but limited increase in accounting returns.

2.2. Irrational managers and the firm

The relationship between less than fully rational managerial behavior and firm's actions has attracted the attention of researchers. The studies examine how the actions of irrational managers affect firm's financial policies, investment, and mergers and acquisitions decisions. Ben-David et al. (2007) look at the effect of overconfidence on firm's financial policies. They calculate overconfidence of CFOs using the narrowness of the individual probability distributions for the stock market returns and report that firms with overconfident CFOs use debt more aggressively, and pay out fewer dividends. Malmendier et al. (2011) use option-based compensation data and consider overconfidence of a CEO as the persistent failure of the manager to reduce his exposure to firm-specific risk by not exercising his in-the-money company stock options. The authors show that conditional on accessing public markets, overconfident CEOs raise external financing (debt or equity)

[2] An incomplete list includes Reinganum (1985), Beatty and Zajac (1987), Weisbach (1988) and Friedman and Singh (1989).