The influence of CEO overconfidence on ownership choice in foreign market entry decisions

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A B S T R A C T

Prior research on foreign-market entry determinants offers various firm-, industry-, and market-level explanations. Yet, few studies consider the subjective psychological attributes of the executives making actual decisions. Based on behavioral decision theory and the psychology literature, this study provides the first empirical evidence of the influence of managerial overconfidence on ownership decisions into foreign markets. The results show that CEOs’ tendency toward overconfidence increases the propensity for full over shared ownership, where their positive relationship is more pronounced when firms are exposed to greater information asymmetry or environmental uncertainty, in terms of greater home-host cultural distances, higher host-country risks, and inexperience in the local market. A powerful board weakens this positive relationship, but does not diminish the effect completely. The results hold with overconfidence measures based on both CEOs’ actual actions and public opinions. Our findings complement extant entry-mode decision literature by highlighting the imperative to incorporate firm leaders’ psychological biases.

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1. Introduction

In the international business literature, the choice of ownership in a firm’s foreign-market entry decision is recognized as being one of the most important issues in a firm’s process of internationalization (Hennart & Slangen, 2015). Researchers over the past decades explore determinants from a variety of theoretical perspectives, including transaction costs, institutional theory, real options, eclectic, and resource-based and knowledge-based theories etc. (Brouthers, Brouthers, & Werner, 2008; Brouthers, 2013; Chari & Chang, 2009; Herrmann & Datta, 2006; Johanson & Vahlne, 2009; Malhotra & Gaur, 2013), whereby antecedents are classified into host country-, home country-, company-, and venture-specific variables. While the literature provides multifaceted reasoning from various theoretical angles, these approaches make the implicit assumption that entry-mode choices are based on economic considerations largely ignoring the psychological traits and perception of top executives making the actual decisions. However, decisions about foreign market entry modes are characterized by complexities, incomplete information, and considerable uncertainty in terms of the anticipated outcomes. This ambiguous situation suggests that decision-makers’ cognitive perspectives and psychological orientation may have an important influence on entry mode decisions. As behavioral decision theory suggests, under highly uncertain decision-making contexts where judgements involve large amounts of ambiguous information and data, managerial choices are often the outcomes of behavioral factors not necessarily in the firm’s best interests (Cyert & March, 1963; March & Shapira, 1992).

We therefore depart from the well-researched economic factors to investigate entry mode antecedents from the perspective of executive decision-makers’ psychological biases. Building on the psychology literature and research on behavioral decisions, we argue that CEOs’ overconfidence tendencies, that is, their perception of themselves as having better-than-average abilities, judgment, or precision can be a key determinant of firms’ foreign ownership policies. The psychology literature has identified a “difficulty effect” linked to overconfidence wherein hubristic individuals tend to pursue difficult or arduous tasks because they believe themselves to be much better than others are at difficult tasks than at easy ones (Picone, Dagnino, & Minà, 2014). Success in challenging tasks allows a more explicit recognition of overconfident managers’ self-perceived superiority over their peers and
signals their strong ability (Chatterjee & Hambrick, 2007). Overseas investments are inherently riskier than domestic equivalents because they involve higher levels of information asymmetry and unfamiliar operational environments that differ from those of the home country (Johnson & Vahline, 2009). We thus expect relatively overconfident CEOs to be especially enthusiastic about pursuing aggressive foreign market entry strategies with high risk/high return profiles, compared to CEOs with more moderate dispositions.

Our work aims to bridge the research gap on the association between CEO overconfidence and foreign entry mode decisions in three ways. First, we synthesize foreign entry and related psychology literature to theorize how CEO overconfidence affects the ownership mode choice. Next, we examine how perceived environmental uncertainty, assessed according to country risk, host country experience, and information asymmetry arising from greater cultural and institutional distance moderates the influence of CEO overconfidence. If overconfidence does spur managerial foreign entry choices toward high resource commitment, its influence would increase in a more uncertain, information-asymmetric environment, which magnifies the risks arising from irreversible investment. We further examine the moderating effect of board versus CEO power because boards are obligated to scrutinize managerial initiatives. Finally, we examine an array of alternative dependent and independent variables, and model specifications to test the sensitivity of our findings.

This study relates to several research areas. First, it contributes to research on the antecedents of entry mode choice by providing the first empirical evidence of the influence of psychological traits, particularly the negative aspects, of top executive decision-makers. A few studies have researched the influence of CEOs’ individual characteristics on firm foreign entry strategies. However, most focus on positive attributes and investigate how CEOs’ experience, expertise, and knowledge reflected in their “objective” demographics, such as tenure, education, nationality, and functional and international background, contribute to optimizing entry mode decisions (e.g., Datta, Musteen, & Herrmann, 2009; Herrmann & Datta, 2002, 2006; Nielsen & Nielsen, 2011). Conversely, their “subjective” psychological states have not been explicitly discussed in the entry mode literature. However, firms make foreign entry decisions based on executives’ choices from among a set of strategic options (Herrmann & Datta, 2006; Nielsen & Nielsen, 2011). Therefore, their psychological orientations and attributes should be considered for a more thorough analysis. The trait of overconfidence is worth studying because, in practice, many top executives show the salient attribute of overconfidence (Hiller & Hambrick, 2005; Hirshleifer, Low, & Teoh, 2012), a trait common in skilled individuals because they lack an obvious comparison group (Kruger, 1999), which aggravates the hazard of erroneous causality inference and exaggerated self-beliefs (Aliche & Govoron, 2005; Miller & Ross, 1975). Such attribution bias can be a critical concern particularly in ambiguous decision environments where causal relationships are not objectively assessable. Considering the liability of foreignness and high information asymmetry characterizing most foreign entry scenarios, the choice of ownership mode thus provides a compelling setting to examine the impacts of CEO overconfidence on strategic outcomes. Findings from the present study can contribute to the research on entry mode choices by introducing a new potential determinant from behavioral factors. This alternative view facilitates a more complete discussion of the antecedents of entry mode choice and supplements the extant entry mode literature, which is mostly based on economic considerations.

Our study of the influence of executive psychological traits also contributes to extant upper-echelons literature mostly researching surface-level demographics. The conventional upper-echelons research holds that observable demographic characteristics imply the psychological cognitive bases and values of top executives, and thus serve as potent predictors of firm strategies (Hambrick & Mason, 1984). However, recent scholars challenge this approach to using surface-level demographics (e.g., tenure, age, educational level, and functional background) as proxies for deep psychological traits (e.g., beliefs, assumptions, and values), which can at best be indirect and vague (Herrmann & Datta, 2006). While using demographics as proxies for managerial cognitive bases remains a source of criticism in current upper-echelons research (Nielsen & Nielsen, 2011), we improve this by using more direct proxies for CEOs’ psychological traits relying on press- and options-based measures, both receiving increasing acknowledgement in current management and finance studies (e.g., Engelen, Neumann, & Schwens, 2014; Humphery-Jenner, Lisc, Nanda, & Silveri, 2016). Our work thus helps advance research on how executives’ psychological traits affect decision outcomes by providing more direct evidence.

Finally, this study contributes to the growing strand of behavioral decision literature that considers the consequences of biased managerial decisions. Earlier studies note that CEO overconfidence has a significant impact on several critical firm decisions, leading to overinvestment (Campbell, Gallmeyer, Johnson, Rutherford, & Stanley, 2011), engagement in value-destroying mergers (Malmendier & Tate, 2008), optimistically biased forecasts (Hirbar & Yang, 2016), smaller dividend payout, less reliance on external financing (Deshmukh, Goel, & Howe, 2013), and so on, but very few address this issue in the international context. By filling this research gap, our findings help clarify the role of top executives’ hubris in firm internationalization strategies and behaviors.

2. Theory and hypotheses

2.1. Influence of managerial overconfidence on corporate decisions

The psychology literature conceptualizes overconfidence as the tendency of individuals to think of themselves as “above average” on positive characteristics such as ability, judgement and prospects for successful outcomes (Aliche & Govoron, 2005; Kruger 1999). This “better-than–average” effect is due to a psychological attribution bias, the self-serving inclination to attribute successes to one’s own dispositions while crediting failures to external forces, leading to an “illusion of control” that one can manage the environment (Miller & Ross, 1975). Successive researchers build on this core concept and elaborate that overconfidence influences individual behaviors in three ways: overestimation of one’s own abilities and probability of success, overprecision in one’s own beliefs and knowledge, and overplacement of one’s own performance relative to that of others (for a review, see Picone et al., 2014). Next, we discuss how these three facets of overconfidence influence managerial decisions in general, and then their implications for foreign entry mode decisions in particular.

First, CEOs with excessive confidence in their abilities tend to overestimate their firms’ resource endowments and outcomes under their control (Malmendier & Tate, 2005). The misapprehension of resource status prompts CEOs to select fanciful investment opportunities that involve substantial and not necessarily affordable capital investments (Campbell et al., 2011). Overconfidence also leads to an exaggeration of one’s own ability to control events; CEOs affected by hubris are thus enthusiastic about challenging
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