Over-confident CEOs can put companies at risk, research shows

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CEOs need to demonstrate strong leadership and good decision-making skills, but CEOs with over-confidence can involve their companies in riskier ventures and put investors' funds at risk, according to a new study from the University of Missouri, Georgia Tech University and the University of Texas-Arlington.

"Over-confident CEOs feel they have superior decision-making abilities and are more capable than their peers," said Stephen Ferris, professor of finance in the MU Trulaske College of Business. "Unfortunately, they tend to make decisions about mergers or acquisitions that can be viewed as risky. For example, CEOs who are over-confident tend to target companies that do not focus on their core line of business. Generally speaking, mergers that diversify companies don't work."

Ferris also found that CEOs who are over-confident often use cash to purchase or merge with other businesses. Over-confident CEOs do this because they believe their stock is undervalued, but Ferris is concerned that this action can deplete a company of important resources and leave it vulnerable to financial problems.

"In our study, we focused on mergers and acquisitions because those actions can involve millions and billions of dollars," Ferris said. "Mergers and acquisitions can either strategically position companies or they can bankrupt them."

While over-confident CEOs can be found in companies across the globe, Ferris and his colleagues found that over-confident CEOs tend to come from countries with cultures that emphasize individualistic characteristics compared to CEOs who are from countries that have cultures emphasizing "long-term orientation" or success through more conservative financial actions. Cultures that emphasize individual characteristics can be found in the U.S., France, Germany and the United Kingdom, while cultures that emphasize more "long-term orientation" can be found in Japan, Brazil and Mexico.

"An over-confident CEO can be a good asset to a company, but investors need to know how to determine if that is the case," Ferris said. "Over-confident CEOs tend to be more at ease and successful when launching innovative products or services and breaking through corporate inertia. No one wants to follow a timid leader; confidence is very contagious and can enhance investor interest and help with innovation. Confidence can create many positive actions for a company."

When deciding to invest in a company, Ferris recommends that new investors should review the financial fundamentals of the company, but also determine the personality of the CEO. If the CEO appears to be over-confident, it's important that the board of directors is independent. Ferris says investors should ask questions such as:

- Who is looking over the CEO's shoulder and determining if decisions are being made too fast?
- Is the board asking good questions before major decisions are made?
- Does the CEO follow the board's direction or make decisions without any consultation with board members?

The answers to those questions should help investors determine if they are interested in buying the company's stock, Ferris said.

Ferris, who also is the senior associate dean for Graduate Studies and Research for the college, and his co-authors, Narayanan Jayaraman from Georgia Tech University and Sanjiv Sabherwal from the University of Texas-Arlington, published the study, "CEO Overconfidence and International Merger and Acquisition Activity," in the *Journal of Financial and Quantitative Analysis*.

Provided by University of Missouri-Columbia