# CEOs gamble with shareholders' money

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CEOs of conglomerates are trusting heavily on their 'gut feeling' when it comes to investment decisions. A new study finds that by doing so, they are destroying shareholder value. At the cost of more rational options, CEOs are attracted to investments characterized by a small chance to win a big prize ('long shots').

This is stated by Oliver Spalt (Professor of Behavioral Finance at Tilburg University) and Christoph Schneider (Associate Professor of Finance at the University of Mannheim) in their paper Conglomerate Investment, Skewness and the CEO Long Shot Bias, forthcoming in the *Journal of Finance*. "CEOs systematically put too much money in projects with high potential upside", Spalt says. "Many CEOs themselves say that 'gut feeling' is important for their investment decisions. The problem is, that there is by now overwhelming evidence from psychology and economics suggesting that intuitive reasoning in financial matters frequently leads to biased and therefore suboptimal decisions. Our paper shows that investment decisions biased towards long shots may indeed be a serious problem in many firms."

In their paper, Spalt and Schneider analyze how US conglomerates (their study covers more than 1,000 multi-segment firms between 1990 and 2009) divide investments among the segments they operate in. These investments are compared with the decisions of their specialized, 'one-segment' competitors. They conclude that conglomerates choose more often for projects with an asymmetrical division of chances. A little chance on a big success is often preferred to a big chance on a moderate success.

For instance, a CEO has to choose between two projects. Project A promises 50 percent chance to a 5 percent payoff rate and 50 percent to a 8 percent payoff. On average, that is 6.5 percent. Project B promises 75 percent chance to a 4 percent payoff, but 25 percent to a 12 percent payoff. That is on average 6 percent. Rationally, project A is the better choice, but in a case like this, the CEO of a conglomerate tends to choose project B. Spalt: "And this leads to the destruction of shareholder value."

Spalt and Schneider provide evidence suggesting the inefficient tilt in investment towards long shot projects is due to biased CEOs. They show it is stronger among CEOs who are more likely to find betting on long shots attractive, such as young CEOs. They also show it is stronger in firms with weak corporate governance, in which CEOs are very powerful. Finally, they determine a correlation between that behavior and cultural factors. Religious beliefs and gambling-norms in the region where headquarters is located, appear to be influential. CEOs are 'taking longer shots' in regions with more Catholic believers (which have been shown by previous research to be more lenient towards gambling) and in regions where people participate more in lotteries.

The study shows that CEOs who rely on gut feeling in making large investment decisions may end up betting on long shots with shareholder's money.

**More information:** "Conglomerate Investment, Skewness, and the CEO Long Shot Bias (June 30, 2015)." *Journal of Finance*, Forthcoming. Available at SSRN: ssrn.com/abstract=1920836 or DOI: 10.2139/ssrn.1920836

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