Behavioral Finance

LENKA DVOŘÁKOVÁ

16.11.2017

EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
Operační program Výzkum, vývoj a vzdělávání

MŠMT
MINISTERSTVO ŠKOLSTVÍ, MLÁDEŽE A TĚLOVÝCHOVY

Behavioral Corporate Finance

Is irrationality influencing financing and investment decisions of firms?

1. Security issuance, capital structure and investment
2. Dividends
3. Models of managerial irrationality

Capital structure and capital markets

- How does it actually work? (video)

Security issuance, capital structure, investment

How a rational manager interested in maximizing true firm value should act in the face of irrational investors?

- Concept of „market timing“

Security issuance, capital structure, investment

How a rational manager interested in maximizing true firm value should act in the face of irrational investors?

- Concept of „market timing“

=> issuing stock when stocks are overvalued, repurchasing when stocks are undervalued

- In general - share of new equity issues among total new issues – the “equity share” – is higher when the overall stock market is more highly valued

Security issuance, capital structure, investment

- Baker and Wurgler (2000):
  - equity share is a reliable predictor of future stock returns

Security issuance, capital structure, investment

- Baker and Wurgler (2000):
  - equity share is a reliable predictor of future stock returns
  - high share predicts low, and sometimes negative, stock returns

  (consistent with the market timing concept – managers issuing at peaks)

- Korajczyk, Lucas and McDonald (1991), Jung, Kim and Stulz (1996), Loughran, Ritter and Rydqvist (1994),...
  - **book-to-market ratio** of a firm is a good cross-sectional predictor of **new equity issuance**

Security issuance, capital structure, investment

- Baker and Wurgler (2002a)
  - firm's weighted-average historical **market-to-book ratio**, where more weight is placed on years in which the firm made an issuance of some kind, whether debt or equity, is a good cross-sectional predictor of the fraction of equity in the firm's capital structure today.

=> irrational investor sentiment affects financing decisions and capital structure

Security issuance, capital structure, investment

- Does irrational behavior of investors affect investment decisions of a company?

Security issuance, capital structure, investment

- Does irrational behavior of investors affect investment decisions of a company?

- Theoretically: should not

Investment – equity dependence

- Does irrational behavior of investors affect investment decisions of a company?

- Theoretically: should not

- Research evidence: applies only to **non-equity dependent** firms
  - =firms that not need the equity markets to finance their marginal investments

Investment – power of investors

- **Power of investors**: Manager faces the danger that if he refuses to undertake projects investors perceive as profitable

  → stock prices may be pushed lower

  → risk of a takeover, or manager removal

Investment – research evidence

- Early studies report weak evidence of investment distortion

X Polk and Sapienza (2001): stronger evidence

Dividends

- Dividends versus shares repurchases
  - Indifferent in theory
  - Tax issues (dividend taxed at higher rate)

Why still investors prefer dividends?

Dividends

- Dividends versus shares repurchases
  - Indifferent in theory
  - Tax issues in practice (dividend taxed at higher rate)

Why still investors prefer dividends?

- Self-control issues
- Mental accounting
- Avoiding regret

Irrationality of CEOs

- Paper discussion:

Malmendier, U. and G. Tate (2008): "Who makes acquisitions? CEO overconfidence and the market's reaction", Journal of Financial Economics 89 (2008), p. 20-43

Summary and references

Summary reading in Barberis and Thaler (2003):

- pages 1104-1110

References:

Baker, M., and J. Wurgler (2000), "The equity share in new issues and aggregate stock returns", Journal of Finance 55:2219–2257

Baker, M., and J. Wurgler (2002a), "Market timing and capital structure", Journal of Finance 57:1–32.

Barberis, N. C. and R. Thaler (2003): "A survey of behavioral finance", In: George M. CONSTANTINIDES, Milton HARRIS, and René M. STULZ, eds. Handbook of the Economics of Finance: Volume 1B, Financial Markets and Asset Pricing. Elsevier North Holland, Chapter 18, pp. 1053–1128.

Jung, K., Y. Kim and R. Stulz (1996), "Timing, investment opportunities, managerial discretion, and the security issue decision", Journal of Financial Economics 42:159–185.

Korajczyk, R., D. Lucas and R. McDonald (1991), "The effects of information releases on the pricing and timing of equity issues", Review of Financial Studies 4:685–708.

Loughran, T., J. Ritter and K. Rydqvist (1994), "Initial public offerings: international insights", Pacific Basin Finance Journal 2:165–199.

Malmendier, U. and G. Tate (2008): "Who makes acquisitions? CEO overconfidence and the market's reaction", Journal of Financial Economics 89 (2008), p. 20-43

Polk, C., and P. Sapienza (2001), "The real effects of investor sentiment", Working Paper (Northwestern University, Evanston, IL).

Thank you for your attention!

Coming next: Behavioral finance and policy making