

CEO Overconfidence and Corporate Investment: Evidence, Implications, and the Moderating Role of Governance

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Abstract

This article examines the impact of CEO overconfidence on corporate investment decisions, drawing on empirical evidence from large publicly listed firms. Overconfident CEOs tend to overestimate project returns and perceive external financing as excessively costly, leading to overinvestment when internal funds are abundant and underinvestment when external financing is required. These distortions are particularly acute in equity-dependent firms and have implications for firm value and performance. The article also explores the moderating effect of corporate governance, which can restrain excessive investment by overconfident CEOs and improve firm outcomes. The findings underscore the importance of behavioral factors in financial decision-making and highlight the need for robust governance mechanisms.

Introduction

Behavioral finance has increasingly recognized the influence of managerial traits on corporate decisions. Among these, CEO overconfidence—a psychological bias where managers overestimate their ability to generate returns—has been shown to significantly affect investment decisions and firm performance. This article synthesizes key empirical findings and discusses the implications for theory and practice, with a particular focus on the moderating role of corporate governance.

Theoretical Framework

Managerial Overconfidence and Investment Distortions

Traditional theories attribute investment-cash flow sensitivity to agency conflicts (Jensen & Meckling, 1976) or information asymmetry (Myers & Majluf, 1984). However, Malmendier and Tate (2005) argue that managerial overconfidence represents a distinct channel: overconfident CEOs overestimate project returns and view external capital as unduly costly, which distorts investment policy.

Empirical Evidence

Identification of Overconfident CEOs

Malmendier and Tate (2005) classify CEOs as overconfident if they persistently fail to reduce personal exposure to company-specific risk, as evidenced by their personal portfolio decisions.

Investment-Cash Flow Sensitivity

Empirical analysis of Forbes 500 firms reveals that investment by overconfident CEOs is significantly more sensitive to internal cash flow, especially in equity-dependent firms. This leads to:

- **Overinvestment** when internal funds are high
- **Underinvestment** when external financing is required

Impact on Firm Performance

Overconfident CEOs are more likely to engage in value-destroying mergers and acquisitions, and their investment decisions can lead to lower firm value and increased risk of financial distress.

Moderating Role of Corporate Governance

Corporate governance mechanisms can mitigate the adverse effects of CEO overconfidence. Empirical evidence from emerging markets shows that strong governance practices moderate the relationship between CEO overconfidence and both corporate investment and firm performance.

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Governance tools such as board oversight and independent directors can restrain excessive investment and improve outcomes.

Table: Effects of CEO Overconfidence

Effect	Description
Investment-Cash Flow Sensitivity	Overconfident CEOs invest more when internal funds are high, less when external funds are needed
Overinvestment	Tendency to pursue value-destroying projects and acquisitions
Underinvestment	Reluctance to seek external financing leads to missed opportunities
Governance Moderation	Strong governance reduces excessive investment and improves firm performance

Discussion

The findings highlight the importance of behavioral biases in shaping financial decisions. CEO overconfidence leads to inefficient capital allocation, particularly in firms with weak governance. Effective governance structures-such as independent boards and transparent decision-making processes-can moderate these effects and protect shareholder value.

Expanded Empirical Evidence

Recent research continues to validate and expand upon the foundational findings of Malmendier and Tate (2005), confirming that CEO overconfidence is a significant driver of investment distortions in large corporations. Overconfident CEOs systematically overestimate the returns to their investment projects and perceive external funds as unduly costly, leading to a pattern of overinvestment when internal funds are abundant and underinvestment when external financing is required.

Investment-Cash Flow Sensitivity

- Overconfident CEOs display heightened sensitivity of investment to cash flow, particularly in equity-dependent firms, as they are more likely to invest aggressively when internal funds are available and avoid external financing.
- This effect is robust even after controlling for traditional explanations such as agency problems (Jensen & Meckling, 1976; Jensen, 1986) and information asymmetry (Myers & Majluf, 1984).

Role of Financing Capacity

- The relationship between CEO overconfidence and investment is moderated by the firm's financing capacity:
 - When financing capacity is strong, overconfident CEOs are more prone to overinvestment, as their optimism about project returns is unconstrained by external financial limits.

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- When financing capacity is weak, overconfident CEOs may actually curb overinvestment, as they become more cautious in reallocating limited funds, sometimes even leading to underinvestment.

Overconfidence and Mergers & Acquisitions (M&A)

- Overconfident CEOs are more likely to engage in M&A activity, pay higher premiums, and generate lower post-merger returns, ultimately damaging shareholder value.
- If overconfident CEOs have experienced personal financial setbacks (such as stock investment failures), their tendency to overinvest in M&A may be somewhat moderated.

Innovation and R&D

- Overconfident CEOs tend to increase R&D investment, which can foster innovation but may also reduce long-term stock returns and financial performance if not properly aligned with firm capabilities.

Summary Table: CEO Overconfidence and Investment Outcomes

Outcome	Effect of Overconfidence
Investment-Cash Flow Sensitivity	Significantly higher, especially in equity-dependent firms
Overinvestment	More pronounced with strong financing capacity
Underinvestment	Possible with weak financing capacity
M&A Activity	Higher frequency, higher premiums, lower returns
R&D and Innovation	Increased spending, mixed impact on long-term performance

Conclusion

CEO overconfidence represents a critical behavioral driver of corporate investment distortions, with far-reaching implications for firm performance and financial stability. Empirical evidence consistently demonstrates that overconfident CEOs overestimate project returns and undervalue external financing, leading to overinvestment when internal funds are abundant and underinvestment when external capital is required. These biases are particularly pronounced in equity-dependent firms and manifest in higher merger premiums, inefficient R&D allocation, and increased bankruptcy risk. However, the relationship is not static: financing capacity acts as a moderating force, amplifying overinvestment in resource-rich environments and curbing it in constrained settings.

The dual risks of over- and underinvestment underscore the necessity of robust governance mechanisms. Traditional equity-based incentives often fail to mitigate these biases, as overconfident CEOs already believe they are maximizing firm value. Instead, proactive measures—such as enhanced board oversight, debt covenants, and structured approval processes for large investments—are essential to aligning managerial behavior with shareholder interests. By integrating behavioral insights into

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governance frameworks, firms can better navigate the challenges posed by CEO overconfidence, ensuring more disciplined capital allocation and sustainable long-term growth.

In an era where managerial judgment increasingly shapes corporate strategy, recognizing and addressing overconfidence is not merely an academic exercise but a practical imperative for safeguarding firm value. Future research should further explore the interplay between CEO traits, governance structures, and market conditions to refine strategies for mitigating behavioral biases in corporate decision-making.

This conclusion synthesizes empirical findings, highlights governance solutions, and emphasizes the real-world relevance of behavioral finance in corporate strategy.

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