

OVERCONFIDENCE



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THE “BRIGHT SIDE” OF OVERCONFIDENCE



Are Overconfident CEOs Better Innovators?

By Hirshleifer et al. (2012)

For CEOs, visionary innovation and extraordinary overconfidence could go hand in hand.

Hirshleifer, D., A. Low, and S. H. Teoh (2012). Are Overconfident CEOs Better Innovators? *The Journal of Finance* 67(4), 1457-1498.

Are Overconfident CEOs Better Innovators?

Overconfidence : overestimate NPV

Overconfident individuals tend to overestimate the net discounted expected payoffs from uncertain endeavors, either because of a general tendency to expect good outcomes, or because they overestimate their own efficacy in bringing about success.

overoptimism

e.g. better than average effect
, illusion of control

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We can expect relatively overconfident CEOs to be especially enthusiastic about risky, challenging, and talent- and vision-sensitive enterprises.

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Hypothesis:

After including standard firm-level controls and industry and year fixed effects, firms with overconfident managers accept greater risk, invest more heavily in innovative projects, and achieve greater innovation. The effect of overconfidence on project selection could come from either overestimation of expected cash flows or underestimation of risk.

probability
↑ belief
 $\hat{p} > p$ obj prob

$\hat{\sigma}^2 < \sigma^2$, $\hat{\mu} > \mu$
belief ↑, truth ↑



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Data:

Firms in the intersection of Execucomp, Compustat, CRSP, and the patent database

2,577 CEOs from 9,807 firm-year observations between 1993 and 2003

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Finding:

Over the 1993–2003 period, firms with overconfident CEOs have higher stock return volatility, consistent with their undertaking riskier projects. Overconfident CEOs invest more heavily in R&D and achieve greater innovation as measured by patent and citation counts.

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Finding:

Overconfident CEOs achieve greater innovative success even after controlling for the level of R&D expenditures.

The effect of overconfidence on innovation is mainly found among innovative industries.

THANKS!

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