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Article

CEO's personal characteristics, ownership and investment cash flow sensitivity: Evidence from NYSE panel data firms

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ABSTRACT

This study tries to extend previous works on behavioral corporate finance by examining the interaction between investment cash flow sensitivity and various CEO characteristics in either the existence or inexistence of managerial optimism. Using a Q-investment model and departing from a sample of 475 annual observations, our results highlight that CEO's financial education, CEO's ownership and their optimism bias can explain distortions in corporate investment policy since they affect investment cash flow's relationship.

Características personales de los directores ejecutivos, titularidad y sensibilidad del cash-flow de inversión: evidencia a partir de los datos del panel de empresas de la Bolsa de Nueva York

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RESUMEN

Este estudio trata de ampliar los trabajos previos sobre el comportamiento de la financiación corporativa, mediante el examen de la interacción entre la sensibilidad del flujo de caja de inversión y las diversas características de los directores ejecutivos (CEO), en términos de existencia o no existencia de un optimismo gerencial. Utilizando un modelo de inversión Q, y partiendo de una muestra de 475 observaciones anuales, nuestros resultados subrayan que la formación financiera, la titularidad, y las tendencias del optimismo de los CEO pueden explicar las distorsiones de las políticas de inversión corporativa, ya que estas afectan a la relación del flujo de caja de inversión.

1. Introduction

The relationship between corporate decisions and CEO's characteristics has been largely ignored in standard financial theory. The investment cash flow relationship has been mainly explained by agency costs (Jensen & Meckling, 1976) and asymmetric

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information problems (Myers & Majluf, 1984). A key feature in the standard theory is that agents are fully rational and so that they are able to make optimal decision that maximize firm value (Oliveira, 2007).

A wave of critics emerges with what commonly called behavioral corporate finance. This approach argues that managers are frapped by some psychological and emotional biases (Baker, Ruback, & Wurgler, 2012; Fairchild, 2005, 2007; Ben Mohamed, Fairchild, & Bouri, 2014). Managers are normal (Statman, 2005) and so they can act in a suboptimal way (Heaton, 2002). In a seminal paper, Heaton (2002) initiates a debate concerning the effect of managerial optimism on corporate policy. He evokes the case of optimistic managers and how the optimism bias can conduct to investment cash flow sensitivity relationship.

Malmendier and Tate (2005a, 2005b), Lin, Hu, and Chen (2005), Huang, Jiang, Liu, and Zhang (2011), Campbell, Jhonson, Rutherford, & Stanley, 2011 and Ben Mohamed et al. (2014) empirically tested the investment cash flow sensitivity under managerial optimism and found that optimism bias can increase investment cash flow sensitivity and so explains why firm doesn't achieve optimal investment strategy and why it can't trade at its optimal value. However, some other characteristics of CEO's can also explain the investment cash flow sensitivity (Malmendier & Tate, 2005a). The young literature on behavioral corporate finance is mainly concentrated on the effect of managerial optimism on corporate decisions while only Malmendier and Tate (2005a) paper evokes such potential effect.

This study tries to extend previous works on behavioral corporate finance by examining the interaction between investment cash flow sensitivity and various CEO characteristics in either the existence or inexistence of managerial optimism. Especially, we investigate the effect of manager's financial background, his/her technical education, tenure, ownership and managerial optimism.

The choice of this subject is highly motivated by the fact that empirical studies that are related to this topic, have adopted relatively old data. Malmendier and Tate (2005a) adopt a panel of American firms during the period 1980 to 1994. Taking into account the dynamic effect, especially of the psychology of managers and investors, it is legitimate to reconsider the effect of managerial optimism and other characteristics of top managers on the sensitivity of investment to cash flows. We must also re-examine this relationship in order to generalize previous empirical findings. In fact, this subject remains marginalized in the financial literature.

In this paper, we will discuss in some depth the effect of CEO's personal characteristics; namely the nature of his/her education, his/her ownerships, and tenure and optimism bias on investment cash flow sensitivity. We will also jointly investigate the effect of managerial optimism and these characteristics on investment cash flow relationship in order to take into consideration the potential interactions between these variables, a thing that may arises when we test the common effect.

The rest of paper is organized as follows. After this introduction, in section 2, we present theoretical background and we develop our hypothesis. Section 3 introduces our methodology and models. Section 4 describes our data. Section 5 reports our empirical findings. Section 6 provides discussions. Section 7 discusses the managerial implications of our results. Finally, section 8 concludes.

2. Theoretical background and hypothesis development

The aim of this paper is to study the effect of CEO's personal characteristics and his/her ownership on corporate firms' investment policy. Especially, we tend to advance another explanation for underinvestment and overinvestment problems by examining the link between investment cash flow sensitivity and CEO characteristics in either the existence or inexistence of managerial optimism.

2.1. Managerial optimism and corporate investment cash flow sensitivity

CEOs are in the center of corporate finance; the agency costs argue that managers are principal agents and so they play a central agent in firms (Jensen & Meckling, 1976). Andrews (1987) and Mintzberg (1973), among others, consider that CEO is typically the most powerful actor since he is an organization's leader.

Beyond the study of the effect of traditional variables such as markets imperfections, there are some research that are oriented to study the effect of CEOs' personal characteristics on firm policy (Milbourn, 2003; Bertrand & Schoar, 2003; Malmendier & Tate, 2005a; Hackbarth, 2005; Parsons & Titman, 2008; Frank & Goyal, 2009; Graham, Harvey & Puri 2009; Malmendier & Tate, 2005b; Yudan, 2010; Lin et al., 2005 and Cronqvist, Makhija, & Yonker, 2012).

Heaton (2002), using a simple model of corporate finance, theoretically predicts that optimistic managers will see external financing as high costly because under their optimism bias, they will see stock markets undervalue their firm's shares. He predicts that corporate investment will be sensitive to the existence and level of internal cash flow. This will cause distortions in corporate investment policy since it will cause overinvestment in case of large internal cash flow, and underinvestment problems in case of short cash.

Empirical validations come from Malmendier and Tate (2005a, 2005b), Lin et al. (2005), Huang et al. (2011), Campbell et al. (2011) and Ben Mohamed et al. (2014). These results diverge to a common empirical result; optimism bias will push managers to make their corporate investment decisions under internal liquidity availability. The effect of managerial optimism on investment cash flow sensitivity should be positive and our first hypothesis can be formulated as follows:

H_1. CEO's optimism bias may affect investment cash flow sensitivity.

2.2. CEOs financial and technical education and investment cash flow sensitivity

An original question in this level is to interrogate if there are other personal characteristics of CEOs that can also have an explanatory power on investment cash flow sensitivity. In the existence of such variables: how do they affect corporate investment when managers are also optimistic?

Holmstrom & Costa, 1986; Scharfstein & Stein, 1990 and Hirshlifer, 1993 suggest that CEOs' careers can affect corporate capital investments. Barker and Mueller (2002) argue that managers' career experience, in various functions, can be a primordial factor that can affect the corporate R&D investment.

Lin et al. (2005) focus on CEOs' professional background. In their study, they document a positive and significant coefficient between CEOs' professional background and the intensity to invest in research and development activities. They support the hypothesis that stipulates that managers' education can affect corporate investment. They report a positive and significant correlation between colleges educated CEOs and the probability to invest in innovation projects.

Investment cash flow sensitivity can be derived by CEOs education. In their work, Malmendier and Tate (2005a) distinguish between two forms of education; the financial education and the technical one. *Finance education* represents a dummy variable that takes one if CEO has undergraduate and graduate degrees in accounting, finance, business and economics. *Technical education* is a dummy variable that takes one if CEO has a graduate or undergraduate degrees in engineering, physics, operations research,