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journal homepage: www.elsevier.com/locate/jempfinManagerial overconfidence and the buyback anomaly^{☆,☆☆}Panayiotis C. Andreou^{a,b}, Ilan Cooper^{c,*}, Ignacio Garcia de Olalla Lopez^d,
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ABSTRACT

While positive, long-run abnormal returns following share repurchase announcements are substantially lower when CEOs are overconfident. This effect is particularly strong for (i) difficult to value firms, such as small, young, non-dividend paying, distressed, and having negative earnings firms, (ii) firms with poor past stock return performance and high book-to-market ratio, indicators of possible overreaction to bad news, and (iii) financially constrained firms. Overall, these results are consistent with the mispricing hypothesis as a motive for repurchases and as an explanation for the buyback anomaly. Additionally, irrespective of the CEO's level of confidence, abnormal returns are considerably larger for financially constrained firms, implying their managers require larger undervaluation due to the higher cost of capital.

1. Introduction

The buyback anomaly is one of the most persistent and difficult to explain stock market anomalies. [Ikenberry et al. \(1995, 2000\)](#) find positive long-run abnormal returns for a period of up to 48 months following share repurchase announcements. Several explanations have been proposed for the buyback anomaly. [Vermaelen \(1981, 1984\)](#), [Chan et al. \(2004\)](#), and [Peyer and Vermaelen \(2009\)](#) argue that mispricing drives the anomaly. Specifically, these authors suggest that the buyback anomaly is a consequence of a correction to overreaction to bad news. By announcing a stock repurchase, managers either try to signal to the market the undervaluation or try to time the market. [Grullon and Michaely \(2004\)](#) argue that changes in the cost of capital following repurchase announcements drive the post-buyback high abnormal returns. Another explanation is the liquidity hypothesis: when firms repurchase stock, they reduce their liquidity. If a liquidity level or liquidity risk are priced ([Amihud and Mendelson, 1986](#); [Pastor and Stambaugh, 2003](#); [Acharya and Pedersen, 2005](#)), then the abnormal returns could be due to the liquidity level or the omission of a liquidity factor in the empirical tests.

Our paper's contribution is twofold. First, we test the mispricing hypothesis. If undervaluation is the motive behind share repurchases, then the long run abnormal returns will be different when the managerial signals to the market are likely to be true

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than when the signals are likely to be biased due to managerial overconfidence. That is, we hypothesize that the post-repurchase announcement long-run abnormal returns of overconfident CEOs are on average lower. Our empirical findings confirm this hypothesis. This finding extends the literature that examines the relation among share repurchase intensity, short run abnormal returns post buyback announcements, and managerial overconfidence.

Second, we test whether the difficulty to value stocks affects the role of managerial overconfidence in the post buyback anomaly. Baker and Wurgler (2006) show that difficulty of valuation is key to the impact of investor sentiment on stock prices. That is, the valuations and returns of difficult to value stocks are substantially more affected by investors' positive and negative sentiments. Given this, we ask whether difficult to value stocks are also the most affected by managers' misvaluation stemming from overconfidence. We find that managerial overconfidence matters for the buyback anomaly only when firms are difficult to value.

Why do we expect the post share repurchase announcements long-run abnormal returns to be lower when managers are overconfident? First, extant literature suggests that overconfident CEOs perceive the stock of their company to be undervalued by the market (Malmendier and Tate, 2005a). Hence, overconfident managers are more likely than underconfident managers to believe that the stocks are underpriced, even when the stock is actually not underpriced. Repurchasing a non-underpriced stock would lead to lower long-run abnormal returns relative to the case when the stock is indeed underpriced.

Second, even if the stocks are indeed underpriced it might still not be optimal for the firm to repurchase them for the following reason. If share repurchase occurs when the shares are undervalued, then staying shareholders benefit from wealth transfer at the expense of outgoing shareholders. However, by repurchasing stocks, a firm may also suffer costs; for instance, reduced financial slack and liquidity, and loss of shareholder base.¹ Overall, the magnitude of undervaluation dictates a trade-off between benefits and costs of stock repurchase and determines long-run abnormal returns. That is, the undervaluation has to be above a certain threshold for the repurchase to be profitable. Overconfident managers overestimate the degree of mispricing and hence are likely to sometime undertake repurchases when the costs outweigh the benefits, leading to lower average long-run abnormal returns for these managers. Thus, for a given level of undervaluation, we expect lower abnormal returns when the CEO is overconfident.

We divide the announcing firms according to the degree of confidence of their CEOs and test whether long-run abnormal returns are different when CEOs are overconfident. We employ three prominent measures of CEO overconfidence. Our primary measure is a press-based measure of CEO overconfidence following Malmendier and Tate (2005a, 2008), Hirshleifer et al. (2012) and Hribar and Yang (2015). The press-based measure employs count of words relating to managerial overconfidence (or its opposite) in proximity to the company name and the keyword "CEO". As robustness checks, we employ two additional measures. First, we use the *longholder* measure based on late option exercise behavior (see, e.g., Malmendier and Tate, 2008; Malmendier et al., 2011). The options exercise measure builds on the idea that a CEO who chooses to be exposed to the firm's idiosyncratic risk by delaying option exercise is likely to be overconfident about the firm's prospects. Second, we divide the sample by the gender of the executive team, and the gender of the CEOs and CFOs. This measure builds on the fact that men have been found to show a heightened overconfident behavior than women (Barber and Odean, 2001; Niederle and Vesterlund, 2007; Dahlbom et al., 2011; Huang and Kisen, 2013).

Using a sample of share repurchases that covers the period 1992 through 2009, we find that firms with overconfident CEOs earn substantially lower post-announcement long-run abnormal returns than firms with underconfident CEOs. Specifically, firms with underconfident CEOs earn a 48-month cumulative abnormal return of 27.80 percent, whereas firms with overconfident CEOs earn only 17.39 percent return.² Consistent with the mispricing hypothesis for share repurchases, this finding suggests that at the buyback announcement time, the shares of firms with overconfident managers are, on average, less undervalued than the shares of underconfident managers. Thus, it appears that there are more overconfident CEOs who announce stock repurchases when the undervaluation, if any at all, is not enough to compensate the costs of the repurchase, and therefore the overall effect is lower than for announcing firms with underconfident CEOs. In other words, while in both groups of firms there will likely be CEOs that misjudge the undervaluation of their firms, the fraction of misjudging CEOs will be larger for the group of firms with overconfident CEOs, and the overall cumulative abnormal returns will be lower for this group of firms.

Interestingly, while the abnormal returns post repurchase announcements are lower when CEOs are overconfident, they are still significantly positive. Hence, although overconfident managers tend to exaggerate the degree of mispricing, there is still a significant number of overconfident CEOs that correctly appraise the undervaluation of their stocks, or that although they exaggerate the undervaluation, it actually exists and is sufficiently high to render the repurchase profitable in spite of potential costs. Thus, on average, overconfident managers are still valuing the company better than the market. At least two reasons could potentially account for this. First, managers (including overconfident managers) likely have more information about the company than the market, enabling them to spot underpricing of their own firms' stocks. Second, the market, realizing that the CEO is overconfident and is prone to undertaking negative NPV real investment projects, could view repurchases by overconfident CEOs positively, or at least less negatively, as free cash flow is reduced and the agency cost induced by free cash flows alleviated (Jensen, 1986). Indeed, overconfident CEOs tend to overestimate project value and underestimate project risk. Malmendier and Tate (2005b) find that overconfident managers overestimate the returns to their investment projects and view external funds as unduly costly. Thus, they overinvest when they have abundant internal funds. Ben-David et al. (2013) indicate that many executives have miscalibrated

¹ This implies that the minimum level of underpricing that triggers a repurchase is not zero.

² The difference in abnormal returns between stocks of firms with overconfident CEOs and stocks of firms with underconfident CEOs becomes economically significant only after two years. This finding is similar to Peyer and Vermaelen (2009), who find that poor past performers begin to outperform other announcing firms only after approximately two years. Peyer and Vermaelen (2009) attribute the late outperformance to mistakes made by analysts. Specifically, according to the analyst mistake hypothesis, the repurchase announcement is a response of the company to a mistake made by financial analysts. As analysts are unlikely to admit they made a mistake, a repurchase announcement receives no support from analysts. If analysts do not change their published opinions after the repurchase, stocks may remain undervalued for an extended period of time.

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