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The spillover effects of management overconfidence on analyst forecasts☆

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ABSTRACT

Overconfident CEOs are known to overestimate their ability to generate returns, overpay for target firms, and take excessive risks. We find a CEO's overconfidence can also indirectly affect other market participants, specifically analysts who issue earnings forecasts. First, firms with overconfident CEOs are more likely to have analysts issue earnings forecasts that are optimistic relative to actual earnings; that is, the earnings forecasts more frequently exceed the actual realized earnings than the reverse. Second, firms with overconfident CEOs tend to have less dispersed analyst earnings forecasts. And third, smaller analyst forecast errors are associated with firms that have overconfident CEOs. These findings demonstrate the importance of CEOs' behavioral characteristics in shaping the environment in which analysts and other market participants make important financial decisions, in some cases improving the information environment.

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1. Introduction

Management disclosures are an important source of information in financial markets and can affect the level and variability of security prices by influencing the beliefs of market participants. It is well established that management communications can influence the earnings forecasts issued by financial analysts; see, for instance, Richardson et al. (2004). Even subtleties such as managerial tone on earnings conference calls can affect analyst forecasts (Druz et al., 2015). In turn, analyst earnings forecasts are used by investors as a bellwether of firms' future prospects and as an input for almost all models of valuation and cost of capital estimators. Given the importance of management as a source of company information for analysts, and the fact that analyst forecasts are known to be influenced by communications from managers, it is conceivable that management traits may influence the content of managers' information disclosures and that differences in managers' traits may, in turn, influence analysts' beliefs regarding different firms' expected future earnings.

Statements quoted in the popular press support this notion. For example, in an article in the financial press (*Financial Post*, December 16, 2009,"TELUS CEO Puts Money Where His Mouth Is"), TELUS CEO, Darren Entwistle, was quoted providing a strong positive message to the market:

> "I'm confident in the opportunity that our company has in the coming quarters", he said on a guidance call with analysts. "Accordingly, I've recently informed the TELUS board of directors that I'll be taking the entirety of my 2010 annual cash salary net of taxes in TELUS shares".

The same article went on to quote an analyst: "It's a huge vote of confidence on their ability to deliver", said Greg MacDonald at National Bank Financial. In this example, not only is the CEO signaling great confidence about the future performance of his firm through his choice about compensation, the analyst is also expressing confidence in the firm's management.

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In this paper, we explore the potential impact of CEO overconfidence on analyst forecasts.[1] An established literature indicates that overconfidence can present itself as both excessive optimism concerning the level of future firm performance and excessive certainty about the precision of their private information.[2] These two manifestations of overconfidence have direct implications for analyst forecasts and provide us with three testable hypotheses. First, overconfident CEOs who overestimate future firm performance are more likely to provide positive information to analysts, thus increasing the likelihood of analysts issuing optimistic earnings forecasts for firms with overconfident CEOs. Second, overconfident CEOs may overestimate the precision of their information and disclose more precise information, which in turn may result in less dispersed analyst forecasts. Finally, managers who exhibit overconfidence show an increased willingness to voluntarily disclose information through management earnings guidance, which may lead to smaller forecast errors relative to managers who are less willing to disclose. We elaborate on these hypotheses in Section 2.3.

We examine a sample of 429 large, publicly traded US firms from 1983 to 1994. The dataset contains 78,493 annual analyst forecast observations from the Institutional Brokers Estimate System (I/B/E/S) with supplementary stock price data from the Center for Research in Security Prices (CRSP). Our primary empirical proxy for overconfidence is a widely used set of measures developed by Malmendier and Tate (2005, 2008) based on the stock-option holding decisions of CEOs. This set of measures exploits the fact that CEOs are often underdiversified.[3] If a particular CEO holds his stock options until the year of expiration even though the options are at least 40% in the money, this behavior can be interpreted as overestimation of future firm performance, and thus the CEO is classified as overconfident. We refer to this set of measures as the portfolio-based measures.

Using the portfolio-based measures of overconfidence, we find statistically significant and economically meaningful support for all three of our hypotheses. We document three main results. First, we find that analyst forecasts for firms with overconfident CEOs are approximately 25% more likely to be optimistic. That is, they are more likely to forecast that earnings will be greater than the earnings the firm eventually realizes. Second, analyst absolute forecast errors are 2.4%–4.3% smaller in magnitude, and thus more accurate, for firms with overconfident CEOs relative to firms without overconfident CEOs. Third, forecast dispersion, as defined by the standard deviation of analyst forecasts for a particular firm, is 3.0%–3.8% smaller for firms with CEOs classified as overconfident using the portfolio-based measures.

We also explore a secondary measure of overconfidence based on how each CEO is described in the press, developed by Malmendier and Tate (2008), which we refer to as the press-based measure. Malmendier and Tate (2008, page 38) emphasize that since the press-based measure is founded on assessments by outsiders, it is "necessarily [a] noisier and less precise" measure of overconfidence than the portfolio-based measures. Consistent with the relatively less precise nature of the press-based overconfidence measure, we find support for the first hypothesis based on this measure, but not the second or third hypotheses. Another possible explanation for the difference in results using the portfolio-based versus press-based overconfidence measures is that some CEOs may display an overconfident persona to encourage optimism about his firm without necessarily providing more or better information, yielding results that do not necessarily align with our hypotheses.

This paper contributes to two main streams of literature. We add to the expanding literature on the influence of behavioral biases on corporate decision-making and the literature on analyst forecasts characteristics which shows that analyst forecasts tend to be optimistic. We add to these literatures by showing that overconfidence can affect the information that CEOs provide to analysts, thereby influencing analyst forecasts and the broader information environment.

The remainder of the paper proceeds as follows. In Section 2, we review the background literature and develop testable hypotheses regarding the influence CEO overconfidence may have on analyst forecast characteristics. We describe the data in Section 3. In Section 4, we describe the CEO overconfidence measures and the analyst forecast data. We present our main results in Section 5, demonstrating the impact that CEO overconfidence has on analyst forecasts. The paper concludes with Section 6.

2. Related literature and hypotheses development

In this section we discuss the literatures on analyst forecasts and management overconfidence. We consider how overconfidence may affect the information that CEOs disclose, which leads to three primary testable hypotheses regarding the impact of CEO overconfidence on analyst forecast optimism, accuracy, and dispersion.

2.1. Analyst forecast literature

Prior research has investigated how analyst forecasts contribute to the information environment. For instance, Brown and Rozeff (1978) show that analyst forecasts tend to be more informative relative to simple time-series estimates, and although there exists some debate, analyst forecasts are generally accepted to be optimistic (see, for instance, Butler and Lang, 1991).[4] Research has also ventured to understand the implications of analyst

[1] In principle, other behavioral traits may also be influential; we consider overconfidence as an example of one of many possible conduits through which manager traits may influence analysts' beliefs and the information environment. Likewise, the traits of managers other than the CEO may be relevant; we focus on CEOs due to their position of leadership within the firm and because of data availability.

[2] One can differentiate between these two types of overconfidence. See, for instance, Moore and Healy (2008), who refer to overestimation of the level of a variable as 'overestimation' and excessive certainty about the accuracy of a variable as 'overprecision'. These different manifestations of overconfidence are often assumed to result from the same underlying psychological causes (Alba and Hutchinson, 2000; Daniel et al., 1998; Juslin et al., 2000; Moore et al., 1999; Stone, 1994). While these are the two specific manifestations of overconfidence of interest, for brevity, we use the term 'overconfidence' to encompass both the concepts of 'overestimation' and 'overprecision'.

[3] CEOs generally hold large portions of their investment portfolios in stock and options in their firm and are compensated by the same firm. Additionally, their human capital is invested in the same firm.

[4] Many studies have proposed and tested hypotheses to explain the optimism bias. In general, these explanations can be classified as either incentives-based or behavioral-based. Incentives-based explanations generally assume analysts rationally issue optimistic forecasts due to incentive conflicts as a result of underwriting relationships (see Dugar and Nathan, 1995; Lin and McNichols, 1998; Michaely and Womack, 1999) as well as relations with firm management (see Lim, 2001; Das et al., 1998). Richardson et al. (2004) provide evidence that managers manipulate analyst behavior by guiding analysts toward beatable targets so that they or their firms can sell equity on favorable terms after an earnings announcement. Proposed behavioral-based explanations to account for analysts' optimistic bias include overconfidence and cognitive dissonance in analyst earnings forecasts, as explored by Friesen and Weller (2006). Further, some researchers posit that seasonality in the bias can arise due to a form of seasonal depression known as seasonal affective disorder (SAD). For instance, Dolvin et al. (2009) find that analyst forecasts are less optimistic during the fall and winter months, and Lo and Wu (2015) find that analysts appear to be less affected by SAD than investors and so their forecasts may actually help to mitigate the effects of SAD in financial markets.

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