



The Mistakes CEOs Make

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Berkshire Hathaway's 1981 Annual Report

"Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from a toad's body by a kiss from a beautiful princess. Consequently, they are certain their managerial kiss will do wonders for the profitability of [Company]"



Berkshire Hathaway's 1981 Annual Report

"We've observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses-even after their corporate backyards are knee-deep in unresponsive toads"





I: Overconfidence



Overconfidence

- 90% of people claim to have above-average
 - Driving skill
 - Ability to get along with others
 - Humour
- Some behavioural biases go away with experience. Why might the opposite be true here?
 - Self-attribution bias
 - Overconfidence leads to risk-taking; more likely to become CEO
 - May not be attenuated by governance (boards, investors)



Measuring Overconfidence

- CEO voluntarily holding onto options
- Media articles describing CEOs as
 - “Confident” (confident, confidence, optimistic, optimism)
 - “Cautious” (cautious, reliable, practical, conservative, frugal, steady)
- “Mr. Huizenga remains ebullient in his optimism, determined to make life miserable for the “disbelievers” who have invested short in Blockbuster stock”
 - Wall Street Journal



The Effects of Overconfidence

- 65% likelier to conduct M&A¹
 - Even higher if merger is diversifying and doesn't require financing
- Average market reaction of -0.9%, versus -0.12% for non-overconfident CEOs
- Investment is highly sensitive to cash flow²
 - Particularly in equity-dependent firms

1. Malmendier and Tate (2008)
2. Malmendier and Tate (2005)

What Causes Overconfidence?





Lee Iacocca in Miami Vice





Bill Gates in Frasier

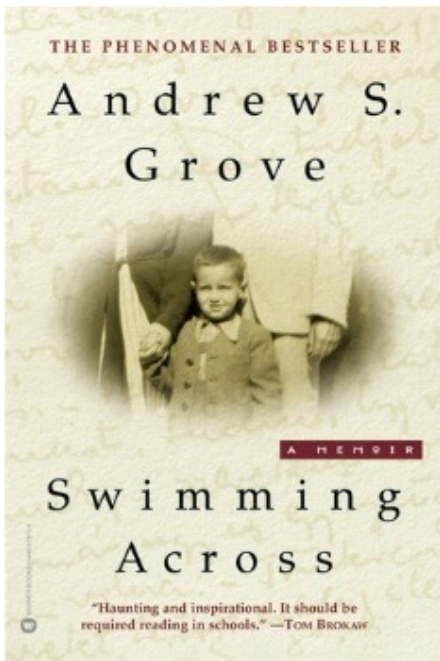




Superstar CEOs

- If award was followed by underperformance, could be mean reversion
 - E.g. “curse” of the Manager of the Month award; “sophomore jinx”
- Sell award winners, buy predicted winners: earn 15-26% over next three years¹
- Manage earnings
- Pay rises
- Get distracted
 - Join outside boards
 - Write books

1. Malmendier and Tate (2009)



"In *Swimming Across*, a true American hero reveals his origins and what it takes to survive . . . And to triumph"



Superstar CEOs

- Get distracted
 - Join outside boards
 - Write books
 - Have lower golf handicaps





Solving Overconfidence

- CEOs make many decisions that are bad for firm value, but some are knowingly bad: *agency problems* not *mistakes*
- Solutions
 - Tie pay more to performance
 - Firing / takeovers for poor performance
- But mistakes due to overconfidence – and other psychological biases – are despite CEOs trying to do good



Solving Overconfidence


- See TED talk “What to Trust in a Post-Truth World” and Gresham lecture “Critical Thinking”, April 2020
- Seek other viewpoints
 - Create a culture of dissent
 - Use investors as a sounding board; don’t view engagement as an attack
- Listen to experts
 - M&A advisors may have expertise but also a vested interest
 - Evidence that diversifying mergers don’t add value
- Stick to the knitting
 - Both in terms of the business and your own time
 - Warren Buffett: “The best CEOs love operating their companies and don't prefer going to Business Round Table meetings or playing golf at Augusta National”



II: Other CEO Traits

What's the main difference that you notice between these two shareholder letters?

ROWAN COMPANIES, INC.
2800 POST OAK BOULEVARD, SUITE 5450
HOUSTON, TEXAS 77056-6127



D. F. McNEASE
CHAIRMAN OF THE BOARD

March 17, 2005

Dear Stockholder:

We invite you to attend the Annual Meeting of Stockholders of Rowan Companies, Inc., which will be held in the Williams Auditorium located on Level 2 of the Williams Tower, 2800 Post Oak Boulevard, Houston, Texas, on Friday, April 22, 2005 at 9:00 a.m., Central Time. Your Board of Directors and management look forward to greeting personally those stockholders able to attend.

At the meeting, stockholders will be asked to elect three Class II Directors. **YOUR BOARD OF DIRECTORS RECOMMENDS A VOTE *FOR* THE ELECTION OF THE THREE NOMINEES FOR CLASS II DIRECTOR.**

Also at the meeting, stockholders will be asked to vote on a proposal submitted by the Board of Directors of the Company for adoption of the 2005 Rowan Companies, Inc. Long-Term Incentive Plan, which will replace the Company's current stock option plans. This proposal is described more fully in the accompanying proxy statement, which you are urged to read carefully. **YOUR BOARD OF DIRECTORS RECOMMENDS A VOTE *FOR* ADOPTION OF THE PROPOSED LONG-TERM INCENTIVE PLAN.**


Regardless of the number of shares you own or whether you plan to attend, it is important that your shares be represented and voted at the meeting. You are requested to sign, date and mail the enclosed proxy promptly.

Both your interest and participation in the affairs of the Company are appreciated.

Sincerely,



D. F. McNease
Chairman

A decorative graphic on the left side of the page, consisting of overlapping yellow, red, and blue squares with a black crosshair.

April 1, 2009

Dear Cephalon Stockholder:

It is my pleasure to invite you to Cephalon's 2009 Annual Meeting of Stockholders. We will hold the meeting on Tuesday, May 12, 2009 at 8:30 a.m., Eastern Daylight time, at our corporate headquarters located at 41 Moores Road, Frazer, PA 19355.

During the Annual Meeting, we will discuss each item of business described in the Notice of Annual Meeting of Stockholders and the Proxy Statement that follows, update you on important developments in our business, and respond to any questions that you may have about the Company.

We have elected to take advantage of the Securities and Exchange Commission rules that allow issuers to furnish proxy materials to their stockholders on the Internet. These rules allow us to provide our stockholders with the information they need, while lowering the costs of delivery and reducing the environmental impact of our Annual Meeting.

Your vote is important. Whether or not you plan to attend the Annual Meeting, I hope that you will vote as soon as possible. Please review the instructions for each of your voting options described in the Notice of Internet Availability of Proxy Materials.

On behalf of your Board of Directors, thank you for your continued support and interest in Cephalon.

Very truly yours,

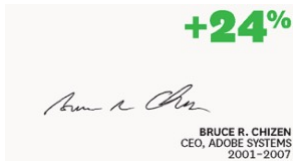
A handwritten signature in black ink, appearing to read 'Frank Baldino, Jr.', written in a cursive style.

Frank Baldino, Jr., Ph.D.
Chairman and Chief Executive Officer



CEO Narcissism

- Overinvestment (especially in R&D and M&A)¹
- Lower profitability and operating cash flow
- Higher pay
- More earnings management and restatements²
- Results remain after controlling for overconfidence



1. Ham, Seybert, and Wang (2018)
2. Ham, Lang, Seybert, and Wang (2017)




Other Measures of Narcissism¹

- Prominence of CEO's photo in annual reports
 - Size; alone or with fellow executives
- Prominence in press releases
 - Number of times CEO is mentioned in press releases / total number of words in press releases
- CEO's use of "I" and "my" vs. "we" and "our" in interviews

1. Chatterjee and Hambrick (2007)

Sensation Seeking

 **INFRINGEMENT NOTICE**
(ISSUED UNDER THE AUTHORITY OF THE LAND TRANSPORT ACT 1966) POL 405
9/2002

Address for correspondence
New Zealand Police Infringement Bureau
PO Box 9147 Wellington

NOTICE NUMBER **N 3735700**

TO USER OF VEHICLE	Forename(s) <i>Justin Alexander</i>	Family Name <i>LEE</i>
Address <i>Auckland</i>		
Occupation <i>Accountant</i>	Date of Birth <i>23 / 6 / 1974</i>	Driver Licence Number <i>BP 086926</i>
ALLEGED INFRINGEMENT OFFENCE(S) DETAILS		
Date of Offence <i>23 / 6 / 1974</i>	Time <i>18:25</i> (24 Hour Clock)	Day of Week <i>S M T W T F S</i>
Vehicle Type <i>Sedan</i>	Vehicle Make <i>Honda</i>	Reg. No. <i>AEH 924</i>
Road/Street <i>STATE HIGHWAY ONE</i>	Locality <i>POKEHU</i>	
Offence Number <i>1</i>	Offence <i>Exceeded 100 kph</i>	Infringement Fee Payable <i>\$ 120</i>

- Household investors with more speeding tickets trade more, and underperform after transactions costs







Sensation Seeking

- Hedge funds managers who own performance sports cars¹
 - Take on more risk
 - But earn no higher return, so lower risk-adjusted return
 - Trade more frequently

1. Brown, Lu, Ray and Teo (2018)



Sensation Seeking in CEOs





Sensation Seeking in CEOs

- CEOs with private pilot licenses run riskier firms (equity volatility), do more M&A¹
- But no effect on value for average firm
- Positive M&A returns to low-value companies (likely with few organic investment opportunities)
- CEOs with private pilot licenses associated with more patents, higher-quality patents, more original patents²
- *Errors of omission vs. errors of commission*

1. Cain and McKeon (2016)
2. Sunder, Sunder, and Zhang (2017)



III: Rules of Thumb



Rules of Thumb

- Hurdle rates, e.g. every investment must earn a return of 15%
 - But required return depends on risk. E.g. 20% in a risky division, 10% in a safe division
- Conglomerates that use a single hurdle rate
 - Overinvest in risky divisions, underinvest in safe divisions
 - Buy risky targets
 - Shareholder returns are 0.8% lower
- 6,115 deals, average acquirer size of \$2b, so total losses of $0.8\% \times \$2\text{bn} \times 6,115 = \98bn



Rules of Thumb in Deal Negotiation

- Standard markup offered, based on prior transactions
 - Independent of runup¹
 - Pay a premium to an already inflated price
 - Anticipation reduces takeover probability; can use rumours as a takeover defence²
- Even tailored prices can be based on rules of thumb
 - Spike in bid prices at 52-week high³
 - Bidder shareholders react negatively to % of offer price driven by 52-week high, suggesting this is overpayment

1. Schwert (1996)
2. Edmans, Goldstein, and Jiang (2012)
3. Baker, Pan, and Wurgler (2012)



Rules of Thumb in Financing

- Past cost of debt affects current cost of debt¹
 - Even controlling for current characteristics
- 1/3 of firms that took out loans in 2005-7 paid the same rate in 2008, despite there being a financial crisis