The purpose of this paper is to reflect the behavioral aspects that govern corporations. The paper briefly presents some of the main pillars of behavioral corporate finance: management, closed – end funds puzzle, dividends and the importance of aggregate earnings releases. The first pillar consists in a brief presentation of the behavioral factors related to the management of corporations, such as the fact that independent directors are not that independent as they should be, they do not have the prerequisite expertise for assessing complex financial risks, the importance of ethics and having a corporate culture that nurtures doing the right thing above anything else and the fact that CEO’s decisions reflect in good part, their personal style rather than a set of criteria determined by the company. In the second part of the paper, it is treated the puzzle why would investors buy a closed-end fund at its IPO price, knowing that it is likely to fall to a discount, when they could buy instead an open-end fund that is guaranteed always to trade at par and some mentions about the way that dividend policy may be influenced by managers “catering” to the demands of investors and also the effects of aggregate earnings announcements over the market returns.

Keywords: Behavioral finance, conflicts of interests, corporate finance, managers, dividends, closed-end fund puzzle, aggregate earnings

Jel Classification: D22, D23, D82, G20, G32, G34, G35, M12

Conventional finance theories are based on the assumptions that people act rationally and consider all available information in their decisions related to investments. Over the last few decades, we have discovered many irrational errors and behaviors related to investment judgment, contrary to the assumptions and theories of conventional finance. Behavioral finance offers complementary points of view, explanations in response to the difficulties faced by the conventional finance, until recently considered to be “proved beyond doubt”. Behavioral corporate finance brings in discussion conventional ideas about corporate finance and compensation strategies. “Behavioral corporate finance argues that in many senses, corporations are natural arbitrageurs” (David Adler). Theories from behavioral finance are in the position to explain the differences in corporate financial policies and capital structures. Behavioral corporate finance study how investors and managers behave. Studies indicated that investors suffer from overconfidence; they tend to overestimate their own abilities and chances for success, driving stock prices away from normal levels. The main psychological traps met in behavioral corporate finance are: narrow framing, confirmation bias, hindsight bias, herding behavior conservatism, the role of affects, wishful thinking, opaque framing, representativeness bias and overconfidence. Overconfident managers over estimate cash flows on projects, use too much debt and tend to feel that their stocks are mispriced by the market. Below, I will realize a brief discussion about some of the pillars of behavioral corporate finance: management, closed-end funds puzzle, aggregate earnings guidance and the role of dividends.
Management

Conflicts of interests among employees, shareholders, regulators and external evaluators (failures and weaknesses in corporate governance) represent an important cause of the latest global financial crisis. The problem is conflict of interest, an issue that is global not local. The mimic philosophy among boards of directors, made them fail miserably in their fiduciary duties to their shareholders. Moreover, the cash bonuses for short-term performance seemed to be more appealing than stock ownership or stock options. Milgram (1974) suggests that individuals have a sensibility to conform to an authority, to be cut off by their peers. Morck (2007) has reason to say that corporate officers and directors are more loyal to their direct boss (CEO) than to their shareholders and to the law (Enron, Worldcom, Hollinger, AIG), even under clear signs of impending financial doom. Corporate governance reforms stimulate instituting independent directors or non-executive board members, committees composed of independent directors. They are supposed to induce more rationality, ethics in corporate governance and a fostering debate of flawed exposures policies before they become lethal – render corporate disasters rarer. That’s in theory at least, because there is evidence that they are tied to CEOs in other informal ways. According to him, many corporate governance failures could have been averted if directors asked serious questions and demanded clear answers. Behavioral factors, such as cognitive dissonance, reciprocal favor trading or group conformity have smashed the independence and the authority of so called independent directors. Higgs report reviewed the role and effectiveness of non-executive directors and of the audit committee, aiming at improving and strengthening the existing Combined Code. 

Higgs strongly backed the existing non-prescriptive approach to corporate governance: "comply or explain". According to the report, “almost half the so-called independent directors on British boards were recruited by the CEO through personal contacts or friendships. A mere four percent had a formal interview”. Taking in consideration this, it is easy to understand that the independence of the directors is compromised. The actual financial crisis has revealed the severe problems that financial companies have regarding the risk management practices. Some of the risks were too complicated and complex (too specialist) to be assessed by the board - many of them did not understand exactly the instruments their banks were trading. Many board members have not the necessary technical financial expertise or business experience in order to fully assess the consequences of their decisions. Nowadays, many of them are reputed teachers (globally recognized) but with no previous business experience or expertise. Kirkpatrick Grant (2010) emphasize that “four of the ten members of the board were over 75 years old” and had no previous banking experience - suggesting the idea that boards might be “retirement home for the great and the good” may have a grain of truth. Even if in large financial companies, there are risk committees, their voice is barely left to be heard and assessed. Stockownership represents probably the best way to link shareholders interests with CEOs interests and wealth. Traders, salesmen and executives are not enough motivated / remunerated to focus too much on long lasting sustainability, sustainability, over decades. There is the same problem with remuneration at both levels: sales and trading. In a study, realized by Fahlenbrach and Stulz (2010), it is shown that Bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis. Consequently, they suffered extremely large wealth losses in the wake of the crisis. With this tremendous financial sophistication, it is pretty difficult to find nowadays financial specialists in supervisory boards, capable to fully assess the risks, the business model and the consequences of their decisions.

40 Kevin Kelly, Les Csorba, Heidrick & Struggles, “Leadership matters”
Optimist managers tend to have better investment cash flow sensitivity than their peers. Kross and Souk (2009) found that managers of firms that have achieved a string of increasing earnings issue more optimistic earnings forecasts, compared to firms without such a string. The optimism in management forecast for these firms seems to dissipate after the string of earnings increases is broken. These results are consistent with the argument that managers are overly optimistic after experiencing earnings growth for several consecutive years, but this optimism does not persist after the earnings performance declines. The decrease of such optimism after the several earnings growth years indicates that managerial sentiment can change within a relatively short period of time. CEO’s decisions reflect in good part, the chief executive’s personal style rather than a set of criteria determined by the firm. Aggressive CEOs tend to misuse leverage, over indebt their companies and tend to expand through acquisitions. On the contrary, the conservative CEOs tend to maintain more cash and tend to grow independently, organically in a sustainable manner (excluding acquisitions) (see David Adler). Itzhak Ben David, Graham and Harvey (2007) show that companies with overconfident CFOs invest more and engage in more acquisitions. Moreover, overconfident managers are less likely to pay dividends, instead using the funds to make investments and have higher debt ratios and rely more heavily on long term debt. Their result indicates that miscalibration depends on personal skills, in addition to corporate characteristics. Baker and Wugler (2004) suggest that is much easier for a chief financial officer to issue more shares when a company is overvalued than it is for a hedge fund to short overvalued shares; if the shares are not truly overvalued, the consequences to the CFO’s own job are relatively modest compared to those for the hedge fund manager. Overvalued companies tend to increase capital while the cheap companies tend to repurchase their share.

Standards of ethics in the decision making process is very important, especially in the financial system. It is well known that banks sell confidence, not money. Oberlechner (2007) claims that ethics goes beyond restraining from unethical behavior because of the potential costs of exposure. Heuristic biases or cognitive dissonance, for example, can also affect ethical decision making. Culture has a great importance for the attitudes of employees. The culture of doing the right thing no matter the cost makes companies less vulnerable especially when comes to trading. Traders are given strong incentives to make great profits, but if they don’t do well, actually they make losses, they don’t have to repay losses, and the worst thing that might happen to them is just to be fired. Practically, there is almost no incentive for respecting sound trading practices and having a prudent money management. Many banks did not develop sufficient operational limits that would restrict the bank’s overall exposure to derivatives, securities or subprime loans. Did banks ignore risks because ignorance, psychological reasons or because they really did not know? How come their risk managers failed to address the real issues? Why did banks hold the most risky assets, insufficient focusing on fundamentals? According to Shefrin (2009), narrow framing and opaque framing were the two psychological traps that banks confronted with. They presented risk incompletely, did not disclose information with those who needed and netted long and short positions, obscuring the manner in which positions were structured. Another cause for distress in financial sector might be the compensation structure that made little recognition of risk issues (employees had no direct incentive to focus on risk when making decisions, establishing unrealistic profit goals and short term profit orientation).

**Closed-End Funds Puzzle**

The job of professional portfolio managers has always been a subject for controversial discussions among pundits over time. Weiss (1989) asserts that younger funds tend to underperform but it remains a mystery why investors have a greater will to invest in younger funds. The impact of managerial turnover would be that new funds (and funds that have recently changed their management team) should exhibit above normal NAV returns; Funds with longer managerial experience should exhibit below normal NAV returns. Only good managers would be
willing to leave voluntarily, meaning the discount should increase (if the fund is trading at a premium the premium should decrease) around voluntary separations or pay increases. As the time goes by, the fund may be traded either at premium or at discount, depending on the managerial abilities and the expectations of shareholders. In case that management fees equal the value added (at least these are the expectations of shareholders), the funds are traded at par. Berk et al (2003) wonder why would investors buy a closed-end fund at its IPO price, knowing that it is likely to fall to a discount, when they could buy instead an open-end fund that is guaranteed always to trade at par. Investors’ irrationality might be a possible explanation. Fees represent a cost for the fund and they are subtracted from the net asset values of the funds. If managers do not generate enough value added, over the value of the fees, the fund shall be traded at discount. Depending on which one is greater, the value added or the fees, the fund shall be purchased at premium or discount. Bear in mind I said “shall”. The things are a little bit more complicated, it’s all about the market sentiment. If a fund is purchased at a discount, the discount might widen if the sentiment of the irrational investors turns pessimistic. The discount changes over time as investors change their beliefs about the manager’s ability to create wealth.

Aggregate earnings guidance
Aggregate earning affect market returns especially in periods of profit “warnings”. Profit warnings are very good informative instruments for investors, because they have a direct influence on the expected future cash flows and expected returns. Anilowski and Feng (2004) assert that important economic aggregates are increasingly dominated by the fortunes of a relatively small number of very large firms. Kothary, Lewellen and Warner (2003) conclude that the strong negative reaction to aggregate earnings news suggests that discount rates rise when earnings are unexpectedly high. They find that earnings are strongly correlated with discount rates. However, these variables only partially explain the market’s negative reaction to earnings news. The results contradict the conventional knowledge affirming that discount rates and cash flows should move in opposite directions. A study of Hirshleifer, Lim and Teoh (2007) indicates that the effects of the earnings announcement for a company may be weaker in busy periods with a large number of other companies releasing earnings results. According to them, the company may record a lower volume reaction and a stronger further post - earnings announcement float. The distraction effect is even larger for positive news than for negative news. Barber and Odean (2005) claim the investor distraction hypothesis, suggesting that investors' limited attention may drive market under react to public news such as post-earnings announcement drift. Chandra, Wasley and Waymire (2004) found that technology sector companies pursue a higher degree of conservatism related to earnings, mostly due of conservative accounting rules for R&D expenses rather than shareholders litigation risk. It is well known that investors may sue managers for excessive volatility of the stock prices; that is why managers tend to be more conservative in their actions and strategies.

Dividends
It is well known that companies prefer increase their capital when stock prices are high and interest rates are low and do the opposite for repurchasing their own shares or for repaying debts when interest rates are high and stock prices are cheap. As Malcolm Baker puts it, when it comes to supply capital effects, it’s all about the combination between the “investor tastes, limited intermediation and corporate opportunism”. The informational advantage over the company earnings help corporate managers get the right mix between the three factors mentioned above. Hoberg and Prabhala (2007) suggest that that risk is the factor that explains (for about a third to almost a half of the times) the Fama-French disappearing dividends puzzle. Fama and French (2001) show that the inclination to pay dividends has declined over time. According to them, long-term returns are univocally positive and institutional (not retail) ownership increases the
release of dividends. Baker and Wurgler (2004) argue that dividend policy may be influenced by managers “catering” to the demands of investors. “Catering” refers to realizing any actions intended to boost share prices above fundamental value. According to them, managers rationally cater investors’ demand, by paying dividends when investors put higher prices on payers and not paying when investors prefer non-payers. In order to represent the company’s long term interests, managers need to have the flexibility of taking unpopular decisions in the market place. But that interest is merely followed. Managers are congratulated when the stock prices rise (even it is a short term rise), not when a sustainable growth long term managerial program is implemented. Remember the financial companies’ way of doing business before 2007. Bankers were more interested in short term profits, regardless of risks. Investors’ preferences vary overtime: in the periods with high dividends, they tend to fly for quality, they orientate themselves to less risky instruments (bonds, bank deposits) or defensive stocks, while the jump in for great growth potential stocks in periods with lower dividends.

Conclusions
As a conclusion, corporations need a lot of improvement in some of those aspects referring to management and corporate governance: sensible incentives that mix the personal interest with corporate risk and reward, control & communication systems, risk management systems, accounting standards and procedures and human resources. As investors, we also need to take in consideration aspects like dividends, earnings announcements and the evolution of closed-end funds industry in order to understand better the investors and the market’s sentiment, the price momentum and price reversal so we may increase further our wealth.

References:


