Managerial Miscalibration

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday September 15, 2010 at 9:07 am

Editor's Note: The following post comes to us from Itzhak Ben-David, Assistant Professor of Finance Department at the Ohio State University; John Graham, Professor of Finance at Duke University; and Campbell Harvey, Professor of Finance at Duke University.

In the paper, ***Managerial Miscalibration***, which was recently made publicly available on SSRN, we study whether top corporate executives are miscalibrated as well as the determinants of their miscalibration. Miscalibration is a form of overconfidence examined in psychology, economics, and law. Although it is often analyzed in lab experiments, there is scant evidence about the effects of miscalibration in practice.

Over the past nine years, we collected over 11,600 S&P 500 forecasts as well as 80% confidence intervals from Chief Financial Officers. The width of the confidence interval gives us a measure of miscalibration. Importantly, the CFOs are forecasting a common market-wide measure. This allows us to exploit cross-sectional heterogeneity in both optimism and miscalibration. By comparing forecasts to realizations over many periods, we also present a simple measure of miscalibration.

We use several methods to show that CFOs are, on average, severely miscalibrated – their confidence intervals are far too narrow. For example, the 80% confidence interval contains only 33% of the realized returns. Because of our rich panel data, we can identify some of the factors behind this behavior. In particular, we find that miscalibration is less severe following periods of poor returns because the lower bound of the confidence interval ("worst case scenario") is very sensitive to past returns. Furthermore, we document that miscalibration is highly persistent and does not change much in light of new information. We find that miscalibration is more severe with age and it is less severe among executives with high incentive pay.

We find evidence that CFO miscalibration is important for decision making. We show that the miscalibration measure, based on predicting the S&P 500 returns, is highly correlated with the miscalibration measure based on predicting own-firm project returns. Furthermore, firms with miscalibrated or optimistic executives invest more on average; this effect is significantly stronger for firms in which executives are both miscalibrated and optimistic.

Overall, our results shed new light on the biases in corporate forecasts and beliefs, which have important implications for corporate finance. Our study implies that miscalibration is an important bias, one that ought to be part of mainstream research in corporate finance.

The full paper is available for download here.

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