Volume : 2 | Issue : 1 | Jan 2013 • ISSN No 2277 - 8160

Research Paper | Finance

Behavioral Corporate finance: A New Paradigm shift to understand corporate decisions

Pinal Shah

2-C-2, Sagar Appartmenmt, Near Shymal cross road, Satelite, Ahmedabad – 380015

ABSTRACT

Corporate finance aims to explain the financial. As a practical matter, this means that managers can take for granted that capital markets are efficient, with prices rationally reflecting public information about fundamental values. Likewise, investors can take for granted that managers will act in their self-interest, rationally responding to incentives shaped by compensation contracts, the market for corporate control, and other governance mechanisms. Behavioral corporate finance challenges conventional ideas about corporate finance and compensation strategies. Behavioral corporate finance is concerned with the manner in which behavioral beliefs, behavioral preferences, and inefficient prices impact the corporate financial decisions made by managers. The paper shows that the way in which behavioral finance differs from traditional finance. This paper explains the behavioral biases of manager and its effect in issuing equity and so the valuation of firm. Managers under their irrationality are taking decision about the security issuance which affects the firm and its value. The paper shows such kind of parameter which affects their decisions.

KEYWORDS: behavioral finance, security issuance, , rationality, efficient market hypothesis

Behavioral finance is the application of psychology to financial decision making and financial markets. It differs with traditional finance is based upon its underlying assumption that decision makers are fully rational, while behavioral finance assumes that people are not always fully rational, their moods, psychology and other psychological theory also play an important role before taking decisions. Behavioral finance (of which behavioral corporate finance is a sub discipline) integrates psychology and economics into the study of human judgment and biases in decision making under conditions of uncertainty.

Corporate finance aims to explain the financial contracts and the real investment behavior that emerge from the interaction of managers and investors. Managers are supposed to develop unbiased forecasts about future events and use these to make decisions that best serve their own interests.

Behavioral corporate finance challenges conventional ideas about corporate finance and compensation strategies. Behavioral corporate finance is concerned with the manner in which behavioral beliefs, behavioral preferences, and inefficient prices impact the corporate financial decisions made by managers. The literature on behavioral corporate finance involves the study of how psychology impacts capital budgeting, capital structure, corporate governance, and mergers and acquisitions. Behavioral corporate finance has begun to look at the investing and financing decisions of executives within firms. If executives are overconfident or overoptimistic, how are their decisions about capital structure affected? Are there ways to push them toward optimal behavior? Theories from behavioral finance are at the forefront of explaining differences in corporate financial policies and capital structures. This paper is organized on the application of behavioral corporate finance like – "security issuance, capital structure and behavioral corporate finance".

Behavioral finance strongly contradicts with the proponents of EMH (efficient market hypothesis) where prices are right according to the information delivered in the market. The EMH argues that competition between investors seeking abnormal profits drives prices to their "correct" value. The EMH does not assume that all investors are rational, but it does assume that markets are rational. The EMH does not assume that markets can foresee the future, but it does assume that markets make unbiased forecasts of the future.

In most cases, however, this assumption doesn't reflect how people behave in the real world. The fact is people frequently behave irrationally. These anomalies prompted academics to look to cognitive psychology to account for the irrational and illogical behaviors that modern finance had failed to explain. Behavioral finance seeks to explain our actions, whereas modern finance seeks to explain the actions of the "economic man"

Behavioral finance has rested on the two pillars that contradict with traditional finance. First pillar is 'limits to arbitrate'. Limits to arbitrage refer to predicting in what circumstances arbitrage (trading based on knowledge that the price of an asset is different than its fundamental value) forces will be effective as well ineffective. It strongly assumes that arbitrage can never be risk less and profitable.

Another building block was cognitive psychology refers to how people think. There is a huge psychology literature documenting that people make systematic errors in the way that they think: they are overconfident, they put too much weight on recent experience, etc. Their Preferences may also create distortions. Behavioral finance has been applied in aggregate stock market which tells you why an individual stock gives more return compared to its peer.

Returning to main topic of behavioral corporate finance, baker et al. (2007b) provides a two-pronged approach in surveying the literature on behavioral corporate finance. The first prong pertains to the impact of irrational investor behavior on rational corporate managers, while the second prong pertains to the manner in which irrational decisions by corporate manager's impact corporate value. The first approach emphasizes the effect of investor behavior that is less than fully rational, and the second considers managerial behavior that is less than fully rational. The "irrational investors approach" assumes that securities market arbitrage is imperfect, and thus that prices can be too high or too low and thus it affects on issuance of security.

Security issuance and behavioral corporate finance The two important things can able to determine the rationality among managers side and irrationality among investor's side and its effect on security issuance. First, irrational investors must influence securities prices. This requires limits on arbitrage. Second, managers must be smart in the sense of being able to distinguish market prices and fundamental value.

Rational managers are assumed to perceive mispricing, and to make decisions that may encourage or respond to mispricing. While their decisions may maximize the short-run value of the firm, they may also result in lower long-run values as prices correct.

The first question arising about corporate finance is "How a rational manager interested in maximizing true firm value?" Thaler state one important concept as 'market timing' and explained that when firm's stock price is too high, the rational manager should issue more shares so as to take advantage of investor's exuberance . Conversely, when the price is too low, the manager should repurchase shares.

Baker and wurgler (2000) also state that equity share is reliable predictor of future stock returns, a higher the share price – low or negative stock returns. This is also consistent with manager timing the market, issuing more equity at its peak.

The book to market ratio of a firm is a good cross-sectional predictor of new equity issuance. Firms with high valuations issue more equity while those with low valuations repurchase their shares. And long term stock returns after IPO are low while long-term returns after the announcement of a repurchase are high. This evidence is consistent with managers timing the market in their own securities. . Graham and Harvey (2001) done their survey and concluded that 675 CFOs said that 'the amount by which stock is undervalued or overvalued is an important consideration when issuing common stock.

This market timing theory is also a base for capital structure theory. Thaler states the comparison of two firms which are identical in terms profitability, size, fraction of tangible assets, market – book ratio. Now if that M/B ration of firm A is much higher that firm B, than managers of a firm may have more equity capital in its capital structure today than B.

Baker and wurgler (2002a) also confirms this prediction. They shows that other things being equal, the firms historical weighted-average M/B ratio (in years where it is high), might have issue some kind of debt or equity.

Manger is rational and interested in maximizing the firm's true value. Now if firm's stock price is too high, the manager should issue more equity and he should not channel the fresh capital into any actual new investment, but keep it in cash or in another fairly priced capital market security. Here investors are rational and having knowledge that firms have many good projects with positive NPV, in reality according to manager they are not and should be avoided in the interest of investors.

Now if stock price is low and manager thinks to repurchases it shares at low prices but they should not reduce investment. So in conclusion, irrational investors may affect the timing of security issuance, but they should not affect the firm's investment plans.

Investor's sentiments also affect the investment of firm. The firms can be classified in two kinds of firms. Non-equity dependent (who have ample funds) and equity dependent firms. For non equity dependent firm's irrational investor's sentiment affects the timing of issuing security but not their investment plans. And for equity dependent firms, other channels through which investor sentiment distort the investment plans. For example consider the case where investors are optimistic about firm's prospects. Now manager is in interested in maximizing true value of firm and avoids even some +ve NPV projects. In such situation investor might depress stock prices, exposing him to the risk of a takeover and he can be even fired.

Now if the mangers are rational than this does not mean that he will only work for maximizing true value of firm. Then also agency problem might arise and some other objective like increasing size of the firm and so a manager can enhance his prestige can also be achieved. In this case manager might use investor exuberance and can implement some –ve NPV 'empire building' projects.

This paper explains relationship of investor's irrationality with the market value of the firm which is being measured by m/b ratio of the firm. So along with the irrationality, behavioral biases of manager's also affect in issuing security and so the value of the firm. This paper suggests that the behavioral approaches to corporate finance offer a useful complement to the other paradigms in the field. They deliver intuitive and sometimes quite compelling explanations for important financing and investing patterns, including some that are difficult to reconcile with existing theory.

REFERENCES

Baker M., Ruback R, Wurgler J., Behavioral Corporate Finance: A Survey Handbook in Corporate Finance: Empirical Corporate Finance. September 2005 | E. Russo and P. Schoemaker, Decision Traps: The Ten Barriers to Brilliant Decision-Making and How to Overcome Them (New York: Simon & Schuster, 1989). Econometrica, Vol. 47 (1979). | Eleswarapu, V.R. and M.R. Reinganum [1993] "The seasonal behavior of the liquidity premium in asset pricing," Journal of Financial Economics 34, 373-386. | J. Martin and J. Petty, Value Based Management: The Corporate Response to the Shareholder Revolution (Boston: Harvard Business School Press, 2000, Ch. 9); and S. Young and S. O'Byrne, EVA and Value-Based Management (New York: Irwin/McGraw-Hill, 2000). | Heaton J., "Managerial Optimism and Corporate Finance," Working Paper, University of Chicago, 1998; | Heaton, and T. Odean, "Capital Budgeting in the Presence of Managerial Overconfidence and Optimism," | J. Stein, "Rational Capital Budgeting in an Irrational World," Journal of Business, Vol. 69 (1996). | Kahneman and A. Tversky, "Prospect Theory: An Analysis of Decision Making Under Risk," | R. Brealey and S. Myers, Principles of Corporate Finance (New York: Irwin/McGraw-Hill, 2000), p. 123. | Rozeff, M.S., and W.R. Kinney [1976] "Capital market seasonality: The case of stock returns," Journal of Financial Economics 3, 379-402. | Shefrin Hersh "Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing" (Boston: Harvard Business School Press, 1999). | T. Loughran and J. Ritter, "The New Issues Puzzle," Journal of Finance, Vol. 50 (1995). | Theory and Evidence," Journal of Finance, Vol. 40 (1985); and T. Odean, "Are Investors Reluctant to Realize Their Losses?," Journal of Finance, Vol. 53 (1998). | Thaler, R. (1993), Advances in Behavioral Finance: Volume I. New York: Russell Sage Foundation. | TVERSKY, Amos, and Daniel KAHNEMAN, 1986. Rational Choice and the Framing of Decisions. The Journal of Business, 59(S4), S251{S278. | Tversky and D. Kahneman, "Rational Choice and the Framing of Decisions," Journal of Business, Vol. 59 (1986).