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Recent Research

Is Your CFO's Confidence Losing You Money?

Bottom Line: *When it comes to forecasting the stock market, CFOs are supremely overconfident in their own predictive abilities. This narrow-minded outlook tends to filter into a firm's financial initiatives, leading to more investment and borrowing.*

Chief financial officers get the big bucks to keep a close watch on the economy and predict how it will affect the fortunes of their firm. But a new study finds that many CFOs are hugely overconfident in their own ability to predict where the stock market will be a year down the road. This overconfidence appears to permeate firms' financial decision making, so that they wind up carrying more debt and getting lower returns on their investments.

As the executive responsible for making accurate projections about the firm's market value and explaining fluctuations in the company's stock price to shareholders, the CFO routinely estimates future demand, future cash flows, and competitors' future financial strategies. In short, he or she should always have a finger on the pulse of the economy and the stock market, watching for trends and gauging the likely outcomes of volatile periods.

The authors of this study analyzed more than 13,300 quarterly surveys of financial officers at large and medium-sized U.S. companies from June 2001 to March 2011. The executives were asked to predict where the S&P 500 Index—widely regarded as a bellwether for the U.S. economy—would stand in a year and in 10 years. Because pinpointing the exact point total for the index would be all but impossible, the authors asked the CFOs to choose a range for their forecasts that they thought would have an 80 percent chance of being correct. However, when compared with the index's actual returns, the ranges the executives selected were far too narrow, and their estimates were severely off.

Instead of hitting the right range 80 percent of the time, the CFOs were correct in only about 36 percent of the cases when predicting the market's point total a year out, the authors found. Even during the least volatile periods in the sample, CFOs had only a 59 percent success rate. The 10-year average return forecasts were also skewed, though to a lesser degree.

"For example, they might say next year's return should fall in the range of minus-20 to plus-20 percent," one of the authors explained in a press release. "If the market return is 10 percent, they are correct. But that is not what we found. They would give really tight ranges, like 11 to 18 percent. If the market return is 10 percent, they are wrong."

Psychologists have long identified this type of narrow outlook as a classic characteristic of overconfident people, who consistently overrate the accuracy of their own predictions and underestimate the risks or uncertainties that could cause their expectations to not materialize.

To determine the effect of this narrow-mindedness on the CFOs' firms, researchers asked respondents to provide projections for their own company's performance as they had for the stock market. The result: CFOs who erred on market forecasts also tended to provide unrealistic estimates of returns on investment for their firm's projects. These hubristic CFOs failed to anticipate volatility and risks, even when they could look to benchmarks like their firm's return on invested capital as a basis for their predictions.

CFOs who erred on market forecasts also provided unrealistic estimates of ROI for firm projects.

As the authors point out, it's well established that corporate investment returns can be highly volatile and are dependent on a wide range of internal and external factors—but the CFOs in the study seemed oblivious to the threats of uncertainty. CFOs did provide wider ranges for their forecasts during times of high volatility in the market. But, alas, their estimates were even more skewed during those up-and-down periods.

Indeed, following the start date of CFOs who misread the stock market tea leaves, their firms' investment rates tended to skyrocket, the authors found. In line with this too-aggressive outlook, overconfident CFOs also tended to borrow more and load their firms with debt. More effective oversight of CFOs is clearly required. For investors, regulators, board members, and other corporate stakeholders who depend on accurate financial forecasts, polishing the CFOs' crystal ball—or better yet, smashing it and replacing it with hard data—should be the first move.

Source: Managerial Miscalibration, by Itzhak Ben-David (Ohio State University), John R. Graham (Duke University), and Campbell R. Harvey (Duke University), *Quarterly Journal of Economics*, Nov. 2013

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