What Drives Capital Structure Decisions?
The Role of Personality Traits in Corporate Financial Decision Making

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Extended Abstract

Recent research in finance has argued that the capital structure decisions and firms’ funding and strategic choices deviate from the traditional neoclassical paradigm (e.g., Shefrin, 2002; Baker and Nofsinger, 2010). This specific, nuanced, research view has led scholars and practitioners to recognize that corporate financial behavior (e.g., capital structure decisions, corporate behavior and performance) also relies on different assumptions (e.g., irrational investors’ behavior, noise in securities’ trading activities, social and cultural influences on investing behavior) from those that were supposed to be held according to the traditional or standard finance paradigm. Baker et al., (2004), Vasilou & Daskalakis, (2009), Graham et al., (2009), among others, support that apart from questioning the implications of the rationality principle regarding investors’ behavior as proposed by neoclassical financial theory, one may also account for the irrational behavior of firm managers in order to make-up a more complete irrationality approach and, hence a more well-grounded theoretical angle of behavioral corporate finance. That is, modern finance theory acknowledges the

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effects of behavior, that is, the human factor, on corporate financial decision making.

Several recent studies have focused mainly on the effects of different managerial traits on corporate investing behavior. For example, optimistic and overconfident managers may predict a pecking order of financing decisions (Baker et al., 2004), managers with growth perception bias overestimate the growth of future earnings generated by their company and hence view external finance as unduly costly (Hackbarth, 2007), CEOs that are more risk tolerant may initiate more mergers and acquisitions projects (Graham et al., 2009), CEOs with heterogeneous beliefs and opinions ascribed to their cognitive errors may deem inconsistent corporate policies that tend to undervalue the company’s stocks in the financial markets (Graham & Harvey, 2001), CEOs with depression experience are averse to debt and lean excessively on internal finance, and CEOs with military experience pursue more aggressive policies, including heightened leverage (Malmendier et al., 2011). Despite the recognized importance of the effects of these personality traits on corporate performance and behavior and resulting financial policies, knowledge of the influence of a global, multi-facet, personality dimension, which may provide a comprehensive and compelling rubric for assessment and description of human (e.g., CEOs) personality, on behavioral outcomes, and hence their impact on capital structure decisions, is limited. Most research in finance has maintained a primarily analytical and descriptive focus and studied the consequences of a priori heterogeneous CEO behavior for single personality (e.g., risk-aversion) traits on corporate finance decisions. The lack of empirical evidence, which can negatively affect the quality of decision-maker choice and researcher understanding of corporate behavior and formation of capital structure choices, is due in part to data constraints as well as difficulties in determining the impact of a global, broad, personality dimension(s) of CEOs on their capital structure decisions- which are not always directly observable—and in accounting for their heterogeneous nature.

In this paper, we expand the literature by examining the impact of the five broad dimensions/traits of CEOs personality - global personality dimensions - on their capital structure decisions and identifying the heterogeneity in CEOs
underlying decision-making process. Specifically, we investigate the personality traits of CEOs of publicly listed companies related to extraversion, agreeableness, conscientiousness, emotional stability and openness to experience (Costa & McCrae, 1992; Gosling, Rentfrow, & Swann Jr., 2003), as well as need for cognition (Cacioppo, Petty, & Kao, 1984), self-esteem (Rosenberg, 1965), life orientation – optimism (Scheier, Carver, & Bridges, 1994), intolerance to ambiguity (Budner, 1962), sensation seeking (Hoyle et al., 2002; Zuckerman, 1994), risk tolerance (Grable & Lytton, 2003), and we examine their impact on capital structure-related decisions. We select these multi-facet personality traits because of their importance and relevance in explaining and predicting the actual behaviour of individual decision-makers as argued by numerous scholars in psychology (Mershon & Gorsuch, 1988; Goldberg, 1993; Paunonen & Ashton, 2001). We investigate the impact of latent heterogeneity on CEOs decisions, and thus we divide them into distinct segments according to their personality traits. That is, crucial knowledge may be revealed regarding differences in the underlying decision making process of CEOs belonging in one segment (implying that they posses similar personality traits) from CEOs belonging in other segment(s), that, in turn, explains differences in their decisions related to capital structure issues (i.e., deciding for the financing mixture; issuing new equity relatively often to avoid obligations like debt; issuing of debenture for a new long-term investment).

To address our objectives, we use survey responses from CEOs that work for publicly listed firms established and operating in Europe. So far 59 questionnaires have been gathered and our survey is on an ongoing data collection level. Our preliminary findings suggest that several personality traits composing the global personality dimension of CEOs have a significant influence on certain capital-structure related choices. Specifically: a) CEOs with high self esteem favor decisions lowering the long-term liabilities-to-equity ratio and issuing new equity that do not lead to financial obligations like debt; b) CEOs that are highly extravert find exploiting possible advantages of each source of finance (i.e the debt tax shield) more important than avoiding possible corresponding negative consequences (i.e. debt financial distress). In contrast, CEOs who are intolerant to ambiguity consider avoiding possible negative consequences more important than
exploiting possible advantages. Extraverted CEOs tend to issue new equity whenever the debt-to-equity ratio is lower relative to the sector's ratio; c) CEOs who are open to new experiences avoid traditional, available, funding sources. They consider as more important the exploitation of possible advantages rather than avoiding possible negative consequences and they tend to issue new equity whenever the stock price is relatively high; d) The more conscientious a CEO is, the more (s)he thinks that the stock market generally evaluates the firm at lower levels than its real value; and finally, e) CEOs high in sensation seeking tend to issue new equity, whenever the debt-to-equity ratio is relatively high compared to the sector's ratio while the more emotionally stable a manager is, the less (s)he prefers issuing debenture. These results also lead us to conclude that personality traits are closely related to specific value maximization impediments, viewed by the behavioral finance perspective, such as aversion to ambiguity, illusion of knowledge, anchoring and the availability heuristic.

Moreover, our results demonstrate interesting insights regarding several combined rather than isolated effects on capital structure decisions. That is, the decision for a certain financing mixture of publicly listed firm is driven by CEOs consciousness, need for cognition and openness to experience. CEOs’ self esteem and need for cognition drive their decisions to issue new equity relatively often. Overall, these findings expand and confirm past research regarding the impact of managerial traits on capital structure decisions. Analytical work is in progress for constructing and examining the impact of a global personality index on certain capital structure decisions as well as the identification of segments among CEOs who posses similar personality traits. Knowledge of the impact of a global personality profile on CEOs’ capital structure decisions may be useful to financial policy makers to better evaluate efforts by CEO subgroups who may strive to influence governance policies and investment strategies and hence, address the importance of several agency-related problems. By acquiring such crucial information, conflicting situations that undermine publicly listed firms’ success in the financial markets may be prevented and continuous enhancement of shareholders’ value may be achieved.
References


