

College of Business book Review by Sanjay Rajagopal.

Title: "Behavioral Corporate Finance: Decisions that Create Value"

Author: Hersh Shefrin

Publisher: McGraw-Hill

Length: 203 pages

Price: \$71.95 (paperback)

Reading time: 8 hours

Reading rating: 6 (1 = very difficult; 10 = very easy)

Overall rating: 4 (1 = average; 4 = outstanding)

This slim volume by Hersh Shefrin entitled "Behavioral Corporate Finance" packs a lot of insight into how a manager's psychology can lead him or her systematically to decisions that not only fail to maximize firm value, but even destroy value outright. In ten fast-paced chapters that offer a mix of theory and startling real-world examples, the author visits virtually every broad category of corporate financing and investment activity. From capital budgeting and acquisitions to capital structure and dividend policy, each realm of decision making is shown to be potentially tainted by the manager's behavioral biases.

The author points to ten psychological phenomena as culprits in this value-diminishing behavior. These are divided into two groups: heuristics and biases, and framing effects. Biases include excessive optimism (underestimating the probability of favorable outcomes), overconfidence (underestimating how frequently one is wrong), illusion of control (overestimating one's ability to control events), and confirmation bias (assigning excessive weight to information that confirms one's own notions). Since uncertainty requires the decision maker to identify the relevant variables and forecast their values, one can readily imagine the costly errors induced by such biases unless they are reigned in.

Further biases are created by the manager's predilection for heuristics, or rules of thumb. Depending on the specific heuristic, the manager can be led into stereotypic thinking, excessive reliance on easily available information, or guidance by emotion and gut feeling. An interesting phenomenon attending the use of rules of thumb is anchoring bias; the manager, in making quick estimates, adjusts an initial value to the arrival of new information, but these adjustments often prove insufficient because the manager's thinking tends to be anchored to the initial value.

Another pitfall awaiting the decision maker is that the terms in which the setting for a choice task is couched can influence the decision—a process known as framing. Loss aversion is one example of a framing effect, and it causes the manager to attach a greater weight to, say, a \$100 loss than to a \$100 gain. Such loss aversion will contribute to excessively conservative behavior (for instance, managers might choose too low a debt ratio if the financial distress effects of debt are given undue weight in relation to the tax benefits of debt). A similar sounding but quite distinct framing phenomenon is that of aversion to a sure loss, which causes a manager to take actuarially unfair risks in an

attempt to beat the odds and break even (rather than terminate a faulty course of action already initiated).

The author is both methodical and engaging in his discussion of these psychological barriers to value maximization. He opens each chapter with an overview of the traditional, rational approach to a corporate finance issue, such as capital budgeting or dividend policy. He follows this with a sobering account of how their behavioral attributes keep managers from applying the objective decision rules urged by textbooks, often with significant costs to the firm. Of course, the author admits that experience and intuition have their proper place in the decision making process; his caution is against biases which run counter to rational thinking. Examples of decisions made by rather visible firms serve to illustrate the prevalence of such pitfalls. But the author does not merely alert the reader to the existence and nature of these psychological phenomena; for each decision process under discussion, he suggests several de-biasing techniques as well. This is a succinct but well rounded treatment of the behavioral issues in corporate finance that the academician and practitioner alike will find very useful.

Sanjay Rajagopal is a professor of Finance in the College of Business at Western Carolina University. His current interests include corporate finance and financial market issues in emerging economies. For previously reviewed books, visit us at our website at [www.wcu.edu/cob/](http://www.wcu.edu/cob/).