

Managerial Overconfidence and Strategic Decision-Making: The Effects on Corporate Risk-Taking and Long-Term Performance

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Article Details	Abstract
Received: 15 Feb 2024 Accepted: 16 March 2024 Published: 09 June 2024 ¹Dr. Manahil Farooq ²Afsheen Jamshid Copyright @Author Corresponding Author: *Dr. Manahil Farooq	Strategic decisions such as acquisitions, capital investment, innovation, and financing are made by managers whose beliefs about their own abilities and prospects shape what they see as attractive. Overconfident managers overestimate the returns to their actions and underestimate risk, and may therefore take more corporate risk than rational analysis would justify. Yet overconfidence can also energize ambitious investments that cautious managers would avoid. This paper develops a conceptual model linking managerial overconfidence to corporate risk-taking and long-term performance. Drawing on upper echelons theory, behavioral corporate finance, and the decision-making literature, we propose that overconfidence increases risk-taking by distorting risk perception and weakening information search and dissent, and that its effect on long-term performance is curvilinear, with moderate confidence helping and extreme confidence harming. We further propose that board monitoring, managerial discretion, financial slack, and industry context condition these effects. The paper presents a table of constructs, a typology of overconfidence, a flowchart of the proposed process, a research design, and governance implications.

Keywords: managerial overconfidence, strategic decision-making, risk-taking, upper echelons, corporate governance, long-term performance

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INTRODUCTON

Organizations are run by people, and people systematically hold beliefs that are more favorable than the evidence warrants. Decades of psychological research show that individuals tend to overestimate their abilities, the precision of their knowledge, and the likelihood of good outcomes (Moore & Healy, 2008). When such beliefs are held by those who control corporate resources, the consequences scale up. Roll (1986) argued that managerial hubris could explain why acquirers often pay too much for targets, and later research has documented links between overconfident chief executives and acquisition behavior, investment levels, financing choices, and innovation (Malmendier & Tate, 2005, 2008; Hirshleifer, Low, & Teoh, 2012).

However, the effects of overconfidence are not uniformly negative. Bold bets are the source of both costly failures and valuable breakthroughs, and some evidence suggests that overconfident managers invest more in innovation and obtain more patents (Galasso & Simcoe, 2011; Hirshleifer et al., 2012). The central puzzle is therefore when overconfidence translates into value-creating risk and when it translates into value-destroying risk.

This paper addresses three questions:

1. Through what decision-making mechanisms does managerial overconfidence increase corporate risk-taking?
2. How does risk-taking driven by overconfidence affect long-term performance?
3. Which governance and contextual factors determine whether the effect is beneficial or harmful?

2. Theoretical Background

2.1 Managerial overconfidence

Overconfidence is not a single bias. Moore and Healy (2008) distinguish *overestimation* (believing one's own ability, performance, or control is higher than it actually is), *overplacement* (believing oneself to be better than others), and *overprecision* (excessive certainty that one's beliefs are accurate). Each plays out differently in strategic settings. Overestimation inflates projected returns, overplacement encourages beliefs that rivals will fail where the manager will succeed, and overprecision narrows the range of scenarios considered. Overconfidence is related to, but distinct from, hubris and narcissism (Hayward & Hambrick, 1997; Chatterjee & Hambrick, 2007).

2.2 Upper echelons and strategic choice

Upper echelons theory holds that organizational outcomes partly reflect the cognitive frames and values of top managers, because strategic situations are too complex to be interpreted objectively (Hambrick & Mason, 1984). The influence of managerial characteristics is greater when managers have more discretion, that is, latitude of action (Finkelstein & Hambrick, 1990). Overconfidence is thus a cognitive characteristic whose effect depends on the room executives have to act on it.

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2.3 Behavioral corporate finance

Behavioral corporate finance examines how managerial biases shape investment and financing. Malmendier and Tate (2005) show that CEOs who hold company stock options longer than rational diversification would suggest invest more and are more sensitive to internal cash flow, consistent with overconfident beliefs that the firm's equity is undervalued. Overconfident acquirers are more likely to make acquisitions, particularly diversifying deals financed internally, and the market reacts more negatively to their announcements (Malmendier & Tate, 2008). Surveys of financial executives also find systematic miscalibration, with executives' forecast ranges too narrow relative to realized outcomes (Ben-David, Graham, & Harvey, 2013).

2.4 Decision processes and the planning fallacy

Kahneman and Lovallo (1993) argue that decision makers adopt an inside view, focusing on the specifics of the project at hand and neglecting base rates, which produces bold forecasts and timid choices at the individual level and aggregated optimism at the organizational level. Camerer and Lovallo (1999) show that overconfidence about relative skill leads to excess market entry. These mechanisms suggest that overconfidence acts not only on the manager's preferences but also on how information is gathered, weighed, and challenged.

3. Conceptual Model and Propositions

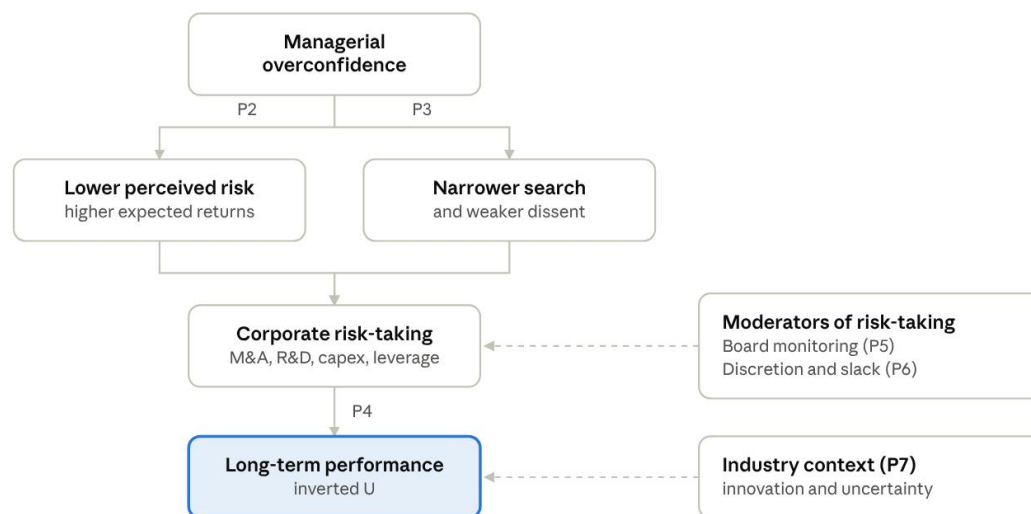
We propose that managerial overconfidence (the independent variable) distorts decision processes in two ways: it lowers perceived risk and raises expected returns, and it reduces information search and dissent. These distortions increase corporate risk-taking, observed in acquisitions, capital expenditure, R&D, and leverage, which in turn affects long-term performance. Board monitoring, managerial discretion, financial slack, and industry context moderate the process. Figure 1 depicts the model and Table 1 defines the constructs.

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Overconfidence raises risk-taking, and only moderate doses pay off



Dashed arrows show moderating conditions

overconfidence-risk-performance model · 2 mediators, 3 moderators

Figure 1. Overconfidence lowers perceived risk and narrows search and dissent, increasing corporate risk-taking (P1); board monitoring, discretion, slack, and industry context shape how risk-taking affects long-term performance.

P1 (Overconfidence and risk-taking). Managerial overconfidence is positively related to corporate risk-taking, including acquisition activity, investment intensity, R&D spending, and leverage.

P2 (Risk perception). Lower perceived risk and higher expected returns partially mediate the relationship between overconfidence and risk-taking.

P3 (Decision process). Reduced information search and weaker dissent in the top team partially mediate the relationship between overconfidence and risk-taking.

P4 (Curvilinear performance). The relationship between overconfidence and long-term performance is an inverted U: moderate confidence supports bold but viable commitments, while extreme confidence leads to overinvestment and value destruction.

P5 (Board monitoring). Active, independent board monitoring weakens the relationship between overconfidence and risk-taking and flattens the downside of extreme overconfidence.

P6 (Discretion and slack). Greater managerial discretion and greater financial slack strengthen the relationship between overconfidence and risk-taking.

P7 (Industry context). In innovation-intensive, high-uncertainty industries, the positive range of the overconfidence-performance relationship extends further than in mature, stable industries, where bold bets have lower upside and higher cost.

4. Constructs and Their Roles

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Construct	Role in the model	Definition	Key source
Managerial overconfidence	Independent variable	Systematic overestimation of own ability, control, and the likelihood of favorable outcomes	Moore & Healy (2008)
Perceived risk and expected returns	Mediator 1	Manager's subjective assessment of downside and payoff of strategic options	Kahneman & Lovallo (1993)
Information search and dissent	Mediator 2	Extent to which alternatives, base rates, and challenges are sought and heard	Hambrick & Mason (1984)
Corporate risk-taking	Mediator 3	Commitment to uncertain, high-variance actions such as acquisitions, R&D, and leverage	Malmendier & Tate (2005)
Long-term performance	Dependent variable	Sustained firm value and profitability over several years	Hirshleifer et al. (2012)
Board monitoring	Moderator	Independence, engagement, and challenge from directors	Finkelstein & Hambrick (1990)
Managerial discretion and financial slack	Moderator	Latitude of action and availability of uncommitted resources	Finkelstein & Hambrick (1990)
Industry context	Moderator	Degree of innovation intensity and environmental uncertainty	Galasso & Simcoe (2011)

Table 1. Constructs in the overconfidence-risk-performance model.

5. Forms of Overconfidence and Their Decision Consequences

Because overconfidence takes different forms, its effects on strategy are likely to differ. Table 2 relates each form to a typical decision distortion and an observable consequence.

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Form of overconfidence	Core belief	Typical decision distortion	Likely observable consequence
Overestimation	My ability and control are higher than they are	Inflated forecasts of project returns and synergies	Overpayment and cost or schedule overruns
Overplacement	I am better than rivals or other managers	Underestimating competitive response and entering crowded markets	Excess entry and margin erosion
Overprecision	My estimate is more certain than it is	Narrow scenario ranges and limited contingency planning	Fragile plans and delayed course correction

Table 2. Forms of overconfidence mapped to strategic decision consequences. The mappings are theoretical expectations.

6. Proposed Research Design

Sample and design. A panel of publicly traded firms over ten or more years, combining executive-level overconfidence measures with firm-level financial and strategic data. Performance is measured over multi-year windows following key decisions to capture long-term effects and reduce short-term noise.

Measures. Overconfidence can be measured through behavior (for example, persistent holding of exercisable stock options, as in Malmendier & Tate, 2005, or net purchases of company stock), through press portrayals of the executive, and through survey-based miscalibration tasks. Risk-taking: acquisition frequency and size, capital expenditure and R&D intensity, leverage, and volatility of returns. Long-term performance: multi-year abnormal returns and operating profitability. Moderators: board independence and director engagement, discretion proxies, slack measures, and industry R&D intensity.

Analysis. Panel regression with firm and year fixed effects, instrumental or matching approaches to address endogeneity, mediation analysis using survey data on decision processes (P2-P3), quadratic terms for the curvilinear hypothesis (P4), and interaction terms for moderation (P5-P7). Researchers should control for firm size, age, governance structure, executive compensation, and prior performance.

Complementary designs. Laboratory and vignette experiments can manipulate confidence and test effects on information search, and qualitative case studies can trace how overconfidence shaped specific strategic decisions.

Proposition	Relationship tested	Method	Expected result
P1	Overconfidence to risk-taking	Panel regression with fixed effects	Positive relationship
P2	Role of perceived risk and expected returns	Survey-based mediation	Partial mediation

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Proposition	Relationship tested	Method	Expected result
P3	Role of information search and dissent	Survey-based mediation, top team data	Partial mediation
P4	Overconfidence squared on long-term performance	Quadratic regression	Significant negative squared term
P5	Board monitoring as moderator	Interaction analysis	Weaker link and flatter downside
P6	Discretion and slack as moderators	Interaction analysis	Stronger link
P7	Industry context as moderator	Subsample or interaction analysis	Wider beneficial range in innovative industries

Table 3. Testing plan for the propositions.

7. Discussion

7.1 Theoretical contributions

First, the model integrates upper echelons theory with behavioral finance by identifying decision-process mechanisms that connect an executive trait to corporate outcomes. Second, it resolves apparent contradictions between studies showing harmful overinvestment and studies showing beneficial innovation by proposing a curvilinear effect shaped by context. Third, it identifies governance and discretion as boundary conditions, framing overconfidence as a risk to be managed rather than simply a flaw to be eliminated.

7.2 Practical implications

- **Build in challenge.** Assign devil's advocates, require pre-mortems, and protect dissent in top team and board discussions.
- **Use the outside view.** Require base-rate comparisons and reference-class forecasts for major investments and acquisitions.
- **Strengthen board monitoring.** Boards with independent, engaged directors can test assumptions and pace large commitments.
- **Stage commitments.** Structure large bets as sequences of smaller decisions with explicit checkpoints and exit criteria.
- **Align incentives with long-term value.** Compensation tied to multi-year outcomes reduces rewards for short-term bold bets.

Warning sign	Recommended action	Proposition addressed
Repeated acquisitions with optimistic synergy estimates	Require reference-class forecasts and independent valuation reviews	P1, P2
Little documented disagreement in top team meetings	Introduce structured dissent and pre-mortems	P3
Large capital commitments	Stage funding with	P4

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Warning sign	Recommended action	Proposition addressed
approved in a single step	checkpoints and exit criteria	
Passive or CEO-aligned board	Refresh board composition and strengthen independent committees	P5
Large cash reserves and few constraints on investment	Set hurdle rates and capital allocation discipline	P6

Table 4. From warning signs to governance actions.

7.3 Limitations and future research

This paper is conceptual and the propositions require empirical testing, with careful attention to endogeneity, since confident managers may also be selected into riskier firms. Future research should compare measures of overconfidence, which may capture different constructs, examine how confidence changes after successes and failures, study team-level overconfidence, and test cross-cultural variation in the acceptability of bold leadership. Longitudinal work can examine whether experience and feedback calibrate managerial beliefs over time.

8. Conclusion

Managerial overconfidence shapes strategy by changing how leaders see risk and how their organizations gather and challenge information. Its effects on performance are not uniformly negative: moderate confidence can energize valuable ambition, while extreme confidence can destroy value, especially when oversight is weak and resources are abundant. Organizations that cannot remove overconfidence can still limit its costs through disciplined decision processes, independent boards, and incentives for long-term value.

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