Rationality and Corporate Finance Puzzles

1. The Asset Pricing—Corporate Finance Link

- Most of the “hard” evidence in corporate finance comes from incorporating security prices and returns into the analysis of corporate decisions

- Most of the theories in corporate finance presumes that capital markets offer no “free lunch” (incentive compatibility constraint)

- Recently, a line of asset pricing research has challenged the “no free lunch” conjecture, replacing it with a (still vaguely defined) “behavioral” view of markets and market participants (slow learning and/or violation of incentive compatibility)

- “Behavioral finance” naturally has its counterpart in “behavioral corporate finance”. Contrasting “behavioral” and “rational” models requires understanding performance evaluation techniques

2. Anomalies/Puzzles

- Anomalies are empirical results that seem to be inconsistent with maintained theories of asset pricing behavior, i.e., conditional on an assumed asset-pricing model

- **Data snooping**: A disappearing "anomaly" may also indicate that the anomaly was an artifact of "data snooping":

   i. Authors in search of interesting results are likely to focus attention on "surprising" results

   ii. To the extent that subsequent authors reiterate or refine the surprising results by examining the same or at least positively correlated data (data snooping), there is really no additional evidence in favor of the anomaly.

   iii. Need to use independent data and/or very different methods for making inferences.

3. Corporate Finance Puzzles

- <u>New Issues</u>
  Investing in new equity issues (seasoned or initial) produces a relatively low total return over a three-to-five year holding period. Why?

- <u>Dividends</u>
  Both the level and value-consequence of dividends and dividend changes are poorly understood against classical paradigms

- <u>Disappearing Rights</u>
  Internationally, small firms issue equity using the inexpensive rights offer method while large firms uniformly switch to underwriting. Why?

- <u>IPO Underpricing</u>
  While plenty of theories, there is currently no consensus as to what explains the systematic underpricing of IPOs. Why are issuers “leaving money on the table”?

- IPO Auctions
  Auctions may reduce underpricing. So why do US investment banks—and increasingly international banks—insist on the book-building procedure?

- Unused Debt Tax Shield
  Firms appear under-leveraged when using measures of the corporate tax benefit of debt

- Bankruptcy
  Auctions appear efficient. Nevertheless, countries almost invariably move towards the structured bargaining system of Chapter 11 in the US. What are the concerns?

- The Pecking Order
  What drives the equity issue decision? Classical tradeoffs or information asymmetry? Is the distinction between inside and outside equity important?

- The Toehold Puzzle
  Both theoretical and empirical research indicates that bidding with target toeholds is advantageous in tender offer contests. So why do most bidders avoid toeholds?

- <u>Poison Pills</u>
  Poison pills increase bargaining power of inefficient management. Why do shareholders of a large fraction of the S&P 500 firms accept such “shareholder rights” plans?

- <u>Executive Compensation</u>
  Why are CEOs in favor of resetting stock options following a price decline but against receiving indexed options as compensation? Do compensation policies reflect self-dealing?