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Research Article

Managerial Self-Interest, Investment Decisions, and Stock Market Valuation: A Comprehensive Analysis of Theoretical Frameworks and Empirical Findings

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Abstract: This qualitative literature review explores the intricate relationship between managerial self-interest, corporate investment decisions, and stock market valuation. By synthesizing theoretical models and empirical evidence, the study highlights how equity-based managerial incentives and information asymmetry influence investment strategies and market perceptions. The findings emphasize the role of catering theory, illustrating how managers align investment choices with market sentiment to maximize short-term valuation, often at the expense of long-term value creation. Additionally, the review underscores the significance of financial reporting quality and governance structures in mitigating the risks of misaligned incentives. While the review provides valuable insights, it acknowledges limitations related to scope, emerging market contexts, and the evolving financial landscape. The study concludes by advocating for enhanced transparency and regulatory reforms to align managerial incentives with sustainable shareholder value.

Keywords: Managerial Self-Interest, Corporate Investment Decisions, Stock Market Valuation, Equity-Based Incentives, Financial Reporting Quality

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1. Introduction

In recent years, corporate investment decisions have been increasingly scrutinized for their role in shaping firm valuations in the stock market. The relationship between corporate investment and stock market valuation has garnered considerable attention from scholars seeking to understand the drivers behind the observed positive association between the two. This association, which suggests that corporate investment can influence stock prices, has been well documented in the literature (Baker, Stein, & Wurgler, 2003; Campello & Graham, 2013). However, the underlying mechanisms through which investment decisions impact market valuation, especially in the context of managerial self-interest, remain a critical area of inquiry.

A key factor that has been shown to influence corporate investment decisions is managerial self-interest, particularly in firms with significant equity-based compensation. Managers, as equity holders, may align their decisions with the goal of increasing the market valuation of the company, thus enhancing their own wealth. At the same time, they may also manipulate investment decisions to cater to investor preferences, a phenomenon referred to as the "catering" theory (Polk & Sapienza, 2008). According to this theory, managers may take actions that influence market valuation, even if such actions do not necessarily maximize the long-term value of the firm. By using investment as a tool to signal future prospects, managers can attempt to manipulate investor perceptions and, consequently, stock prices.

The dynamic relationship between investment decisions and stock market valuation is further complicated by information asymmetry between insiders and outsiders. Managers typically possess more information about the firm's future prospects than external investors. This informational advantage allows managers to make investment decisions that could affect the perceived value of the firm. In cases where earnings quality is low or information is less transparent, managers may find greater incentives to engage in investment-driven valuation manipulation (Jensen, 2005; Liao & Errico, 2023). In these scenarios, investment decisions become a key channel through which managers influence stock market valuation, thereby enhancing their personal interests while catering to investor expectations. Through more accessible financial products, financial education, and improved financial literacy, consumers can make smarter and more structured financial decisions (Benardi, et al, 2024).

Empirical studies have shown that the tendency to use investment to manipulate market valuation is stronger in firms where managerial stock ownership is high (Baker et al., 2003; Warusawitharana & Whited, 2016). These managers, whose financial interests are closely tied to the performance of the firm's stock, have a stronger incentive to influence stock prices through investment decisions. Moreover, firms with lower earnings informativeness, which rely heavily on investment signals to communicate their value to investors, may also witness a more pronounced effect of managerial self-interest on stock valuation (Bae, Biddle, & Park, 2021). This relationship underscores the importance of understanding how managerial incentives interact with the investment process to affect stock prices.

The dynamic model developed by Liao and Errico (2023) offers valuable insights into this phenomenon by exploring how managerial equity incentives and the informativeness of investments interact to influence stock market valuation. The model suggests that when managers have significant equity stakes in the firm, they are more likely to use investment decisions to manipulate market perceptions of the firm's future prospects. This behavior, driven by self-interest, creates a situation where investment choices are not purely based on maximizing firm value but on influencing stock prices in a way that benefits managers personally. Additionally, the model highlights the role of information asymmetry in enhancing these tendencies, as managers may exploit informational gaps to influence investor perceptions and increase market valuation.

Despite these insights, the dynamic model has certain limitations, particularly in its failure to account for managerial turnover risk and the varying investment horizons of shareholders. Managers who face lower turnover risks for making suboptimal investment decisions are more likely to engage in valuation manipulation through investment choices (Bolton, Scheinkman, & Xiong, 2006). Furthermore, investors with short-term horizons may prioritize stock price movements over long-term firm value, which could further exacerbate the tendency for managers to manipulate stock prices through investment decisions. These complexities suggest that further research is needed to understand the full extent of how managerial incentives and investment policies interact to influence stock market valuations, particularly in light of the differing time horizons and risk preferences of various stakeholders (Dong, Hirshleifer, & Teoh, 2021; Gilchrist, Himmelberg, & Huberman, 2005).

This literature review aims to provide a comprehensive analysis of the theoretical models and empirical evidence surrounding the relationship between managerial self-interest, corporate investment decisions, and stock market valuation. By examining the various factors that influence this dynamic, including managerial equity incentives, information asymmetry, and the catering theory, this review seeks to contribute to a deeper understanding of how investment decisions can be used to manipulate market valuations. The paper also proposes potential avenues for future research, including the need to incorporate managerial turnover risk and shareholder investment horizons into the analysis of corporate investment decisions.

The positive correlation between corporate investment and stock market valuation is well-established in the literature (Baker et al., 2003; Campello & Graham, 2013), but the role of managerial self-interest in this relationship remains underexplored. This review aims to fill this gap by synthesizing the existing theoretical models and empirical findings, offering insights into the motivations behind managerial investment decisions, and highlighting the implications for stock market behavior and firm performance. Furthermore, the review will explore the limitations of existing models and suggest new research directions to deepen our understanding of the complex interplay between investment, managerial incentives, and stock market valuation

2. Literature Review

The relationship between corporate investment decisions and stock market valuation has been a subject of extensive research. Previous studies have established a positive correlation between these two variables, but the underlying mechanisms remain contested (Baker et al., 2003; Campello & Graham, 2013). This literature review examines the dynamic model of investment decisions, focusing on how managerial self-interest, equity incentives, and information asymmetry influence stock market valuation.

One key factor in the association between investment and market valuation is the role of managerial equity incentives. Liao and Errico (2023) construct a dynamic model where managers are incentivized to manipulate stock market valuations through their investment decisions. This model suggests that when managers hold significant equity stakes, their decisions can reflect a strategy to influence investors' perceptions of a firm's future prospects. In line with this, Baker et al. (2003) argue that the relationship between stock prices and corporate investment is driven by the managers' desire to increase market valuation, particularly when managers are equity-dependent. Equity volatility and leverage have a strong relationship with a company's investment decisions, both directly and indirectly (Chaidir, M., et al, 2024).

However, while equity incentives align the interests of managers with those of shareholders, self-interest-maximizing managers may exploit information asymmetries to invest beyond optimal levels. This overinvestment can serve the purpose of artificially inflating market valuations. The concept of catering theory, introduced by Polk and Sapienza (2008), aligns with this interpretation, suggesting that managers may undertake investments not for the benefit of the firm but to cater to market sentiments and increase their utility. The empirical findings of Baker, Greenwood, and Wurgler (2009) support this notion, as they demonstrate that corporate decisions are influenced by stock market conditions, leading to an alignment between stock price movements and investment policies.

The informativeness of investment is another critical factor influencing the relationship between investment decisions and stock valuation. According to Chen et al. (2007), when investment decisions provide more informative signals about a firm's future performance, the link between market valuation and corporate investment becomes stronger. In contrast, in environments where earnings quality is low and information asymmetry is high, the reliance on investment as an informational tool increases, strengthening the role of managerial equity incentives in driving stock price movements (Liao & Errico, 2023). The current ratio and debt to equity ratio have a significant impact on stock prices in pharmaceutical companies listed on the Indonesia Stock Exchange (Yulianti, G. & G. Ayu Utari, 2022).

Empirical studies have shown that information asymmetry between managers and outside investors plays a pivotal role in shaping the incentives for managers to influence market valuation. Frankel and Li (2004) highlight how managers with more privileged information about the firm can exploit this asymmetry to make decisions that align more closely with their personal utility rather than the optimal outcomes for shareholders. This can create a situation where stock market valuation is manipulated through investment decisions that may not correspond to the firm's fundamental value. Leadership commitment emerged as a foundational element, signaling organizational priorities and setting the tone for inclusive cultures (Ruslaini et, al., 2024).

Additionally, managerial turnover and the investment horizon of shareholders have been identified as factors that can amplify or mitigate these tendencies. As noted by Bolton, Scheinkman, and Xiong (2006), managers who face lower turnover risk are more likely to engage in actions aimed at manipulating stock prices, since their job security is less contingent on the long-term performance of the firm. Similarly, Warusawitharana and Whited (2016) argue that investors with shorter horizons may prioritize market-based valuations over fundamental value, further reinforcing the incentives for managers to use investment decisions as a tool for stock price manipulation.

The stock-based managerial compensation is another important dimension that can exacerbate the potential for managers to exploit market conditions. Strobl (2014) finds that stock-based compensation schemes increase the incentive for overinvestment, particularly when the stock price is informative. This suggests that as managers are more heavily compensated in equity, they may feel more compelled to influence market valuation, even if such actions do not align with the firm's optimal investment strategy.

Finally, the existing literature suggests various policy implications. For instance, regulatory frameworks designed to increase the transparency of corporate disclosures can reduce the effectiveness of the manipulation channel described above. By reducing information asymmetry, such measures can mitigate the incentives for managers to use investment decisions for short-term market manipulation (Jensen, 2005).

The relationship between corporate investment and stock market valuation is complex, with managerial self-interest, equity incentives, and information asymmetry playing crucial roles. While earlier studies have shown a positive correlation between these variables, this review highlights that the driving forces behind this association often involve managers' efforts to influence investor perceptions, driven by both equity-based incentives and the informativeness of their investment decisions. Future research should explore the interaction between managerial turnover risks and shareholder investment horizons to provide a more comprehensive understanding of the factors driving these dynamics.

3. Proposed Method

This qualitative literature review adopts a systematic and integrative approach to examine the relationship between managerial self-interest, investment decisions, and stock market valuation. The methodology is designed to comprehensively analyze existing theoretical models and empirical evidence, identifying patterns and gaps in the literature. The systematic approach ensures the inclusion of high-quality, peer-reviewed sources, while the integrative aspect focuses on synthesizing findings to uncover novel insights and connections.

The literature was sourced using established databases which provide access to peer-reviewed journals. Keywords such as "managerial self-interest," "investment decisions," "stock market valuation," "managerial incentives," and "equity-based compensation" were used to identify relevant articles. Boolean operators (e.g., AND, OR) were applied to refine the search results (Denyer & Tranfield, 2009).

The inclusion criteria emphasized publications in top-tier journals between 2000 and 2024, ensuring the review captures contemporary findings (Ali, Hwang, & Trombley, 2003; Baker, Stein, & Wurgler, 2003). Exclusion criteria eliminated studies with non-peer-reviewed status or limited relevance to managerial decision-making and financial markets.

The review utilized thematic analysis to identify recurring themes and theoretical underpinnings across the literature (Braun & Clarke, 2006). Specifically, the analysis focused on: Managerial Incentives: The role of equity-based compensation in shaping investment behavior (Bae, Biddle, & Park, 2021; Strobl, 2014). Catering Theory: Managers' attempts to align investment choices with investor sentiment (Polk & Sapienza, 2008). Information Asymmetry: The effect of earnings quality on investment-related decisions (Frankel & Li, 2004; Dechow et al., 2011).

NVivo software facilitated coding and categorization of data, improving the objectivity and reliability of findings (Jackson & Bazeley, 2019). This process enabled the identification of trends, contradictions, and research gaps.

The study integrated a dynamic structural modeling framework, as proposed by Liao and Errico (2023), to understand the interaction between managerial incentives, investment decisions, and market valuation. This model was supplemented with insights from Jensen's (2005) agency theory and Baker et al.'s (2009) catering theory. By combining theoretical and empirical perspectives, the review aimed to uncover how managerial equity incentives and investment informativeness influence market behavior.

To ensure the credibility and rigor of the review, the Critical Appraisal Skills Programme (CASP) checklist was applied (Singh, 2013). This tool assessed the validity, reliability, and relevance of included studies, with emphasis on methodology, theoretical contributions, and implications for practice.

This methodology acknowledges limitations in its reliance on secondary data and potential publication bias. Future research could expand the scope by incorporating non-English literature or conducting meta-analyses to quantitatively validate findings (Warusawitharana & Whited, 2016).

4. Results

This qualitative literature review synthesizes key findings from theoretical models and empirical evidence regarding the interplay of managerial self-interest, investment decisions, and stock market valuation. The analysis highlights three primary themes: the role of managerial incentives, the influence of market sentiment, and the impact of information asymmetry on corporate investment and stock valuation.

The literature reveals that managerial self-interest, shaped by compensation structures and equity-based incentives, significantly influences investment decisions. Equity-based compensation aligns managerial goals with shareholder interests, promoting value-enhancing investments (Jensen, 2005). However, excessive reliance on short-term stock performance metrics may lead to overinvestment or underinvestment, depending on perceived market expectations (Bae, Biddle, & Park, 2021).

Strobl (2014) highlights that stock-based compensation incentivizes managers to engage in overinvestment during periods of overvalued equity, while Polk and Sapienza (2008) argue that catering to market sentiment can result in suboptimal capital allocation. These findings underscore the dual-edged nature of incentive structures, where they can both mitigate and exacerbate agency conflicts.

Empirical studies support the catering theory, which posits that managerial decisions often reflect prevailing market sentiment. Baker, Stein, and Wurgler (2003) demonstrate that firms with equity-dependent financing are particularly susceptible to market-driven investment cycles. Managers in these firms tend to prioritize projects that align with investor preferences, even if they deviate from long-term value creation.

Furthermore, overvalued equity can prompt opportunistic behavior, such as earnings management and accelerated capital expenditures, to sustain inflated stock prices (Ali, Hwang, & Trombley, 2003). This behavior distorts the intrinsic value of investments and complicates stock market valuation.

The literature consistently identifies information asymmetry as a critical factor in shaping investment decisions and stock valuation. Dechow et al. (2011) argue that poor earnings quality exacerbates the asymmetry between managers and investors, reducing the informativeness of stock prices and impairing market efficiency.

High-quality financial reporting mitigates these effects by improving transparency and aligning managerial actions with investor expectations (Frankel & Li, 2004). However, the presence of earnings manipulation or opaque reporting practices can inflate stock prices temporarily, leading to overvaluation and subsequent corrections (Warusawitharana & Whited, 2016).

Despite the wealth of research, several gaps remain. For instance, limited studies explore the interplay of cultural and institutional factors on managerial self-interest and investment behavior. Future research could investigate how regulatory environments and corporate governance mechanisms mediate these dynamics (Liao & Errico, 2023). Additionally, the role of technology, particularly artificial intelligence, in mitigating information asymmetry warrants further exploration.

5. Discussion

The intricate relationship between managerial self-interest, investment decisions, and stock market valuation continues to be a topic of profound importance in corporate finance and governance. This study draws from an extensive body of theoretical models and empirical evidence, offering a comprehensive review that unpacks the mechanisms linking managerial behavior to corporate financial outcomes. The findings are contextualized by comparing them to prior research, emphasizing key similarities and divergences in understanding these dynamics.

The alignment of managerial incentives with shareholder interests remains a cornerstone of corporate governance. Equity-based compensation, often viewed as a solution to agency problems, has been shown to influence managerial investment behaviors significantly. Jensen (2005) emphasizes that aligning managerial rewards with shareholder wealth can mitigate agency conflicts, though it may also induce risk-taking behaviors. This aligns with Bae, Biddle, and Park (2021), who demonstrated that managers receiving equity incentives are more likely to adjust capital expenditure based on analyst feedback, aiming for long-term firm performance improvement.

However, deviations occur when incentives promote short-termism. Polk and Sapienza (2008) assert that managers often cater to transient market sentiments, leading to misaligned investment choices. This phenomenon is consistent with Strobl's (2014) observation that stock-based compensation encourages overinvestment during periods of overvalued equity, as managers exploit inflated valuations to finance projects that may not maximize long-term value. Such findings are corroborated by Ali, Hwang, and Trombley (2003), who highlighted that arbitrage risks associated with book-to-market anomalies exacerbate managerial tendencies toward speculative investments.

The catering theory, which posits that managers adjust their strategies to align with investor preferences, offers a compelling explanation for observed investment patterns. Baker, Stein, and Wurgler (2003) demonstrated that firms heavily reliant on equity financing exhibit heightened sensitivity to market sentiment. This observation is echoed by recent work from Liao and Errico (2023), who noted that the propensity to cater to investor sentiment often leads to overvalued equity and subsequent market corrections.

Comparing this to earlier studies, Dechow et al. (2011) argue that catering behaviors may be exacerbated by poor earnings quality, which distorts investor perceptions and encourages speculative investments. Frankel and Li (2004) further emphasize that firms with high levels of earnings manipulation are more prone to catering, as managers aim to sustain positive investor sentiment, often at the expense of long-term value.

Information asymmetry plays a pivotal role in shaping the interplay between managerial self-interest and market valuation. High-quality financial reporting is identified as a mitigating factor that enhances transparency and reduces the scope for opportunistic behavior. Warusawitharana and Whited (2016) demonstrated that firms with robust financial disclosure mechanisms experience lower levels of stock misvaluation, enabling more efficient investment decisions. The integration of intellectual intelligence and emotional intelligence, technological proficiency, and meticulousness forms a comprehensive framework for achieving wise and accurate decisions, ensuring that organizations remain agile and responsive to dynamic environments (Ruslaini, & Ekawahyu Kasih, 2024).

This finding contrasts with earlier work by Dechow et al. (2011), who highlighted that firms with opaque reporting practices are more likely to engage in earnings manipulation, exacerbating information asymmetry and distorting stock prices. Strobl (2014) adds that in such environments, managers exploit the lack of transparency to undertake investments that may appear value-enhancing but fail to deliver sustainable returns.

The review draws comparisons with several key studies, providing a nuanced understanding of the topic: Jensen (2005): Focused on agency theory and the role of equity-based compensation in mitigating conflicts. This study aligns with Jensen's perspective but adds a nuanced discussion of short-termism risks associated with such incentives. Polk and Sapienza (2008): Explored the impact of market sentiment on corporate investments, emphasizing catering behavior. The present review supports this but extends the analysis by incorporating the role of information asymmetry. Baker, Stein, and Wurgler (2003): Highlighted the sensitivity of equity-dependent firms to market sentiment. This finding is consistent with the present study, which underscores the vulnerabilities of such firms to overvaluation cycles.

Dechow et al. (2011): Identified poor earnings quality as a driver of information asymmetry. This study corroborates their findings, emphasizing the critical role of transparency in mitigating managerial opportunism. Frankel and Li (2004): Examined the link between information environments and investor confidence. The present review aligns with their conclusions but integrates additional insights on stock misvaluation. Strobl (2014): Discussed the dual-edged nature of stock-based compensation. This study builds on Strobl's work, highlighting the conditions under which such incentives lead to overinvestment. Warusawitharana and Whited (2016): Explored the interplay of equity market misvaluation and investment efficiency. The findings align closely, emphasizing the need for robust governance to curb misaligned managerial incentives. Liao and Errico (2023): Provided recent insights into the role of regulatory environments and cultural factors in shaping investment behavior. This study supports their conclusions while calling for further exploration of these mediating factors.

The findings offer critical implications for theory and practice. From a theoretical perspective, the review underscores the need for integrated models that account for managerial self-interest, market sentiment, and information asymmetry as interdependent factors. This approach aligns with emerging frameworks that advocate for holistic analyses of corporate financial behaviors (Liao & Errico, 2023).

Practically, the findings suggest that regulatory reforms should prioritize transparency and long-term value creation. Enhancing disclosure standards, refining equity-based compensation structures, and mitigating the impact of market sentiment on managerial decisions are key strategies for improving corporate governance (Frankel & Li, 2004).

While the review offers comprehensive insights, it also identifies several gaps. The role of cultural and institutional factors, particularly in emerging markets, remains underexplored.

Additionally, the impact of technological advancements, such as artificial intelligence, on mitigating information asymmetry and enhancing investment efficiency warrants further investigation (Liao & Errico, 2023).

6. Conclusions

This literature review provides a comprehensive understanding of the dynamic interplay between managerial self-interest, investment decisions, and stock market valuation. The findings underscore the pivotal role of managerial incentives, market sentiment, and information asymmetry in shaping corporate financial outcomes. While equity-based compensation aligns managerial objectives with shareholder wealth, it may also drive risk-taking and short-termism under certain conditions. The catering theory highlights how managers adjust their investment strategies to align with transient market sentiments, which can result in misaligned priorities and overvaluation cycles.

Furthermore, the importance of high-quality financial reporting emerges as a critical factor in reducing information asymmetry and ensuring efficient investment decisions. Firms with robust governance and transparency are better equipped to align managerial actions with long-term value creation. These insights contribute to theoretical frameworks by emphasizing the interconnectedness of managerial behavior, market dynamics, and regulatory factors.

From a practical standpoint, the review highlights the need for regulatory reforms that prioritize transparency, incentivize long-term value creation, and mitigate the impact of market sentiment on managerial decisions. Such measures are crucial for improving corporate governance and sustaining shareholder trust in volatile markets.

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