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Managerial incentives, myopic loss aversion, and firm risk: A comparison of family and non-family firms☆

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ABSTRACT

Protecting family interests can affect the risk preferences of family firms relative to nonfamily firms. Given family firms' long-term orientation, we propose that they are less likely to suffer from myopic loss aversion, and therefore exhibit higher levels of downside risk, or the potential for loss, than nonfamily firms. We test these relationships on a sample of S&P 1500 firms from 2003 to 2006, finding a positive relationship between family involvement and risk. Additionally, we consider how managerial incentives alter family and nonfamily firms' risk preferences. Greater managerial stock ownership, which has a longer-term time horizon, results in a larger increase in risk for nonfamily firms relative to family firms. Greater bonus pay, which has a shorter-term horizon, results in a larger decrease in family firm risk, relative to nonfamily firms. Thus, managerial incentives can enhance or mitigate risk preferences depending on whether they are aligned with the firm's investment time horizon.

1. Introduction

The risk preferences of family firms have received considerable attention. Traditionally, because the family tends to view the firm as an asset to be passed on to future generations, family firms are portrayed as conservative and risk averse (e.g., Bennedsen & Nielsen, 2010; Gentry, Dibrell, & Kim, 2016; La Porta, Lopez-de Silanes, & Shleifer, 1999; Le Breton-Miller & Miller, 2011). However, family firms can become risk seeking when the family's control or future prosperity is threatened, (e.g., Gomez-Mejia, Hynes, Nunez-Nickel, & Moyano-Fuentes, 2007; Sirmon, Arregle, Hitt, & Webb, 2008). Gedajlovic, Carney, Chrisman, and Kellermanns (2011) highlight these conflicting findings, calling for additional research to better understand the risk preferences of family firms. Further, more research is necessary to explain differences among family firms. Our study addresses these gaps by extending the myopic loss aversion lens to examine family and nonfamily firms' tolerance for risk.

The long-term orientation that is typical of family firms (Gentry et al., 2016; Lumpkin & Brigham, 2011) shapes their risk preferences and influences their strategic investments (e.g., Chrisman & Patel, 2012). Myopic loss aversion describes decision-makers' preoccupation with avoiding loss, which is amplified with short-term goals (Benartzi & Thaler, 1995). Greater myopic loss aversion reflects a situation where decision makers frequently evaluate investments to prevent losses due to their short-term investment horizon. In contrast, lower levels of myopic loss aversion indicate a longer-term investment horizon, which increases the attractiveness of risky long-term investments (Loewenstein & Thaler, 1989). Accordingly, family firms' long-term orientation may reduce myopic loss aversion, resulting in a greater acceptance of longer-term investments, which may increase risk. Thus, the portfolio of strategic investments for a family firm is likely to result in greater levels of organizational risk, relative to nonfamily firms.

Additionally, contextual factors inside and outside the organization may influence family firm risk preferences (Gomez-Mejia et al., 2007; Gomez-Mejia, Makri, & Larraza-Kintana, 2010; Sirmon et al., 2008). One contextual factor that has been relatively unexplored in the family firm literature is the role of managerial incentives, despite extensive research that has demonstrated the link between various managerial incentives and risk (e.g. Beatty & Zajac, 1994; Larraza-Kintana, Wiseman, Gomez-Mejia, & Welbourne, 2007; Sanders, 2001; Sanders & Hambrick, 2007). Given that different types of managerial incentives encourage different time horizons (e.g., Alessandri, Tong, & Reuer, 2012; Carpenter & Sanders, 2004; Sanders, 2001), managerial incentives may differentially affect the degree of myopic loss aversion, and thus the risk preferences of family and nonfamily firms.

In this research, we rely on the myopic loss aversion perspective to

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first explore how the level of family involvement affects the firm's risk preferences in terms of downside risk. Family involvement represents the family's ability to influence decisions through the combination of ownership and involvement in managing day-to-day decisions, which can provide the ability to pursue family interests (Alessandri, Cerrato, & Eddleston, 2018; Kappes & Schmid, 2013; Schmid, Ampenberger, Kaserer, & Achleiter, 2015). Family involvement is measured as the percentage of family ownership, providing that (a) the family owns at least 5% of the firm's equity; and (b) at least two family members serve on the TMT. If these conditions are not met, family involvement is equal to zero, signifying a nonfamily firm (Chrisman & Patel, 2012; Patel & Chrisman, 2014).

Furthermore, we contend that managerial incentives moderate the relationship between family involvement and downside risk. Managerial incentives that encourage a short-term perspective will foster greater myopia, enhancing the preference for lower risk in nonfamily firms, while mitigating the acceptance of greater risk by family firms. Managerial incentives with a longer-term orientation will reduce myopia, aligning with the family firms' preferences toward acceptance of more risk, while mitigating the risk preferences of nonfamily firms.

This research makes three contributions to the literature. First, we extend the myopic loss aversion perspective by demonstrating how the use of managerial incentives have different effects in family firms and nonfamily firms due to their alignment, or misalignment, with their investment time horizons, adding new insights into our understanding of family firm risk preferences. Second, we investigate how an increasing level of family involvement affects a family firm's tolerance for risk, demonstrating the heterogeneous risk preferences of family firms, particularly when managerial incentives are taken into account. Finally, in line with myopic loss aversion's emphasis on sensitivity to losses, we examine organizational downside risk since managers, owners, and investors tend to perceive risk in terms of the magnitude and probability for loss (Chatterjee, Wiseman, Fiegenbaum, & Devers, 2003; March & Shapira, 1987), offering a unique perspective on family firm risk preferences.

2. Theory and hypotheses

2.1. Organizational risk preferences and myopic loss aversion

Individuals are more sensitive to losses than gains (Benartzi & Thaler, 1995; Wiseman & Gomez-Mejia, 1998). Myopic loss aversion combines the sensitivity to losses with the notion of time horizon (Benartzi & Thaler, 1995; Chrisman & Patel, 2012; Thaler, Tversky, Kahneman, & Schwartz, 1997). The foundation for myopia is the concept of mental accounting, which involves both the framing of decisions and the frequency of evaluation of decisions (Benartzi & Thaler, 1995; Kahneman & Tversky, 1979; Thaler, 1985). For example, does the individual evaluate each investment in isolation (narrow framing) or as part of a broader portfolio (broad framing)? And how often are the investments evaluated? Myopia refers to a narrow framing of decisions and a narrow framing of outcomes, which tend to occur together (Thaler et al., 1997). Thus, *myopic loss aversion refers to the negative relationship between the period of evaluation, the framing of the investment and the risk aversion of decision makers: for loss averse individuals, shorter evaluation time frames with narrow framing lead to greater risk aversion, while individuals are likely to accept greater risk (i.e., greater variation in outcomes) when investments are evaluated over a longer time frame with a broader framing (Benartzi & Thaler, 1995; Thaler* et al., *1997)*. Thus, greater myopic loss aversion will lead to a series of individual investments that are focused on avoiding loss, thus resulting in lower risk. In contrast, lower levels of myopic loss aversion will encourage longer-term investments that are viewed as part of a portfolio, resulting in higher risk.

Given the sensitivity to losses in the myopic loss aversion perspective, we focus on organizational downside risk, which emphasizes the potential for loss (Miller & Leiblein, 1996; Miller & Reuer, 1996). Downside risk captures negative performance deviations relative to a target performance level. In contrast, traditional volatility-based measures of risk (i.e., standard deviation of returns) incorporate both positive and negative outcomes. Managers, owners and investors tend to perceive risk in terms of the magnitude and probability of loss (Chatterjee et al., 2003; March & Shapira, 1987). The firm's level of downside risk captures the potential for loss of the firm's portfolio of strategic investments.

2.2. The influence of family involvement on organizational downside risk

We define a family firm as a firm where the family has meaningful ownership of the firm's equity and the family is involved in the top management team (Alessandri et al., 2018; Chrisman and Patel (2012), Patel & Chrisman, 2014). This combination provides the family with voting rights as well as the ability to influence daily operations, which results in greater ability to pursue family interests (Kappes & Schmid, 2013; Schmid et al., 2015).

Family firms typically possess several unique characteristics. First, the family can exercise considerable influence over the business. The family tends to balance generating economic wealth with maintaining control of the firm in order to protect the family's interests (e.g., Chrisman & Patel, 2012; Gomez-Mejia et al., 2007; Le Breton-Miller & Miller, 2011). Compared to nonfamily firms, family firms may be willing to accept below-target financial performance in an effort to retain control of the firm and protect their socioemotional wealth, which reflects the family's accumulated endowment in the firm (Gomez-Mejia et al., 2007).

Second, their patient capital allows family firms to invest in projects that nonfamily firms typically avoid (Zellweger, 2007). Family firms tend to possess a long-term orientation, involving far-sighted decisions and future payoffs (Gentry et al., 2016; Lumpkin & Brigham, 2011; Zellweger, 2007). Thus, family firms maintain relatively stable investments (Le Breton-Miller & Miller, 2006; Zellweger, 2007). Third, much of the family's monetary wealth is tied to the firm, which influences their decisions (Gomez-Mejia et al., 2007; Zahra, 2005). In turn, the importance of maintaining the family's control, protecting interests and both current and future wealth influences the family risk preferences. Family firms must weigh potential financial gains and losses, as well as potential gains and losses to socioemotional wealth (Gomez-Mejia et al., 2014). This may cause family firms to be “willing to be vulnerable to the possibility of financial loss” (Gomez-Mejia et al., 2010: 225).

Family firms' long-term orientation results from the family's view of the firm as an asset to be passed on, rather than a source of wealth to be consumed during their lifetime (Anderson & Reeb, 2003). Family firms are more likely to use extended time horizons when making decisions (Anderson & Reeb, 2003; Le Breton-Miller & Miller, 2006;Lumpkin & Brigham, 2011 ; Zellweger, 2007), which likely reduces their focus on short-term returns, i.e., myopic loss aversion.

The time horizon used when considering investments represents a continuum, spanning from short-term to long-term. While our arguments will tend to focus on the ends of the continuum to contrast family and nonfamily firms, clearly there will be instances where the time horizons of these two types of firms may converge (i.e., toward a medium-term time horizon). The time horizon used to evaluate investments impacts the framing of strategic choices, thereby altering the attractiveness of potential opportunities (Chrisman & Patel, 2012; Gomez-Mejia et al., 2014; Lumpkin & Brigham, 2011). Longer time horizons tend to result in a more favorable view of riskier investments (Benartzi & Thaler, 1995; Fellner & Sutter, 2009), which is likely due to commitment to longer-term goals and less frequent evaluation (Thaler et al., 1997).

In terms of family firms, as family involvement increases, concerns for socioemotional wealth and firm longevity also increase. As they seek to protect family interests, family firms likely take a broader