



## Career concerns and the busy life of the young CEO<sup>☆</sup>



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### ABSTRACT

We examine how real investment decisions of firms are affected by their CEOs' career concerns. Relative to their older counterparts, younger CEOs are more likely to enter new lines of businesses and exit from existing ones. Younger CEOs undertake bolder expansions and divestments, which lead to significant increases and decreases in firm size, respectively. Younger CEOs also prefer to grow through acquisitions than de novo investments. However, such busier investment style of the younger CEOs appears not to hurt firm efficiency. Additional results also shed light on how CEO favoritism distorts capital allocation within firms.

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## 1. Introduction

In this paper, we examine how career concerns affect the investment activities of younger Chief Executive Officers (CEOs) compared with older CEOs. Career concerns matter because managers are expected to deliberately adjust their investment behavior to influence the labor market's perception of their abilities, and hence their reputation and future prospects. Extant literature, such as Gibbons and Murphy (1992), points out that career concerns are stronger when managers are further away from retirement as the increase in returns from influencing the market's belief about their abilities is higher. Therefore the investment decisions of younger CEOs are expected to be more affected by their career concerns than those of older CEOs.

Consistent with the idea that career concerns affect real investment decisions, we find that relative to older CEOs, younger CEOs are more likely to undertake restructuring activities. Prior literature has argued that younger CEOs acquire more due to compensation benefits associated with firm size increases. However, we show that not only are younger CEOs more likely to undertake restructuring activities that increase firm size, they are also more likely to exit from existing business lines which reduces firm size. Therefore, younger CEOs are not only motivated by explicit financial incentives, they are also motivated by the implicit goal of influencing labor market's perception of their abilities. Our use of plant-level data from the U.S. Census Bureau allows us to

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further examine the characteristics of the restructuring activities and also differentiate between internal and external investments. We find that younger CEOs undertake bolder investment decisions and prefer to grow aggressively through acquisitions.

Indeed, the theoretical literature has long recognized that a firm's investment decisions are contaminated by its managers' career concerns (see, e.g., Holmstrom and Ricart i Costa, 1986, Prendergast and Stole, 1996, and Holmstrom (1999)). The empirical evidence on career concerns from specialized labor markets, such as mutual fund managers (Chevalier and Ellison, 1999), security analysts (Hong et al., 2000), and macroeconomic forecasters (Lamont, 2002) finds that younger decision makers, with a long prospective career ahead, avoid bold decisions that can lead to negative outcomes and adversely affect the labor market's perception about their abilities. Therefore, the *Market Learning Hypothesis* generally predicts that younger decision-makers will behave conservatively and underinvest. However, there are reasons to question whether the results of other specialized labor markets apply to the CEO labor market as well.

The serious downside, forced terminations, is relatively rare for CEOs compared to that for other managers in the specialized labor markets (see e.g., Jenter and Kanaan, 2015; Kaplan and Minton, 2011). Even in extreme circumstances of firm bankruptcies, many departing CEOs find full-time employment within one year with little change in compensation (Eckbo et al., 2016). In contrast, there is significant upside potential for younger CEOs who successfully signal superior ability. For example, Gudell (2010) reports that there is a sizeable market for serial CEOs, along with large increases in compensation across jobs. With their long career horizons to reap benefits, younger CEOs are predicted to have stronger incentives to boldly signal ability by adopting a more active and possibly riskier investment strategy (Prendergast and Stole, 1996). Such career concerns are captured through the *Managerial Signaling Hypothesis*.

Using comprehensive data from the U.S. Census Bureau, we study real investment activities across all sectors of the economy and address questions dealing with the impact of career concerns on three salient aspects of investment behavior: the extent and type of investment activities, the associated productive efficiency, and the favored internal capital allocations.

The plant-level data from the U.S. Census Bureau allow us to characterize investments broadly to include all firm activities that alter the composition of a firm's asset base. In particular, we make use of plant-level information from the Longitudinal Business Database (LBD), which covers every U.S. private non-farm sector establishment (not just manufacturing sector), to construct a complete profile of all the plants and industry segments in which a firm operates. We then construct real investment variables based on the year-to-year change in the composition of the firm's asset structure. We show that a CEO's age has first order effects on a firm's investment decisions. In particular, we find that younger CEOs lead a “busy life.” Younger CEOs are more likely to alter a firm's current asset base by both entering new business segments and withdrawing entirely from existing business segments. In contrast, as CEOs get older, they seem to prefer a “quiet life” by refraining from churning their firms' existing business portfolios. Other things equal, firms with CEOs under 50 years of age are 5.9 percentage points less likely to keep the firm's business profile the same as last year, compared to firms with CEOs aged 60 and above. In contrast, firms with CEOs younger than 50 are 2.6 percentage points more likely to enter a new business segment and 3.7 percentage points more likely to exit from an existing business segment, relative to firms with CEOs aged 60 and above. These findings are statistically significant and economically relevant, even against a backdrop of fairly dynamic ongoing restructuring among our firms. We further find that external governance mechanisms such as stronger shareholder rights, rather than compensation contracts, can partially attenuate the distortion in investment policies caused by a CEO's career concerns.

We have shown that younger CEOs restructure more, consistent with the *Managerial Signaling Hypothesis*. Under this model, it is also predicted that younger CEOs will undertake bolder and riskier investments in a bid to signal their superior ability. They tend to overweight their own information and magnify their investment decisions in order to try and persuade the market of their superior talents (Prendergast and Stole, 1996; Serfling, 2014). Indeed we find that younger CEOs are more likely to undertake more aggressive restructuring activities; the net firm size effects of the restructuring activities are more pronounced for younger CEOs. In particular, when younger CEOs expand into new segments, they bring more job growth; when younger CEOs divest existing segments, they also shed more jobs, compared with older CEOs. Younger CEOs are also associated with increased research and development (R&D) expenditures, a type of investment that is often considered very risky (Coles et al., 2006). A CEO can initiate a new project by either building a de novo plant or by acquiring a plant from another firm. The latter is often thought of as a riskier strategy due to the significantly higher upfront, irreversible cost and also the information asymmetry between the acquirer and target (see e.g., Lee and Lieberman, 2010). Between the two ways of initiating a plant, we find that younger CEOs favor acquiring a plant from another firm over building a plant from scratch, consistent with our predictions.

We argue that the age-investment relation is driven by CEO career concerns. Several compelling alternative explanations are potentially viable and may explain the negative relation between CEO age and restructuring propensity. First, the age effects may be due to confounding firm characteristics or other known factors that determine the matching between firms and specific types of CEOs. Second, the age effects are simply picking up the effects of CEO tenure. Third, the age-investment relations are due to other CEO personal traits, such as education and overconfidence, and CEO compensation incentives. Finally, the age-investment relation may be driven by industry-specific waves.

We perform a battery of tests to deal with the first alternative explanation – confounding firm characteristics. First, we conduct a propensity score matching analysis. The idea is to compare the restructuring decisions made by two groups of firms with otherwise similar observable characteristics except for CEO's age. The age-investment relations continue to hold in this alternative specification. Second, young CEOs are more likely to manage young and focused firms and so we perform sub-sample analysis and find that the results continue to hold in various subsamples segregated based on number of business segments and firm size. Third, the age-investment relations may reflect the selection of young CEOs by firms that need more restructuring. To the extent that restructuring needs are firm-specific, we control for firm fixed effects and our results continue to hold. Fourth, a firm's

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