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CEO optimism and the board's choice of successor

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ABSTRACT

Research suggests that boards of directors select CEOs using signals of ability. However, little is known about how boards determine the combination of attributes that constitute a 'good' CEO, especially attributes without an *ex ante* clear impact on managerial quality, such as CEO optimism. I argue that boards will learn the optimal level of such attributes more quickly from past success, and empirical results support this. Boards, particularly those with high reputation/independence, are significantly more likely to select a moderately optimistic (optimal) successor following a moderately optimistic CEO departure. Robustness checks rule out alternate explanations and support this conclusion.

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1. Introduction

A wealth of literature has studied the labor market for chief executive officers (CEOs) when noisy signals of managerial ability are used in CEO selection decisions. For instance, Fee and Hadlock (2003) predict that the likelihood of a manager being hired away to be the CEO of another firm will be positively related to the performance of the manager's current firm, and support this prediction empirically. The authors motivate the study in part by noting that measures of performance, such as stock returns, are an inherently noisy measure of managerial ability (Rosen, 1992) and it is not clear *ex ante* what weight the labor market will place on such a measure. This inherent noise also suggests that the hiring firm would benefit from additional measures of the manager's impact on the firm.

However, the use of additional measures requires knowledge of the managerial characteristics that constitute 'high ability.' The prediction that the board of directors will use informative signals to hire a manager with greater ability is a relatively straightforward one, as it is clear that higher ability is more optimal, *ceteris paribus*. In a more general sense, however, 'ability' could be thought of as any characteristic that affects the manager's impact on the firm. This might include the manager's knowledge, experience, risk aversion, intrinsic motivation, biases, or any characteristic that could impact decision-making. As Kaplan et al. (2012) show, both general managerial ability and individual CEO characteristics have a significant impact on firm performance, and there is considerable variability in these characteristics that is not captured by standard observables such as age and college selectivity. Understanding the contribution of each characteristic to managerial quality may provide the hiring firm with a greater likelihood of selecting a high quality manager, even when relying on noisy signals. Thus, an interesting question is: how do boards of directors learn the specific characteristics that determine who will be an optimal manager?

More specifically, I examine whether boards of directors learn more from past hires with beneficial or suboptimal characteristics when trying to determine the set of characteristics that would constitute a high quality CEO. I explore this question in the context of a CEO characteristic that is predicted to have a non-monotonic impact on firm value: CEO optimism, or the *over*estimation of one's

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ability to positively impact average returns/payoffs. Recent theoretical and empirical results (Campbell et al., 2011; Giat et al., 2010; Goel and Thakor, 2008) suggest that moderate managerial bias is beneficial to the firm as it reduces underinvestment problems driven by managerial risk aversion. This provides an interesting setting for the analysis of board learning because it is unlikely to be clear *ex ante* that a somewhat irrational CEO may be best for the firm.

Evidence from other fields—including psychology, management, and marketing—suggests that individuals and groups may learn more quickly from negative outcomes than positive ones (Hayward, 2002; Zakay et al., 2004). This suggests that the board will learn more quickly from failure—in this context, hiring a CEO with the suboptimal characteristic of low or excessively high optimism. On the other hand, Ellis and Davidi (2005) note that while the personal motivation/desire to learn from negative outcomes is high, there may be a significant *need* to learn from positive results when the results could be driven by luck or the potential consequences of failure are high. Importantly, CEO selection decisions will meet each of these conditions. This is further complicated when multiple CEO 'types' are suboptimal, as eliminating one suboptimal characteristic will not equate to identifying an optimal one.

I argue that the board will learn more from success than failure. In particular, I predict that a board will learn more quickly that a moderate optimism CEO is beneficial (on average) through actually hiring such a CEO. I test my predictions by examining CEO selection decisions and the optimism levels of the outgoing and incoming CEOs. Following Campbell et al. (2011), I classify a CEO as having low, moderate, or high optimism based on the CEO's decisions for his/her personal and firm-level investments. I then examine the impact of the outgoing CEO's optimism level on the board's choice of successor.

Empirical results support my predictions. Boards are significantly more likely to hire a moderately optimistic CEO following the departure of a moderately optimistic CEO, consistent with learning more quickly from success than failure. Boards that had previously hired a moderately optimistic CEO are also most likely to "repeat" by selecting a successor with the same level of optimism as the outgoing CEO. Finally, boards have a greater likelihood of hiring a low (high) optimism successor when the outgoing CEO was also low (high) optimism. This may suggest that these boards started with a different prior belief about the impact of CEO optimism, and cannot quickly overcome their prior even after updating their beliefs. I also find that more diligent boards—those with greater independence or reputation—benefit more (learn more quickly) from experience hiring moderately optimistic CEOs.

Importantly, additional tests show that my results are not driven by firm or CEO characteristics that may be correlated with the measures of optimism (e.g., growth options, the firm's typical investment levels, etc.). The results also hold controlling for firm characteristics typically associated with CEO selection and when using firm random-effect models to account for unobserved firm heterogeneity. Additional tests show that the results are not caused mechanically by the optimism definitions or sample selection. Overall, the results provide strong support for my predictions and are consistent with the conclusions of prior works suggesting an interior-optimum level of managerial bias and boards of directors' desire to hire such managers.

My findings contribute to the large literature on CEO selection and growing literature on managerial biases. I contribute to the literature by providing evidence that boards learn to hire CEOs with beneficial (moderate) optimism through past experience hiring and working with such CEOs, and this learning occurs at a higher rate for more diligent boards. This suggests an additional important avenue through which board characteristics could impact the firm beyond direct monitoring or the setting of incentives. I also contribute more generally to the literature on CEO selection by analyzing board learning regarding the benefits of CEO characteristics when it is not clear *ex ante* what value of the CEO characteristic is optimal for the firm. While studies in other fields suggest that learning may occur more quickly following failure rather than success, the opposite appears to be the case for board learning when the cost of failure is high, luck can drive the result, and multiple values of a CEO characteristic can lead to a negative outcome.

The remainder of the paper is structured as follows. Section 2 discusses the prior literature and hypotheses. Section 3 describes the data and measures, while Section 4 presents the results and rules out alternate explanations. Section 5 concludes.

2. CEO optimism, board learning, and empirical predictions

An emerging area of research examines the implications of managerial biases in decision-making, such as managerial optimism or overconfidence, for firm level outcomes including investment decisions, agency costs, and CEO turnover/promotion. For instance, Giat et al. (2010) develop a structural model of the principal-agent problem when the manager is optimistic, or overestimates average project returns/payoffs, and must raise funding for investment. In their model, moderate optimism can lead to more optimal investment decisions and reduce agency costs, while highly optimistic CEOs overinvest and are thus detrimental to the firm. Results from calibrating this model to R&D project investment data further support these predictions.

In a related vein, Campbell et al. (2011) show theoretically that a CEO with moderate optimism will invest closer to a first-best level, and predict that such CEOs will be less likely to face forced removal by the board of directors. The authors support this prediction empirically, documenting that CEOs with moderate optimism face a significantly lower likelihood of forced turnover than CEOs with very low or very high optimism. Similarly, Goel and Thakor (2008) predict theoretically that moderate managerial overconfidence (the underestimation of risk) will lead to better investments decisions, promotion, and lower likelihood of forced turnover.

A prediction common to each model, and supported by empirical tests, is that moderate CEO bias can decrease underinvestment problems due to managerial risk aversion. However, highly biased CEOs will tend to overinvest, decreasing firm value. For example, Malmendier and Tate (2008) show that overconfident CEOs overpay for targets and are more likely to engage in value-destroying acquisitions. Consistent with this result, the authors also find that shareholders react more negatively to takeover announcements when the CEO of the bidding firm is overconfident. This suggests that biased CEOs can harm the firm and decrease shareholder value. In theory, the board should update its estimate of the CEO's bias by observing the CEO's decisions, and remove a CEO if it believes that the CEO has a suboptimal level of bias. An important conclusion from these works is that CEOs with a moderate level of bias are more optimal for shareholders, and the board should seek to hire and retain such CEOs while replacing suboptimal ones.

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