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Silverback CEOs: Age, experience, and firm value☆

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ABSTRACT

Approximately half of S&P 1500 firms have adopted policies mandating retirement based on age. This study investigates the merits of CEO mandatory retirement policies (MRPs) using a sample of 12,610 firm-year observations from 2143 unique firms. It also addresses the question of whether CEO age is relevant to the success of an organization. We fail to find consistent evidence that MRPs are intended to limit CEO entrenchment. MRPs are, however, positively associated with CEO age and negatively associated with firm-specific human capital. Further analysis reveals that CEO age is significantly negatively related to firm value, operating performance, and corporate deal-making activity. Splitting our sample according to whether an MRP is in place, we observe that the negative impact of age exists only for those firms which do not have MRPs. We therefore conclude that MRPs represent an effective form of firm governance designed to mitigate the underperformance of older CEOs.

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1. Introduction

Many CEOs do not have the opportunity to continue their career late in life. Approximately half of S&P 1500 firms have adopted policies mandating retirement based on age. The legendary Jack Welch trounced the Dow Jones Industrial Average during his twenty-year tenure as CEO of General Electric from April 1, 1981 to September 1, 2001. Over this period GE's stock price increased by 2200% compared to 730% for the Dow. Despite this performance, he was forced to step down shortly after his 65th birthday due to GE's retirement policy.

This issue surfaced in the Ontario legislature with a proposal to abolish mandatory retirement ages in the Canadian province. Bill 211, also known as the Mandatory Retirement Statute Law Amendment Act, was passed on December 8, 2005. A survey conducted by COMPAS Inc. prior to the bill's passage revealed that over 90% of Canadian executives were opposed to any form of mandatory retirement. One CEO respondent to the survey stated that “although he works a shorter week and has less energy, he still has the skills, determination and drive to run his business. ‘I challenge anyone younger that has more flexibility, management ability, problem-solving ability and all the good things needed in a business’” (Evans, 2005).

Not everyone agrees, however, that chief executives should be allowed to manage an enterprise well into their golden years. The Conference Board has expressed concern regarding aging CEOs continuing beyond their ability. “Many an aging CEO finds that

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the kinds of companies he was trained to manage no longer exist. Senior executives, for instance, often find it hard to connect with younger staffers whom they find uncoachable" (Krohe, 2005). Interestingly, an article in *The Wall Street Journal* (Ante and Lublin, 2012) raises precisely this point, noting that the "ascension [of young CEOs] is airing anew arguments about the value of youth in corporate decision-making. The debate typically pits the benefits of creativity and familiarity with emerging technologies against the need for disciplined decision making and experience dealing with hard times."

Mandatory retirement policies are programs implemented by shareholders to force the retirement of a CEO or director at a specified age. These policies are typically initiated through shareholder proposals and therefore represent an alternative form of corporate governance. This study investigates the prevalence of CEO mandatory retirement policies (MRPs) and their determinants. It also addresses the question of whether the age of the CEO is relevant to the success of an organization. In doing so, it sheds light on the mandatory retirement age debate and offers perspective to the value consequences of hiring a young or old CEO.

We offer two potential motivating factors for a firm adopting an MRP. First, since they are the outcome of shareholder-initiated proposals, they represent a mechanism through which shareholders can circumvent the undue influence that a powerful CEO might have over the board of directors and force his or her removal. Under this *CEO Entrenchment* hypothesis, one would expect the incidence of MRPs to be increasing in the presence of an entrenched CEO. MRPs might also simply be increasing in CEO age as shareholders perceive that an aged CEO is no longer able to maximize shareholder wealth. This *CEO Age* hypothesis suggests the likelihood of an MRP would be increasing in CEO age.

However, when MRPs remove an older CEO, the firm will likely forfeit years of acquired company-specific experience and this may present a deterrent to implementing these policies. During his forty-plus tenure at General Electric, Jack Welch accumulated a significant amount of firm-specific human capital. Unfortunately for GE's shareholders, much of this experience was non-transferable. Despite extensive consulting arrangements between Welch and his hand-picked successor, Jeff Immelt, the company languished following Welch's departure in 2001. We therefore examine the association between CEO acquired human capital and the likelihood of a firm having an MRP.

To examine the effects of CEO age and acquired firm experience, we present two alternative hypotheses which challenge the null that management's age and experience are unrelated to the value of the firm. Both hypotheses are presented under the contention that managerial ability is an input factor for production valued by investors. The *CEO Age* hypothesis predicts that firm value is decreasing with CEO age due to documented neurophysiological changes in cognitive ability as a person ages. The *Firm-Specific Human Capital* hypothesis predicts that the CEO's experience offsets this effect, as acquired company knowledge leads to improved firm performance and increased shareholder value.

We examine 12,610 firm-year observations from 2143 unique firms and find that the presence of an MRP is not associated with proxies for CEO entrenchment. However, MRPs are positively related with CEO age and negatively associated with the amount of firm-specific experience. These findings suggest that shareholders not only perceive the costs of retaining an aged CEO to be significant, but also consider their experience when deciding on their retirement policies. Further tests reveal that CEO age is significantly negatively related to Tobin's q after controlling for known covariates, omitted variables, and potential endogeneity. Parameter estimates imply that investors discount firms by as much as 0.34% each year the CEO ages. However, the results indicate that experience mitigates the negative impact of age as firm-specific human capital is significantly positively related to firm value.

Further tests reveal that the age related deficit is not transitory. Estimations of long-run abnormal portfolio returns grouped according to age indicate that firms with CEOs 42 and under outperform those with CEOs 68 and older. However, intra-cohort differences between experienced and inexperienced CEOs reveal that the underperformance of the 68 and older CEOs is only observed with the inexperienced CEOs. Two explanations for these results are supported empirically. First, we show that firms led by older CEOs are less likely to engage in firm activities such as mergers, joint ventures or strategic alliances, divestitures, and capital restructurings. Second, we find that CEO age is negatively related to industry-adjusted return on assets as CEOs 42 and under outperform those 68 and over by as much as 155 basis points per year. Nonetheless, the amount of invested firm-specific human capital continues to be beneficial as it is significantly positively related to industry-adjusted ROA. Collectively, our evidence suggests that, while retaining an aging CEO with accumulated firm-specific experience has positive effects on firm value, hiring an older outside CEO with little institutional knowledge may be detrimental to firm value.

Finally, we revisit MRPs to determine if these policies are effective in mitigating the underperformance of older CEOs. Splitting our sample according to whether a firm chooses to adopt an MRP, we observe that the negative impact of CEO age on firm value and performance exists only for those firms which choose not to adopt these policies. We therefore conclude that MRPs represent an effective form of firm governance designed to mitigate the underperformance of older CEOs.

2. Literature review and hypothesis development

2.1. CEO entrenchment hypothesis

The literature documenting the importance of management to shareholder value is vast. Zingales (2000) argues that successful firms capture growth opportunities that other firms are either unable to take advantage of or simply overlook. Fama and Jensen (1983) charge senior management with the responsibility of initiating and implementing strategies which explicitly take advantage of these opportunities. Managerial power or CEO entrenchment can, however, allow for agency problems and often coincides with disappointing operating and stock performance to the detriment of the firms' shareholders. Under this managerial power

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