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Stockholder Reactions to CEO Changes in Large Corporations

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STOCKHOLDER REACTIONS TO CEO CHANGES IN LARGE CORPORATIONS

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The literature on leadership suggests that the performance context of a succession event and the origin of a newly appointed leader moderate the relationship between the succession and its consequences for performance in large corporations. We tested that premise with data from 477 large corporations and a measure of excess stock market returns. The findings show that investors are most favorably predisposed to successions in which outsiders are appointed to financially healthy firms.

The scholarly and business worlds alike are giving increasing attention to executive accountability, partly because pressures from stockholder groups are mounting on this issue. Researchers, however, remain divided as to whether appointing a new leader influences the performance of a large organization. Some have found that leadership doesn't matter: a leader will not alter performance because organizations—particularly large ones—tend to run themselves (Hannan & Freeman, 1977; Lieberson & O'Connor, 1972; Mintzberg, 1979). Thus, the replacement of a leader also will not matter; succession becomes ritual scapegoating (Gamson & Scotch, 1964). Others have found that leadership does matter (Weiner & Mahoney, 1981) but that the disruption that succession causes cancels the positive effect of replacing an unsuccessful manager (Pfeffer & Davis-Blake, 1986). Still other researchers have argued that whether a new leader has a positive, neutral, or negative influence on performance depends on the match between the leader's characteristics and the job requirements (Gupta & Govindarajan, 1984; Hambrick & Mason, 1984). However, subsequent studies have not uncovered a consistent set of contingent factors that explain when a positive succession-performance relationship will occur in large corporations (Beatty & Zajac,

1987; Friedman & Singh, 1987; Furtado & Rozeff, 1987; Lubatkin, Chung, Rogers, & Owers, 1986; Reinganum, 1985).

There are at least three reasons, however, to investigate further the possibility that executive succession can influence the financial performance of large organizations. First, compelling anecdotal evidence from the business world supports the position that leadership can make a difference in large organizations. For example, it is difficult to overlook the contributions of Jack Welch at General Electric, John Opel at IBM, and Lee Iacocca at Chrysler Corporation. Second, most studies have overlooked the presuccession performance of firms experiencing succession and failed to consider the origin of a successor in light of that context. Research on corporate turnaround (Hofer, 1980; Schendel, Patton, & Riggs, 1976) and on the causes of executive succession (Dalton & Kesner, 1985) has, however, recognized the importance of these two contingent factors, as did Hall (1987), who argued that a leader is important only in times of organizational crisis, change, and growth.

Third, some of the ambiguity surrounding the succession-performance issue may originate in the way that financial performance is defined. Succession studies have traditionally defined performance by an accounting-based measure such as return on assets or by a security market–based measure such as abnormal returns. The finance literature, however, has developed a strong case for using a security market measure called excess returns (Scholes & Williams, 1977). This measure overcomes the principal criticisms of the abnormal returns measure and grants researchers the advantages of using stock market data. Only recently have data files existed that allow researchers to adopt this measure in large-sample studies.

The present study extended past research efforts by examining two factors that are believed to be important determinants of succession and leadership effects: organizational context, in terms of presuccession performance, and successor's origin as an insider or as an outsider. Using a multiple regression design, we simultaneously considered the independent and interactive effects of those two contingent factors while controlling for organizational size. We calculated the dependent variable, excess returns, over various time horizons to distinguish between succession effects and longer-term leadership effects. Finally, a large data set (477 instances of appointments) permitted a rigorous testing of hypotheses relating chief executive officer (CEO) succession to performance.

PREVIOUS RESEARCH

Performance Context

Previous research has suggested that the performance of an organization before a leader's replacement is an important contextual factor. For example, organizational performance is a major determinant of executive tenure (Allan & Panian, 1982; James & Soref, 1981; Salancik & Pfeffer, 1980), and executive replacement is a common response to poor financial performance (Brady & Helmich, 1984; Dalton & Kesner, 1985).

Strategic management and organization theory scholars have also asserted that an organization's performance influences its adaptiveness (Bourgeois, 1981; Dutton, Fahey, & Narayanan, 1983; Litschert & Bonham, 1978). Firms that can generate resources in excess of their needs to pay suppliers, develop markets, attract employees, fend off competitors' attacks, and otherwise engage in basic business activities have "slack." Slack gives an organization the luxury of making decisions that are based on extensive information searches (Fredrickson, 1985), maintaining stability through intermittently good and bad times (Cyert & March, 1963), and attracting capital at low cost from the debt and equity markets (Porter, 1985). Slack may also foster creative behavior (Bourgeois, 1981), a motivated and committed work force (Gupta & Govindarajan, 1984), and a culture that identifies with winning; opposite effects are expected in low-performance settings. In addition, the leaders of high-performing firms should perceive a wide array of investment options and be granted great discretion in adjusting to environmental influences (Hambrick & Finkelstein, 1987).

It is tempting to conclude that leaders who inherit a high-performance context have greater opportunity to affect future performance than leaders who inherit a low-performance context. However, low performance may also influence the adaptiveness of organizations, although the process is quite different. Low performance is associated with a sense of urgency and a departure from some desired status quo. Although managers may lack the time and resources for extensive information searches during times of low performance, their decisions may be at least as rational and have as much impact as those made in a high-performance context. As Cyert and March (1963) observed, poor performance pressures managers to make precise, discriminating decisions because they have little margin for error. Mintzberg, Raisinghani, and Theoret (1976) noted that during times of high performance managers tend to direct attention to problems but are more casual with opportunities, which they assume can be exploited. Hall (1987) viewed both performance contexts as important.

Two studies have examined the role of presuccession performance in explaining stock market reactions to succession events. Lubatkin and colleagues (1986) found no relationship, and Friedman and Singh (1986) found (at the .10 level of significance) that when presuccession performance is poor, the market's reaction to succession tends to be positive. The two studies share three potential research flaws. Both dichotomized the context variable into high- and low-performance categories rather than letting it remain continuous and thus lost information that may have borne on their results. They used as their dependent variable a short-term measure of abnormal return that may have failed to capture the full stock market reaction to the succession events. Finally, they failed to adequately account for another important contextual factor, organizational size.

Given the drawbacks in past studies of the performance-context issue and the conflicting theories on the subject, we will again test the following general hypothesis:

Hypothesis 1: Holding size constant, the performance of a firm at the time of a succession event will affect the ability of a newly appointed leader to influence future earnings.

Successor Origin

Previous research has also supported the existence of a linkage between the origin of a successor and firm performance. For example, during a small-sample field study, Kotter (1982) observed that outsiders who lacked a thorough understanding of the business that they were inheriting generally contributed less to their organizations than did insiders. Further, outsiders have a greater disruptive influence on an organization (Allen, Panian, & Lotz, 1979), which may in turn produce negative outcomes like a decline in morale and an increase in turnover (Grusky, 1964). Finally, an outside appointment may signal the failure of a firm's human-capital-investment program to develop depth in its management ranks and therefore raise questions about the firm's ability to compete in the future (Furtado & Rozeff, 1987).

As with performance context, the linkage between successor origin and future organizational performance remains conceptually appealing but empirically ambiguous. Lubatkin and colleagues (1986) and Friedman and Singh (1987) found that outside appointments produced significantly higher abnormal returns than inside appointments. Furtado and Rozeff (1987) found the opposite, and Beatty and Zajac (1987) found no distinction between the two types of appointments. Reinganum (1985) found significant, positive abnormal returns only for outside appointments in small firms in which the announcement of the appointment coincided with the announcement of the departure of the former officeholder. None of these studies has explicitly accounted for the size of each firm studied, though all have recognized that size is a potentially important covariate.

In light of the inconsistent findings about successor origin,

Hypothesis 2: Holding size constant, the origin of an appointed successor will affect his or her ability to influence future earnings.

Interactive Effects

A contingency view of management succession suggests that whether a new leader has a positive, neutral, or negative influence on performance depends on how well the characteristics of the leader match the requirements set by the context of a job (Fiedler, 1964; Gupta & Govindarajan, 1984; Hambrick & Mason, 1984). Consistent with this view, we developed an additional hypothesis that recognizes that the different task demands associated with high- and low-performing firms may require the different leadership influences associated with outside and inside appointments.

A contingent relationship is expected for firms that are performing poorly at the time of a succession event. Previous research suggests that outsiders will be more able to turn such firms around than will insiders

(Bibeault, 1982; Hofer, 1980; Starbuck, Greve, & Hedberg, 1978; Schendel & Patton, 1976). Because insiders may have a limited perspective (Cyert & March, 1963), they are less able to deal with changes in an organization's environment (Hambrick & Mason, 1984). In contrast, outsiders have been associated with organizational adaptiveness and change since they have less commitment to an organization's strategies and values (Helmich, 1975; Pfeffer, 1981). As a result, they are more likely to alter its mission, objectives, and strategy (Pfeffer & Salancik, 1978).

The opposite contingent relationship is expected for high-performing firms. Because insiders are less disruptive to an organization than outsiders (Brown, 1982; Helmich, 1977), they may be more able than outsiders to maintain high performance.

> Hypothesis 3: The performance of a firm prior to a change in leadership and the origin of a successor moderate the relationship between executive succession and subsequent earnings. Specifically,

> Hypothesis 3a: Outsiders will have a more positive impact on performance in low-performing firms than insiders will.

> Hypothesis 3b: Insiders will have a more positive impact on performance in high-performing firms than outsiders will.

Organizational Size: An Extraneous Influence

Many studies of leadership have recognized the importance that the size of an organization has for the ability of a leader to influence performance. For example, large organizations are associated with entrenched power structures that help to insulate top management from external pressures. As a result, it seems that large organizations are more likely than small ones to replace top managers from inside (Dalton & Kesner, 1983; Furtado & Rozeff, 1987) and more likely to minimize the influence that a new leader may have on corporate performance (Hall, 1987; Hannan & Freeman, 1977). Although most succession studies have not established explicit controls for size, it follows that such controls are important. The studies by Furtado and Rozeff and by Reinganum established categorical controls by arbitrarily splitting their samples into two size groupings, large and small firms, and then presenting abnormal returns for each. A limitation with categorical controls is that they lose information that may have a bearing on the results. The present study controlled for the effects of size by including it as a continuously scaled independent variable in a multiple regression equation.

METHODS

Sources of Data

An exhaustive list of firms in which a succession had taken place and the origins of the successors were identified from *Forbes's* annual June is-

sues about executive compensation. Because these issues list the 800 firms with the highest paid executives, the population is biased toward organizations that believe in the importance of leadership, at least in so far as high salaries are evidence. Indirect support for this assertion comes from a study by Coughlan and Schmidt (1985), who found compensation (salary plus bonus) to be significantly related to abnormal stock-price performance. We identified 1,187 CEO successions during the period 1971–85. We then excluded CEO appointments where we could not clearly identify the first public announcement in the *Wall Street Journal* and all appointments in firms that made confounding announcements of major corporate events such as mergers, dividend changes, and capital expenditure plans during a two-month period (50 trading days) before the succession announcement ($t - 50$, $t - 1$). We used that criterion to control for the possibility that announcements of other events might bias findings attributed to an executive appointment. The period over which we measured presuccession performance (described under Independent Variables) was also carefully screened for possible takeover bids, succession events, and other major corporate events that might conceal the firms' long-term performance trends. Also, the appointments made had to be lasting; we excluded firms that made a second CEO appointment during the 200 trading days after the succession event we were studying. In short, the general selection rule followed was to exclude a succession event if there was reasonable evidence of a potentially confounding event. A total of 573 cases remained. Of those, 505 met an additional requirement for inclusion which was that the firm be listed on the Center for Research in Security Prices (CRSP) Daily Excess Returns Data File for a full 300 trading days (approximately 15 months) before and after the succession announcement so that we could obtain estimates for the five dependent variables (see Time Frame) and the performance-context variable. A final criterion for inclusion had to do with determining the origin of the successor: we excluded 28 cases from further investigation because the successor did not fall into either origin category (categories are described under Independent Variables). The final group therefore included 477 succession cases at 357 firms and represented 40 percent of the 1,187 cases identified in *Forbes*.[1]

Dependent Variable: Excess Returns

Given the limitations of accounting-based measures, researchers in management have given more attention to the use of capital market measures to evaluate the effect of events like management succession (Lubatkin & Shrieves, 1986). These measures are ex ante measures in that they reflect investors' expectations of future performance. As such, capital market measures contrast with traditional accounting-based measures, which are ex post, reflecting historical performance patterns. Capital market measures

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[1] Eight percent of the group were delisted from public listings between 14 and 60 months after the announcement of the CEO changes we studied.

assess the influence of an event on a firm's security (common stock) by estimating the normal, or expected, return to the stock in the absence of an event. The abnormal, or unexpected, return to the stock is the difference between its observed return and its expected return. Positive abnormal returns suggest that stockholder value is being created.

Theoretically, abnormal returns represent an unbiased estimate of investors' evaluation of the changes in future earnings that they expect because of some firm-specific event, such as a change in leadership, and not because of overall market movements. Thus, abnormal returns should be a strong surrogate for actual economic performance. In practice, however, the market model's ordinary-least-squares estimates of abnormal returns suffer from a potentially serious econometric problem. The problem results from nonsynchronous trading of securities: many securities are traded infrequently, and their prices are therefore only reported at distinct random intervals. This irregularity makes calculations of returns "for almost all securities biased and inconsistent" (Scholes & Williams, 1977: 310). To date, researchers have tolerated this bias because of computational difficulties associated with correcting for it.

In 1983, CRSP made available a daily returns file that corrects for nonsynchronous bias. For this file, called the Daily Excess Returns File, CRSP computes excess returns, or the unbiased analogues of abnormal returns, through a three-step procedure originally developed by Scholes and Williams (1977). First the Scholes-Williams beta, or systematic risk, is computed for each security using a three-day moving-average market window. Beta, or systematic risk, represents the sensitivity of a firm's returns to overall stock market trends. The three-day moving average ensures against potential nonsynchronous trading problems (Brown & Warner, 1985). Next, on the basis of average annual betas, CRSP ranks all securities traded on the New York and the American Stock Exchanges into ten risk classes; the first contains securities with betas in the 90th percentile or higher, the second, securities with betas in the 80th to 89th percentiles, and so on. Finally, excess returns are computed for each firm for each day by (1) calculating the firm's one-day common stock return, which is change in price after adjustment for any stock splits or dividends, (2) identifying the risk class that most closely matches the firm's level of systematic risk, and (3) calculating the one-day portfolio returns of all firms in that risk class and then subtracting that return from the firm's stock return. The Appendix details this three-step procedure.

In addition to correcting for nonsynchronous bias, excess returns use a superior benchmark, or control, to represent normal or expected returns. Whereas abnormal returns are calculated for each firm by comparing its returns to some market-wide adjusted average, excess returns compare a firm's returns only to the returns of firms in the market that have similar levels of systematic risk. To the extent that firms that have similar risk profiles are also similar along various dimensions that determine systematic risk and stockholder return, such as organizational size (Ben-Zion & Shelit,

1975), financial leverage (Hamada, 1972), cyclicality (Fabozzi & Francis, 1979), and market power (Moyer & Chatfield, 1983), excess returns will better control for influences extraneous to research objectives than will abnormal returns.

All capital market measures, including excess returns, however, suffer from one shortcoming: they can only estimate the full impact of wholly unanticipated events. Succession events are not likely to be wholly unanticipated; indeed, we could argue that all leadership changes are partially anticipated, except, of course, those caused by the untimely death of an incumbent. This shortcoming, however, need not invalidate the use of market measures for hypothesis testing. First, early anticipation biases the results against finding stock returns that differ in a statistical sense from their expected level, thus promoting a conservative test (Beatty & Zajac, 1987; Brown & Warner, 1985). Second cumulating excess returns over various time horizons surrounding an announcement day allows approximation of the impact of early investor awareness on stock returns. A later section discusses the issue of time frame and describes the horizons used in this study.

Independent Variables

The performance context of firms at the time of the succession events was approximated by cumulating their excess returns over 200 trading days (approximately 9.5 months), beginning 300 trading days before the first public announcement of an executive change. This period should be adequate to capture long-term trends in investors' expectations of future earnings and thus should approximate firm performance in the absence of a change in leadership. We excluded the 100 trading days immediately preceding the announcements to minimize the chance that the succession events themselves would bias the context measures, which would be the case if investors anticipated events before their first public announcement. The validity of the context variable used in this study to represent the financial well-being of a firm at the time of the succession event can be gauged by observing the ratio of succession firms we studied with negative context measures —those performing less well than firms with similar risk—and those with positive context measures. Inasmuch as executive replacement is a common response to poor performance, a valid context measure should find most successions to be in poorly performing firms. Indeed, about 65 percent of the firms used in this study performed less well than firms with similar risk during the designated context period. A chi-square statistic significant to the .01 level suggested that the observed frequency of low-performing firms differed from what would be expected if below-market performance randomly occurred in the population.

The origin of the successor CEO was determined in a straightforward categorical way with one provision: to avoid blurring the distinction between insider and outsider, we designated an insider as a successor who had

at least five years of tenure with the firm in question and an outsider as a successor who had not been with the organization for more than one year before moving to the top. In virtually all cases, outsiders were brought directly into the position of CEO. Thus, the definition used in this study represents extreme cases of outside appointments and is comparable to Vancil's definition of recent outsider (1987: 262), rather than to his broader definition of outsider (1987: 56). We excluded cases that did not fall into either category from further investigation. Computationally, origin is a dichotomous dummy variable defined as 0 if a successor was an insider and as 1 if a successor was an outsider. We examined possible moderating effects of context and origin by including an interaction variable in the multiple regression model.

A final independent variable, corporate size, was added to the regression equation as a control variable. We measured size as a continuous independent variable, by calculating the logarithm of each firm's stock market capitalization (price per share times number of shares outstanding) on the last trading day of the year immediately preceding the year of a CEO appointment. We also controlled size by limiting the population of succession cases to large organizations. Finally, we checked correlation of size with the other independent variables to determine if size was an important covariate.

Time Frame: Selecting the Relevant Horizon Length

If a change in CEO is viewed as a favorable indicator for future earnings, the market price of a firm's stock will increase as investors learn of a leadership change. The problem facing researchers is determining exactly when investors know all succession-related information (Malatesta & Thompson, 1985). Studies in finance journals have tended to define the relevant succession time frame as the announcement day plus the trading day preceding it (Furtado & Rozeff, 1987).

Studies in management journals, however, have argued that the two-day announcement effect may not capture the full market evaluation of a succession event (Beatty & Zajac, 1987; Lubatkin & Shrieves, 1986; Reinganum, 1985). For example, Reinganum discussed the possibility of information leaking to the marketplace before a change in leadership is officially made public. He also recognized the possibility of noninstantaneous investor reactions occurring during the period after an announcement. For the current study, therefore, we cumulated excess daily returns over five different horizons and then performed multiple regression analyses on each. Figure 1 illustrates the five horizons.

One horizon is the commonly used 2-day announcement period ($t - 1$, $t = 0$), in which $t = 0$ is the day of the first public announcement of a succession and $t - 1$ is the trading day immediately preceding the announcement day. The results of such short-term analysis should capture investors' perceptions about the effects on a firm's future earnings of a suc-

FIGURE 1
Various Time Horizons Surrounding Succession Announcements
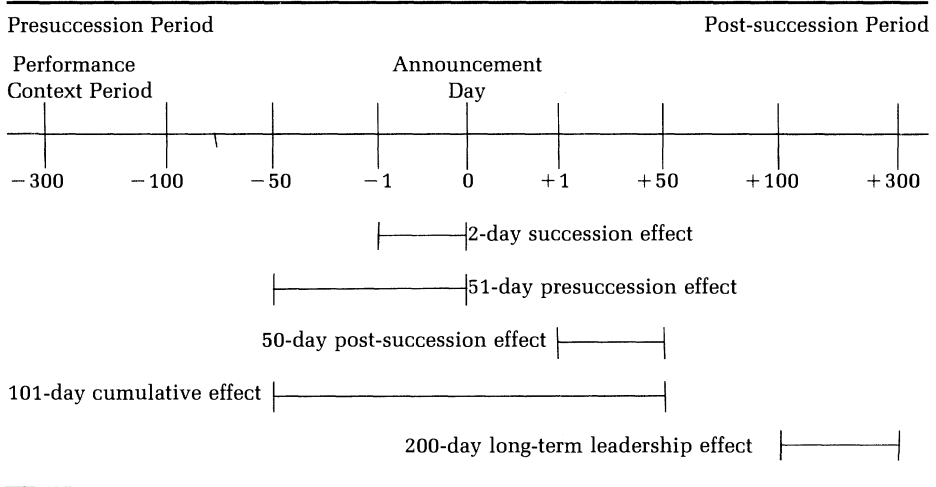
cession event itself, rather than the anticipated effect of the newly appointed leader.

The second horizon ($t - 50$, $t = 0$) is a period of about two and a half months (51 trading days) preceding and including an announcement day; it is designed to capture early market awareness of a leadership change. Although it was not possible to identify the precise date of market awareness for each firm, the time period examined here should be long enough to capture most succession-related information and short enough to avoid any serious bias from unrelated, firm-specific events.

The third horizon ($t + 1$, $t + 50$) allowed us to examine excess returns during the two-and-a-half-month period immediately following an announcement day. With the uncertainty resolved concerning *if* and *when* a leadership change will occur and *who* will be appointed, investors can re-evaluate their initial expectations about future earnings. Further, investors are likely to form their revised perceptions on the basis of a different set of factors, those that can only be known with certainty after the appointment of a new leader. This situation pertains particularly if investors did not anticipate who the new leader would be.

The fourth horizon ($t - 50$, $t + 50$) covers the full 101 trading days surrounding and including an announcement day and allows cumulation of the returns for the second and third horizons.

The final horizon ($t + 100$, $t + 300$) captures the performance of firms over a nine-and-a-half-month period beginning 100 trading days after a succession announcement. This period should be adequate to capture long-term trends in investor expectations but be free of any residual succession effects. Further, the results for this horizon may best capture leadership effects be-

cause it approximates a period when a new leader is likely to make substantive changes in strategic and operational domains.

Methods of Analysis

A multiple regression equation for both the independent and interactive effects of the two contingent factors and the independent effects of corporate size on stockholder returns, the dependent variable, was developed in the following form: excess returns = f (context, origin, context × origin, size).

Although the signs and magnitude of the regression coefficients are sufficient for testing the significance of the interaction between context and origin, they do not say much about the form of the contingency relationship. Specifically, the coefficients alone may not allow for clear inferences about when it is best to hire an insider and when an outsider. By segregating the firms by origin and by performance context, we pushed the analysis of the third hypothesis to a second stage. In order to dichotomize the context variable, we first ranked firms according to their context measure and then partitioned the ranking into approximate thirds. The high-performing third consisted of firms with positive context measures, or firms that demonstrated the ability to yield returns better than the security benchmark returns during the designated context period. The low-performing third consisted of firms with strongly negative context measures. In order to maximize contrast, we excluded the middle third from this investigation but included it in the regression analysis. We then calculated a mean measure of excess returns for each of the four possible contingencies that come from the intersection of the two origin and context classifications. Finally, separate two-tailed t-tests of mean differences were used to statistically compare investors' reactions to insider and outsider appointments to each of the two presuccession contexts.

RESULTS

Of the 477 succession cases analyzed, 305 firms (65 percent) performed less well than firms with similar risk during the designated context period. Inside appointments were involved in 423 firms. The low percentage of outside appointments (11.3%) is consistent with the findings of other succession studies in large corporations. For example, Beatty and Zajac (1987) found the incidence of outsiders to be 12 percent and Friedman and Singh (1987) found it to be 15 percent. Also, Furtado and Rozeff (1987) found that as firm size increased, the incidence of outsiders decreased.

Finally, the current data are heavily biased toward largeness. The mean equity market capitalization is $1,825 million, with a minimum of $17 million (Allied Supermarket in 1975) and a maximum of $46,792 million (IBM in 1982). The firms are therefore considerably larger than the typical large firm in Reinganum's (1985) sample, which had a median market value of $280 million. Finally, only 21 firms (4.4%) in the current sample had market values below $65.5 million, the size used by Reinganum to separate large firms from small ones.

In sum, the high incidence of poor performance before changing CEO, the low incidence of outside appointments, and the overall largeness suggests that the set of firms collected in the present study adequately represents the population of large industrial organizations at a time when they change their CEOs.

Table 1 presents the means, standard deviations, and intercorrelations of all variables. Table 2 summarizes the results for the 51-day preannouncement period $(t - 50, t = 0)$, the 50-day post-announcement period $(t + 1, t + 50)$, and the 101-day cumulative succession period $(t - 50, t + 50)$. Similarly, Table 3 summarizes the results of the multiple regression equation performed on excess returns during the 2-day announcement period $(t - 1, t + 0)$ and the 200-day long-term leadership period $(t + 100, t + 50)$.

Overall, investors are not indifferent about changes in leadership. Rather, the means in Table 1 shows that investors, on the average, revise downward their earnings expectations, driving down a firm's stock price an average 1 percent during the preannouncement period $(p < .01)$ and an additional 3.5 percent during the 50-day post-announcement period $(p < .01)$. These findings suggest that investors do not view CEO succession as unimportant or as an exercise in ritual scapegoating (Gamson & Scotch, 1964). Further, they suggest that investors do not generally hold an overly "romanticized view of leadership" (Meindl, Ehrlich, & Dukerich, 1985). To the contrary, investors appear skeptical about the alleged positive intentions that motivate succession decisions. However, as predicted, the consequences of succession for performance depend on the conditions surrounding the event.

The hypothesis about context (Hypothesis 1) received partial support. As expected, the performance of a firm during the time preceding a succession event influences investors' assessment of executive changes, at least during the 51-day presuccession horizon, as reported in Table 2. During this presuccession period, the influence of context on excess returns is positive and significant $(p < .05)$, indicating that the better firms perform before changing CEOs, the more favorably predisposed investors are to a change. However, context as an independent factor does not appear to have an important bearing on investors' expectations during the 50-day post-succession period (Table 2) and the 2-day announcement period (Table 3), suggesting that the information value of context as it relates to a succession event is fully discounted by the time an event occurs. Finally, context again appears to influence investors' expectations during the 200-day post-succession period, although the causation is weak $(p < .10)$ and inverse (Table 3). We posited that during this stewardship period, investors base their expectations on their assessment of a leader's initial strategic and operational decisions rather than on the effects of succession per se.

The results also indicate partial support for the hypothesis about origin (Hypothesis 2). In the case of outside appointments, origin appears to have positive and significant effects on investors' expectations for all time frames

TABLE 1
Means, Standard Deviations, and Intercorrelations for All Variables[a]

Variables[b]	Means	s.d.	1	2	3	4	5	6	7	8
1. Context	-0.07**	0.25								
2. Origin	0.11**	0.31	-.06							
3. Interaction term	-0.01**	0.11	.42**	.15**						
4. Logarithm of size	6.13**	3.43	-.05	-.13**	.07					
5. Daily excess returns (-1, 0)	0.00	0.04	-.00	.08*	.04	-.03				
6. Daily excess returns (-50, 0)	-0.01**	0.12	.12**	.04	.07	.03	.21**			
7. Daily excess returns (1, 50)	-0.03**	0.13	.07	.09*	.09*	.02	.00	-.09*		
8. Daily excess returns (-50, +50)	-0.04**	0.17	.14**	.09*	.12**	.04	.15**	.65**	.70**	
9. Daily excess returns (100, 300)	-0.05**	0.24	-.09*	.10**	-.08*	.02	.02	-.01	.11**	-.01

[a] $N = 477$

[b] Daily excess returns are cumulated over the time frame indicated within the parentheses.

† $p < .10$

* $p < .05$

** $p < .01$

TABLE 2
Results of Multiple Regression of Succession for Three Time Horizons

Variables	51-day Presuccession Period[a]		50-day Post-succession Period[b]		101-day Cumulative Interval[c]	
	Betas	Standard Errors	Betas	Standard Errors	Betas	Standard Errors
Intercept	−.004	.015	−.022	.015	−.027	.020
Context	.057*	.025	−.005	.024	.052	.033
Origin[d]	.029	.019	.055**	.019	.084**	.025
Interaction of context and origin	.025	.060	.156**	.058	.181*	.078
Size	.000	.002	−.002	.002	−.002	.003
$F_{4,472}$	2.31*		3.76**		5.42**	
R^2	.02		.03		.04	

[a] Period defined as $t - 50, t = 0$
[b] Period defined as $t + 1, t + 50$
[c] Period defined as $t - 50, t + 50$
[d] Origin is a dichotomous dummy variable with 0 = inside successor, 1 = outside successor.
† $p < .10$
* $p < .05$
** $p < .01$

except the 51-day presuccession period. The findings, therefore, clearly suggest that investors view an outside appointment as having a more favorable impact on earnings than an inside appointment. Further, the origin findings are noticeably different from the context findings regarding when each influences investors' expectations: investors appear to be more concerned with the context of succession events before CEO changes and more concerned with the origin of new leaders after the changes. Apparently, investors have no accurate knowledge of information embedded in the broad origin measure on the likelihood of strategy, policy, and administration changes until after a successor is announced.

Perhaps the most interesting results come from testing Hypothesis 3. During the 50-day post-succession period, the time after investors have discounted the effects of context, new information, such as origin and origin in light of context, appears to influence investors, as shown by a positive interaction term ($p < .01$). Similarly, the 101-day cumulative period also reveals a positive and significant interaction term ($p < .02$).

Finally, the regression model as a whole does not explain much variance in excess returns, as evidenced by the low R^2 statistics. However, the F-statistics reveal that the model does account for significant variance in excess returns for all but the 2-day announcement period. A significant F suggests that at least one hypothesized relationship is not equal to zero.

TABLE 3
Results of Multiple Regression of Succession for Two Time Horizons

Variables	2-day Succession Period[a]		200-day Leadership Period[b]	
	Betas	Standard Errors	Betas	Standard Errors
Intercept	−.001	.004	−.041	.029
Context	−.004	.007	−.083†	.048
Origin[c]	.012*	.006	.068†	.037
Interaction of context and origin	.025	.017	−.022	.115
Size	−.000	.001	−.004	.004
$F_{4,472}$	1.52		2.48**	
R^2	.01		.02	

[a] Defined as $t - 1, t = 0$.

[b] Defined as $t + 100, t + 300$.

[c] Origin is a dichotomous dummy variable with 0 = inside successor, 1 = outside successor.

† $p < .10$

* $p < .05$

** $p < .01$

Further, the importance of each independent variable changes over the different time horizons. These findings support the contention, raised in management journals, that research needs to assess investors' reactions to corporate events over a number of pre- and post-event time periods.

It is also important to note that the multiple regression model includes size as an independent variable, and in no case does size emerge as an important explanatory variable. Further, size is significantly correlated with origin, although the correlation, as reported in Table 1, is small (− .13). The low magnitude of correlation suggests that any distortions in the regression coefficients due to multicollinearity were minor. The explanation for finding no size effect may lie in the construction of both the data set and the excess returns measure. Recall that the data set only consists of large firms and that the returns measure uses a control that minimizes extraneous influences on stock returns like size.

Table 4 presents two contingency matrixes to help clarify the form of the significant interaction terms and in the process provide additional insight as to the two contingent relationships predicted by the third hypothesis.

Regarding the first contingent relationship, investors seem indifferent to origin when succession occurs in low-performing firms. Whether leaders are appointed from inside or outside an organization, the values of these low-performing firms drop an additional 4 percent during the 50-day post-succession time frame and about 6 percent overall for the 101-day cumulative time frame, suggesting that investors are generally pessimistic about the ability of a new leader to reverse a firm's behavior. The findings on insiders

TABLE 4
Contingency Matrixes: Mean Excess Returns by Origin and Context[a,b]

(a) 50-day Post-succession Period

	Performance Context	
Origin	High	Low
Insiders	−.038 (.123)	−.042 (.154)
	144	131
Outsiders	.021 (.133)	−.038 (.200)
	17	23
Mean difference	1.85†	0.11

(b) 101-day Cumulative Interval

	Performance Context	
Origin	High	Low
Insiders	−.036 (.160)	−.056 (.183)
	144	131
Outsiders	.071 (.250)	−.057 (.249)
	17	23
Mean difference	2.53**	0.02

[a] In each cell, the first number is the mean excess return expressed as a decimal. The number in parentheses is the cross-sectional standard deviation of the mean. The bottom number is the number of observations for that cell.

[b] Overall, during the designated 200-trading-day period, firms in the high performance succession context (the top thirtile) had a mean excess return and standard deviation of 0.204 (.175) and the low performing firms (bottom thirtile) had −0.324 (.139). To maximize contrast, we excluded 162 midrange performers from this investigation but included them in the regression analysis. Overall, the midrange performers had a mean excess return and standard deviation of −0.083 (.057).

† $p < .10$
** $p < .01$

are therefore consistent with the third hypothesis, but the findings on outsiders are not. We predicted that outsiders will be more able to turn low performers around than insiders would be.

Regarding the second contingent relationship predicted by the third hypothesis, the results suggest that good presuccession performance amplifies investors' positive evaluation of an outside appointment. The value of these firms' stock increased an average 7 percent during the 101-day succession interval, a mean return significantly larger ($p < .01$) than the 3.5 percent decline observed for inside appointments in the same performance context. This finding is inconsistent with the prediction that outsiders will be less able than insiders to maintain high performance.

DISCUSSION

This study showed that investors typically seem to revise their expectations of cash flows downward during the time surrounding a succession announcement. However, not all appointment announcements convey neg-

ative information. For example, investors appear to react favorably to announcements when the two independent factors—high performance and outside appointment—coincide.

Since the results for outside appointments in high-performance settings departed from expectations, some reconciliation with prevailing theory is in order. Fundamental to the second and third hypotheses is the assumption that outsiders have a disruptive influence on organizations because they are less committed to the organizations' strategies, values, and people than are insiders. Perhaps, contrary to expectations, high-performing firms are more receptive to hiring from the outside because the security and status of existing managers are relatively secure during periods of prosperity. As Helmich (1975) stated, successful groups may perceive a new successor as a force that will stimulate change and reinforce positive behaviors. This is not to say that capable insiders could not be as effective, but rather that the pool of all available candidates may be larger for high-performing firms. Moreover, perhaps investors interpret the appointment of an outsider to a high-performing firm as a signal of the firm's intention to remain adaptive. Perhaps investors expect outsiders to serve investors' interests more than entrenched insiders. These explanations are generally consistent with those in a recent Hay Group Incorporated study reported in *Business Week* (1986). Its major finding was that many firms, including companies that are growing, benefit by putting outsiders in key positions.

The annouecement of an inside appointment in the high-performance context may not convey the same adaptive message. Rather, an inside appointment may signal the continuation of the previous administration's mind set. Although that is not necessarily bad, organizational studies have shown that when success breeds pervasive continuity, political obstacles to reorientation grow.

The result for outside appointments in low-performance contexts is also interesting because it suggests that although the appointment of an outsider may be an essential ingredient for turnaround, it may not be sufficient. Perhaps an outsider brought into a low-performance context with the task of turning a company around will have a great disruptive effect. One reviewer of the present research pointed out, however, that the level of disruption may have more to do with the expectations the members of a firm hold regarding the origin of the successor than the origin per se. For example, Gouldner (1954) found outsiders to have a disruptive influence, but Guest (1962) did not. However, the gypsum mine workers in Gouldner's study were accustomed to inside successors, and the employees at the automobile plant in Guest's study were expecting an outside successor. A second reviewer suggested caution when comparing leadership succession among industrial workers with executive succession at large corporations.

Perhaps, in a competitive market for management talent, low-performing firms are unable to attract the best available managers (Pfeffer & Davis-Blake, 1986). Or perhaps such firms, faced with dwindling resources,

deteriorating morale, and competitive disadvantages in their current product markets, tend to continue to decline in spite of a leadership change. Whatever the explanation, one point is clear: succession-induced turnarounds such as Chrysler Corporation's may be the exception. As Hambrick and Schecter noted: "There is an abundant folklore on how to revive poorly performing businesses, but systematic evidence about turnaround is scant" (1983: 231).

The overall evidence suggesting that investors view outside successors more favorably than insiders is puzzling, given the dearth of outside appointments. Recall that investors reacted favorably to outside appointments at the time of announcements (the two-day succession effect). Further, they continued to revise their expectations significantly upward during the post-succession period and the long-term leadership period. In light of these findings, why are insiders favored by a margin of nine to one?

Other questions emerge from the findings of this study. What motivates a high-performing firm to change leaders? Are low-performing firms openly aware of their poor performance? Do investors react more favorably to firms in which the transition between top managers is orderly and to firms that disclose the true reasons for a change in CEO? These questions call for additional investigations of succession events.

Finally, this study has implications for traditional event-study methodology and for the conclusions of succession studies that have used such methodology. First, we introduced a measure of security benchmark returns that retains the advantages of stock-price measures and overcomes their principal limitations. Second, this study investigated investor reactions to succession announcements over various horizons preceding and following the events and found that the results of the regression model were significant for all but the two-day announcement period. Further, this study found that each explanatory factor is important during a different horizon. The contrast in findings for the two-day announcement period and the longer horizons suggests that studies that rely on short horizons immediately surrounding an event may not accurately capture succession-related returns. This observation does not call into question the efficiency of capital markets but suggests that investors cannot make final judgments on what they do not yet know with certainty. Since all recent empirical investigations of succession in large organizations have used a potentially biased measure of performance, and most have used short horizons, it is not surprising that a consistent set of findings about whether a new leader can alter corporate performance has not emerged.

CONCLUSIONS

This study has shown that the performance context of a succession event and the origin of a newly appointed leader moderate the relationship between the succession and its consequences for performance in large cor-

porations. In general, succession conveys negative information to investors. However, they seem to revise their expectations of cash flows upward when outsiders are appointed to high-performing firms.

The study has limitations that temper the strength of its findings. It focused on one background factor and one dimension of organizational context while controlling for size. We did not control for the multitude of other possible background and context factors but assumed their influence would be random. A recent study by Coughlan and Schmidt (1985), however, found that stock prices predicted CEO succession only when a predecessor was less than 63 years old. Another limitation of the present study is that it used chief executives as the units of analysis. Although it is true in most firms that the chief executive exerts the most power of any manager, Hambrick and Mason (1984) asserted that studying entire management teams may increase the predictive strength of a model. Finally, the study followed a stringent decision rule when defining origin. Vancil (1987) suggested a less stringent rule, whereby appointees with one to five years of tenure in an organization were considered outsiders.

Clearly, there are opportunities for future research. Nonetheless, empirical analysis of premises concerning executive background characteristics, organizational context, and corporate size have been long overdue, and the current study made an attempt to test some of those premises.

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APPENDIX
Derivation of Beta[a]

$$\text{Beta}_i = \frac{\sum\limits_{t} (\text{ret}_{i,t}\ \text{mret3}_t) - \left(\frac{1}{N}\right)\left(\sum\limits_{t} \text{ret}_{i,t}\right)\left(\sum\limits_{t} \text{mret3}_t\right)}{\sum\limits_{t} (\text{mret}_t\ \ \text{mret3}_t) - \left(\frac{1}{N}\right)\left(\sum\limits_{t} \text{mret}_t\right)\left(\sum\limits_{t} \text{mret3}_t\right)},$$

where

$\text{ret}_{i,t}$ = log of (1 + return for security i on day t),
mret_t = log of (1 + value-weighted market return on day t),
mret3_t = $(\text{mret}_{t-1} + \text{mret}_t + \text{mret}_{t+1}) \div 3$,[b] and
N = the number of observations for the year.

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[a] See the CRSP Daily Excess Returns File for additional detail.
[b] This is a three-day moving-average market window.

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