CEOs Who Play to Type Win the Market

An important CEO attribute that shapes firm strategies such as mergers and acquisitions is uncovered.

When the going gets tough, the tough goes shopping for M&A targets. This year looks set to be a record year for mergers and acquisitions, with **US$2.4 trillion of deals** signed by the end of May, the highest year-to-date total since 1980. The frenzied dealmaking continues a rebound that began in the latter half of 2020, a stunning recovery from the doldrums of the preceding six months when the world was in the throes of Covid-19.

What might explain such an acquisitive streak? By some **analyses**, companies holding up well or thriving in the pandemic are snapping up assets to grow or transform, enabled by high liquidity, low costs of borrowing and a booming stock market. It may also have something to do with the people running these companies. Research has shown that **chief executives shape firm strategies** such as M&A in different ways depending on personality as well as their interactions with **senior managers** or the board of directors.

Yet comparatively little is known about *how* the nature of CEOs' human capital shapes firms' strategic behaviour and performance. A new **study** I co-authored with **Sterling Huang**, **Denisa Mindruta** and INSEAD Associate Professor of Strategy **Philipp Meyer-Doyle** could fill the gap. We show that generalist chief executives, or chief executives with a broader set of experience, knowledge and skills, are more acquisitive than specialist CEOs if their firms are governed by generalist board members.

Generalist CEOs are also more likely to buy companies in unrelated industries whereas specialist CEOs are wont to target related companies. The good news is, the market tends to reward a fit between a CEO's generalist/specialist characteristic and the type of acquisitions they undertake. This benefits firms whose chief executives play the M&A game according to type.

The importance of fit

We sourced data on CEOs at S&P 1500 firms from 1998 to 2007, using the **CEO General Ability Index** to assess whether they were generalists or specialists. The index captures five aspects of the CEO professional career: the number of past positions; the number of firms worked for; the number of industries worked in; any previous CEO experience at a different firm; and any experience working for a conglomerate. We merged these data with corporate financial data as well as details on all firms' M&A deals. The sample comprised 7,782 firm-year level observations and 1,723 deal-year level observations.

Our analysis, which controlled for CEO age and other variables, indicated that generalist CEOs were more acquisitive (based on the number of deals firms made in a given year) and more likely to acquire firms in a different industry than specialist CEOs. These results are consistent with the idea that CEOs engage in strategic behaviour that corresponds to the nature of their human capital.

We further found that the stock market reacted positively when a generalist CEO engaged in an unrelated acquisition or when a specialist CEO engaged in a related acquisition – in other words, when CEOs played to type – and negatively otherwise. Market reaction was measured via cumulative abnormal return (CAR), or the difference between the expected return in general market conditions and the actual return. Likewise in the long term, market performance tended to be stronger when the acquisition type matched the CEOs' generalist/specialist characteristic.

Examples from our data include the purchase by Champion Enterprises, a mobile home manufacturer led by generalist CEO William Griffiths, of an unrelated firm in 2005, and high-end apparel company Oxford Industries' buy of a related firm in 2003 under specialist CEO J. Hicks Lanier. Both netted positive CAR.

Conversely, in 2006, Anadarko Petroleum's related purchase under generalist CEO James Hackett and Sapient Corp's diversifying deal by specialist CEO Jerry Greenberg suffered negative stock returns.

Another piece of the puzzle

We did further analyses to test the possibility that our initial findings might be driven not by chief executives' human capital but rather firm and board attributes. The latter are potential confounding factors that bedevil many studies on CEO effect.

For our study, whether a firm's board of directors were on the whole generalist or specialist was a significant variable since boards are responsible for selecting and hiring CEOs. It is plausible that directors hire a CEO in their or the firm's image, and she or he subsequently pursues M&A strategies associated with the generalist/specialist attribute.

Indeed we found that generalist CEOs were more likely to pursue more acquisitions only if they worked at firms with more generalist boards. Other results of our initial analyses held. Which is to say, generalist CEOs pursued unrelated acquisitions irrespective of board type, and CEO-acquisition fit was associated with stronger performance. There was no statistically significant difference in acquisition performance *between* the two types of fit, i.e. generalist CEOs with unrelated acquisitions, and specialist CEOs with related acquisitions.

Our findings could explain why firms continue to make unrelated acquisitions despite such deals' underperformance in stock markets on average. CEO **overconfidence** might play a part, but it turns out that having a generalist at the helm stands a firm in good stead in diversifying business marriages. An examination of human capital allows one to predict when an idea that might look bad on paper – an unrelated acquisition – may in fact be good for performance.

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