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CEO Career Horizon and Investments in Flexibility

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A large body of research has investigated reasons that the interests of a firm's top management might not always align with the interests of investors. Recent research in the *Strategic Management Journal* sheds light on the expected term of a CEO's appointment and how it might affect their firm's investment decisions. Researchers examined decisions around *real options*, which are investments that increase management flexibility by opening or preserving future opportunities that may or may not materialize. Because these investments are risky and only likely to pay off in the long term, the researchers predicted that CEOs who are more likely to be in their jobs longer – younger CEOs and those newer in their jobs – would be more likely to make these investments. Those are the CEOs most likely to benefit personally from the investments.

Key Takeaways:

- Firm-level decisions about real options, investments that open or preserve future opportunities that may or may not materialize, can sometimes be influenced by a CEO's personal interests.
- CEOs who are younger and newer to their firm invest more heavily in the long-term strategy of investing in the flexibility of real options.
- Long-term incentives and institutional ownership help align the interests of investors and the CEO, reducing the effects of CEO characteristics on real options investments.

Studying historical data from large, public, nonfinancial firms over 20 years, the researchers assessed the career horizons of CEOs compared to industry averages, and a measure of their investment in real options. They found CEOs with shorter career horizons made fewer such investments. The differences were weaker in firms with more institutional ownership and where

CEOs earned more of their total compensation from long-term incentives like stock options..

The researchers recommended that CEOs with shorter career horizons should be carefully compensated and monitored to promote long-term focus. They caution that their financial data cannot point to specific decision-making processes or motivations. They also note that real option investments are not always good for every firm. More research is needed to better understand the personal motivations behind investment decisions CEOs make on behalf of their firms.

Source: Lee, J. M., Park, J. C., & Folta, T. B. (2018). CEO career horizon, corporate governance, and real options: The role of economic short-termism. *Strategic Management Journal*, 39, 2703-2725. doi: 10.1002/smj.2929