Finance Principles Apply to CEO Succession
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When Should You Groom CEOs From Inside versus Go Outside for New Blood?

The CFO at a company that needs to hire a new CEO doesn't get to make the decision, of course. But it would make sense for the board to get the finance chief's input on succession planning for that role. Leadership decisions are not unlike investment decisions, in that they incorporate considerations of volatility and risk.

CFOs, for their part, ought to be interested in providing such input. Even in situations where they're not vying for the top job themselves, they certainly have a vested interest in who's going to get that job. In that light, here is some food for their thought. Also, although the research described here focused on CEO's, it's possible these patterns may apply to other C-suite positions, like CFO.

One way to hedge risk when planning CEO succession is to create a candidate pool in which each candidate has different capabilities, so that one will be a fit for future conditions that eventually emerge. That may require bringing in one or more people from outside the organization. Another way is groom a new CEO from inside, building a capability to work effectively within the organization through trusted, long-term relationships with key players and constituents. That capability would likely be useful in any future scenario. But it may not be perfectly suited to a particular eventual future.

Such leadership investment decisions are particularly vital at companies facing an unstable future or that have a history of less-than-stellar performance. In those situations boards might intuitively seek to bring in "new blood" from outside. But research on CEO succession by Nandini Rajagopalan at the University of Southern California and her colleagues suggests that may be the wrong investment approach.

In one study, Rajagopalan's team found that at companies with CEOs hired from outside, company performance increases are larger where the degree of strategic change is low to moderate. But where the level of strategic change is moderate to high at such companies, performance decreases are larger with an external CEO. That suggests that if a company is performing so poorly that it needs a fundamental change in its strategic direction, promoting a CEO from within may be a better choice.

In another study, the team compared three types of CEO succession: "relay succession" (the CEO designates and grooms a successor before departing); "non-relay succession" (the successor comes from inside but was not specifically designated before the previous CEO's departure); and "outside succession" (the successor comes from outside). Relay succession was associated with higher performance at companies with low pre-succession performance and post-succession stability challenges.

(An interesting twist to the question of internal vs. external CEOs has to do with gender. Women CEOs may bring valuable diversity, but The Economist recently reported that they are forced out of their jobs more often than men. Perhaps that's because 35 percent of women CEOs come from the outside, compared to 22 percent of men, as externally appointed CEOs are more likely to fail.)

The Rajagopalan studies relied on data from the 1990s. Arguably, the 21st century may be more turbulent than its predecessor. Does that mean companies should never expect CEOs hired from outside to thrive? Not exactly. Perhaps winning organizations may need to take leadership-portfolio optimization to the next level, by creating a hybrid approach, just as with financial options.

Companies could become world class at nurturing externally-sourced leaders. They could develop "boomerang" career paths, where leaders leave the company to gain needed capabilities elsewhere and then return, as did the CEO of Shell. Companies also might find ways to connect with high-quality leaders before they need them, through joint leadership projects, board appointments, and even inviting leaders from industry partners to leadership development programs. That could produce the best of both worlds, CEO's that have strong organizational familiarity and diverse outside perspectives.

Like financial assets, a leadership portfolio needs to reflect market conditions, performanceand volatility. Evidence shows that a company can apply principles it uses for deploying financial assets to make more precise leadership decisions. Are you investing in leadership that way?
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