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Hitch your corporate wagon to a CEO star? Testing two views about the pay, reputation, and performance of top executives

James B. Wade, Joseph F. Porac and Timothy G. Pollock, University of Illinois at Urbana-Champaign and James R. Meindl, State University of New York at Buffalo

INTRODUCTION

This article develops two opposing viewpoints regarding the relationship between CEO media reputation, corporate performance, and CEO compensation. We open these arguments to empirical testing by using data from a sub-sample of the S&P 500 over a five-year period from 1990-1994. Our data suggest that high reputation CEOs, defined as executives who win *Financial World* CEO of the Year medals, manage firms with better performance in the years prior to their award. They are also paid more highly than their less repu-

table peers, and have more satisfied shareholders. Their firms do not, however, perform any better than the firms of less reputable CEOs in the years following their award.

BACKGROUND

It is just common sense that a company's reputation is often colored by the reputation of the CEO who manages it. This seems true whether a company is large or small, new or old, local or global. Common sense aside, however, there are valid reasons for the intermingling of man-

agerial and corporate reputations. Corporate successes and failures are complex events with over-determined and ambiguous causes. Yet, key constituents such as stockholders, employees, suppliers, and customers must make sense of these events in their efforts to determine whether a company is a going concern. In the flux of conflicting, ambiguous, and overlapping forces that determine how a company performs, the recognized ability of its CEO is an important clue about the company's future prospects (Meindl, Ehrlich, and Dukerich, 1985). Managerial ability is thus an object of some fascination for analysts and the business press who search out and propagate evaluative information about particular CEOs.

As useful as this information may be to corporate constituents seeking ability-related news, some have claimed that the business media have created a managerial 'star system' by amplifying the successes of certain highly publicized CEOs at the expense of lesser knowns. Economist Robert Frank, for example, suggests that this star system has generated a 'winner-take-all' ideology in the market for CEO talent by forcing corporate constituents, particularly employees and stockholders, to subsidize lavish compensation packages in order to attract and retain CEOs with star appeal (Frank and Cook, 1995). Recruiting highly visible executives thus comes at a very steep price. Given that the issue of managerial pay has, in recent years, been so explosive (Crystal, 1991), it is important to ask whether star CEOs are really worth this high price. This is the question that we take up in this article. First we discuss two opposing arguments relating corporate performance to CEO reputation and compensation. We then summarize the results of a study that we conducted to test these arguments on a sample of US firms taken from the Standard & Poor's 500.

TWO PERSPECTIVES ON CEO REPUTATIONS

Top managers acquire reputations when key constituents observe the activities and outcomes of firms that have operated under their stewardship. When these observations are revealed through public discourse, reputational signals circulate through social and resource networks (eg, Fombrun, 1996). This circulation is amplified by the business media through both journalistic coverage of particular CEOs and media-sponsored rankings of executive performance. For example, *Financial World* magazine sponsors a highly-regarded annual CEO of the Year contest in which CEOs from a large number of industries are evaluated by analysts on the basis of financial, managerial, and social performance indicators. The highest-ranking executives are awarded a gold, silver, or bronze medal in recognition of their superior managerial achievements. These awards are very visible and create status orderings among executives within and between industries by publicly sanctioning the activities of some managers to the exclusion of others. These status orderings derive their power from the perceived neutrality and expertise of the rating organizations. CEOs such as Jack Welch of General Electric, Eckard Pfeiffer of Compaq, and Robert Crandall of American Airlines, all medal winners during the early 1990s, have defined the modern prototype of the successful CEO and have stellar public reputations as a result of their well-publicized managerial accomplishments.

But of what worth are these reputations to companies who employ famous CEOs? Should corporate boards pay more to attract and retain a highly-visible top executive under the assumption that higher compensation will be balanced by better company performance? Or, are CEO reputations a result of media-hype having little predictive power regarding how a manager

will perform in the future? Although academic research on CEO reputations is almost non-existent, one can construct two opposing arguments that bear upon these questions. We call these two arguments the *star power* and the *star image* points-of-view.

The star power argument draws its logic from agency theories of corporate governance. According to agency theorists (eg, Jensen and Meckling, 1976; Fama, 1980), ownership in the modern corporation is dispersed and uncoordinated. This fragmentation makes it difficult for owners to monitor managerial behavior, thereby encouraging self-interested, rather than owner-interested, managerial action. Although compensation contracts can be written to discourage managerial shirking and guile — for example, by making a manager's pay contingent on shareholder value creation — the ultimate disciplining device is the market for CEO employment, and, more generally, the market for corporate control. Agency theorists assume that these markets transmit information perfectly about managerial performance and that such information searches out high-performing CEOs with superior managerial abilities.

Perfect information implies that the reputational signals emanating from the CEO talent market are indicative of underlying managerial ability. They are thus important clues about both a manager's past performance as well as his or her likely performance in the future. Within the star power account, reputational rankings, such as those embodied in *Financial World's* CEO of the Year contest, play a key information dissemination role by summarizing the current 'market wisdom' about the distribution of CEO abilities (eg, Johnson, Young and Welker, 1993). Because they are reliable signals of managerial ability, these rankings can, and should, be used by corporate boards in their CEO hiring decisions. High reputation CEOs are

thus sought after by many corporations, which drives up their price in the open market. The compensation premium paid for high reputation CEOs is, however, returned by superior company performance in the future.

In contrast to the star power agency perspective, the star image argument draws from social constructionist and attributional theories of managerial behavior (eg, Meindl et al, 1985). According to this view, the linkage between corporate performance and managerial competence is muddied by a variety of non-managerial variables such as technological path dependence, organizational slack, industry competition, and general economic conditions. Thus, it is difficult to establish a one-to-one correspondence between high company performance and the ability of a particular CEO (eg, March, 1984). Instead, CEO ability is an attribution that is generated within organizational communities as social observers retrospectively examine a company's performance. Reputations are summaries and interpretations of the past with unclear predictive power about future accomplishments. There is no assumption that, in a complex and ambiguous world, managerial ability is inherently sustainable, that past success is a good indicator of future success under different circumstances. Indeed, there is no assumption that top managers have much control over organizational performance at all. Yet, reputable CEOs can demand higher salaries because the reputational signals produced in the business press create momentary opportunities for star CEOs to capitalize on their current esteem and use their influence to capture higher wages, knowing full well that the future is inherently unpredictable. Previous research has suggested that influential CEOs use their power to extract higher salaries than can be explained by performance alone (Finklestein and Hambrick, 1989; Main et al, 1995). As Frank

and Cook (1995) and Bok (1993) have suggested, these power differentials may drive up the salaries of highly reputable CEOs who are only marginally more able than their less reputable counterparts.

Figure 1 compares and contrasts the star power and star image viewpoints in summary form. Both perspectives suggest that a CEO's reputation is determined by the past performance of his or her company. Both also suggest that highly reputable CEOs should be more satisfactory to owners and be paid more highly than their less reputable peers. The key difference between the two arguments, however, is that the star power perspective suggests that CEO reputations are predictive of future company performance, while the star image perspective makes no such claim. In the next section, we examine evidence obtained from a sample of 280 large US firms that bear upon the relative merits of these opposing points of view.

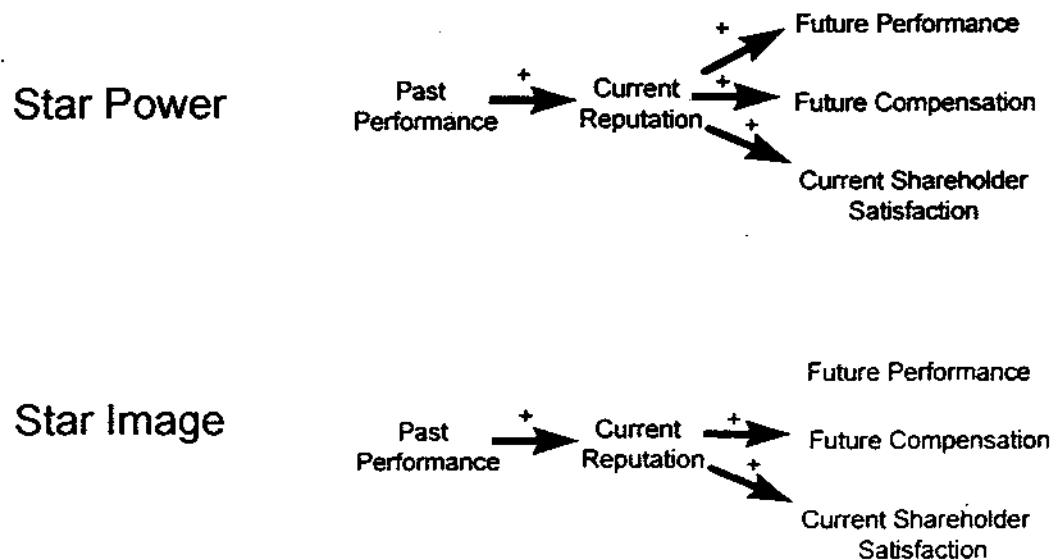
THE PAY, REPUTATION, AND PERFORMANCE OF S & P 500 CEOs: 1990-1994

Sample characteristics

Our study sample was selected from the companies that were members of the S&P 500 at the end of 1992. The original sample included the 366 companies that had fiscal years ending on December 31. We selected companies with 12/31 fiscal years to avoid any sampling problems which might arise from fiscal years differences, such as significant changes in the market environment in the non-overlapping periods. Missing data reduced our sample to 280 companies. T-tests revealed no significant differences between our sample and the entire S&P 500 along such dimensions as size, performance, and industry representation. The firms in our sample were a cross section of relatively large US firms. They included such well-known companies as American

Figure 1

Star Power vs Star Image Arguments



Note: Arrows imply causal direction. Signs mean increase or decrease in effect.

Airlines, Boeing, Anheuser-Busch, Blockbuster Entertainment, and ALCOA.

Variables

For each of our sample companies, we gathered time series data on CEO reputations, salaries, and company performance for the five years starting in 1990 and ending in 1994. A more detailed single-year cross-sectional analysis was performed for the 1992 year to investigate the relationship between CEO reputation and shareholder satisfaction. We defined a number of variables for our regression models. We assessed *CEO reputation* by using data obtained from *Financial World's* annual CEO of the Year awards. *Financial World* began this annual contest in 1975 and each year surveys a large group of business analysts who rate CEOs on four criteria: financial results, competitive position, the quality of the managerial team and social performance. Security analysts select three bronze medal award winners for each of a number of industries. The top vote winners in each industry are grouped and silver medal award winners are selected by research directors at Wall Street's largest investment houses. Finally, the editors of *Financial World* choose the sole gold medal winner for that year. We coded the gold medal winner as a three, silver medal winners as a two, bronze medal winners as a one, and all others as zeros for each year from 1990 through 1994. Some of the consistent medal-winning CEOs in our sample were Dean Buntrock of Waste Management, Frank Shrontz of Boeing, Hugh McColl of Nation's Bank, Jack Welch of GE, Maurice Greenberg of American International Group, Stanley Gault of Goodyear and Rubbermaid, and Norman Augustine of Martin Marietta.

In addition to this reputation score, we also measured *CEO compensation* as the logged sum of an executive's base salary and incentive bonus for a given year (ie,

total annual compensation). These were collected for 1990 through 1994 from annual proxy statements. We assessed *company performance* with both accounting and market measures. Market return was defined as the total yearly stock return of the company, assuming reinvestment of dividends.

We also obtained yearly return on equity (ROE) which is a measure of how well a company is using the equity provided by stockholders. ROE is often the basis for awarding incentive pay. Both performance measures were obtained from the COMPUSTAT database. We assessed *shareholder satisfaction with management* by counting the number of shareholder resolutions submitted for vote at the 1993 annual shareholder's meeting. In addition to these key variables, we also controlled for a number of subsidiary variables such as firm, size, CEO tenure and age, industry performance, and ownership concentration.

Results

We used cross-sectional time-series regression to examine the relationships among the above variables over the 1990-1994 period. Our resulting analyses are more consistent with the star image than star player perspective. Table 1 summarizes our results. Consistent with both arguments, our results suggest that CEOs are more likely to win a *Financial World* medal in a given year when their company performs well in the previous year, when the CEOs are older and have shorter tenure as CEO, and when they are managing larger firms. Our one-period regression analysis of shareholder satisfaction also suggests that medal-winning CEOs have fewer resolutions submitted by shareholders at the company's 1993 annual meeting. Also consistent with both arguments, our results suggest that CEOs have higher total annual compensation in a given year when they are older and more experienced in their

Table 1: Summary of study results

- 1 CEOs are more likely to win a *Financial World* medal when:
 - a) their companies perform well in the year prior to the award
 - b) they have less tenure in their current CEO post
 - c) they are older
 - d) they work for larger firms.
- 2 Medal winners get fewer shareholder resolutions submitted for a vote in their company's annual meeting than CEOs who did not win a medal.
- 3 Medal winners are paid more in total annual compensation than CEOs who did not win a medal.
- 4 The companies of medal winners did not perform any better post award than the companies of non-winners.

current CEO position, when their companies are larger and better performing, and when they win a *Financial World* medal during the previous year or the year in question, or both.

Consistent with the star image perspective, and inconsistent with the star power argument, our results suggest that winning a *Financial World* medal is not associated with a company's future performance. Companies perform better in a given year only when their industries are performing better that year, when the companies themselves performed well during the previous year, and when the companies are smaller in size.

SUMMARY AND IMPLICATIONS

Organizational communities are complex socioeconomic environments in which multiple forces combine to influence how well a company performs. Some of these forces are controllable through foresight and planning. Others create contingencies that are impossible to predict and difficult to manage. Despite these complexities, stakeholders must stabilize their understanding of a company's outcomes by cutting through the fog of causal ambiguity to

decipher the base drivers of a company's success or failure. Common wisdom tells us that the ability of top managers is one of these drivers, and that high-performing CEOs should be publicly applauded, rewarded well for their competencies, and singled out in the business media as corporate stars. But as Meindl et al (1985) tell us, this common wisdom romanticizes corporate leadership and imputes more causal force to top managers than is often warranted by the powerful contextual factors shaping a company's performance. In Meindl et al's view, CEO reputations may say more about the need of stakeholders to attribute responsibility for corporate affairs than anything about managerial competence itself.

The results of our study give substantial credence to this view. Our analyses suggest that attracting and retaining star CEOs by offering higher salaries may make corporate boards and owners feel better about the stewardship of their organization, but it is unclear whether these higher salaries return better company performance in the long run. *Financial World* medals were awarded to CEOs whose companies performed well prior to the award. In addi-

tion, medal winners, some of the most famous CEOs in America today, were paid higher salaries and had fewer shareholder resolutions proposed at annual shareholder meetings than their less reputable counterparts. But the companies of medal winners performed no better after the award than the companies of less renowned executives, leading to the conclusion that high salaries for high reputations are rewards for past accomplishments rather than investments in the future.

This conclusion must be tempered, however, by one very practical consideration: it is difficult to price the social psychological benefits that accrue from believing that one's fate rests with a competent and highly reputable CEO. If it is the case, as some finance scholars have suggested, that a company's stock price is controlled by random market fluctuations, the compensation premiums awarded to highly reputable CEOs seem a small price to pay to reduce the psychic buffeting that is triggered when one realizes that one's financial well-being is unpredictable. Moreover, as Bok (1993) suggested, paying more for a highly reputable CEO may be a corporate board's insurance against possible criticism if the CEO fails to produce shareholder benefits. After all, who can criticize a board for hitching their corporate wagon to a CEO star?

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Strategic alliances and firm-based legitimacy

Paul Olk, University of California-Irvine

Peter Smith Ring, Loyola Marymount University

INTRODUCTION

The purpose of this article is to bring together two separate research streams by

investigating how a strategic alliance can affect the legitimacy of a partnering organization. In the last few decades, alliances