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J.L. Stimpert
Colorado College

Julie A. Chesley
Pepperdine University

Amanda S. Ostrowitz
University of Denver

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THE INSIDER'S ADVANTAGE: CEO EXPERIENCE AND THE PERFORMANCE OF LARGE DIVERSIFIED FIRMS

J. L. Stimpert, Colorado College
Julie A. Chesley, Pepperdine University
Amanda S. Ostrowitz, University of Denver

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Much upper echelons research focuses on the effect of CEO experience on firm performance outcomes. This paper extends this research stream using human and social capital theories as a framework to examine the effect of CEO experience on the performance of large diversified companies. Our analysis of 239 Fortune "500" companies finds that larger companies are more likely to select insiders and individuals who have more firm-specific experience to be their CEO. We also find that the selection of insiders and CEOs with more firm-specific experience is associated with significantly higher firm performance. These findings highlight the importance of the human and social capital possessed by company insiders, and shed additional light on the strategic leadership of large diversified companies and other complex organizations.

Upper echelons research emphasizes the value of the human and social capital provided by firms' CEOs and other top managers (Bailey & Helfat, 2003; Castanias & Helfat, 1991). Some scholars claim that the human and social capital contributed by top executives may be a firm's most important and enduring source of competitive advantage (Adler & Kwon, 2002; Burt, 2000; Moran, 2005). Yet, more than 50 specific studies examining the influence of CEO background on firm performance have produced few consistent findings (Karaevli, 2007). In reviewing this literature, Karaevli attributes the disparity in research findings to the use of unsophisticated measures of CEO background and to a lack of appreciation for the importance of organizational context, and she urges researchers to adopt more refined measures of CEO origin and to give more attention to the importance of contextual factors.

This paper builds on these ideas and suggestions by incorporating key insights from the human and social capital literature, and by employing a new, more refined measure of CEO experience. We also examine the influence of CEO experience in the specific and important context of large diversified firms because human and social capital are likely to be especially valuable resources that play a key role in the effective management of these complex organizations. We begin by reviewing the literature on executive experience, focusing on the executive succession literature, research on the management of diversification, and the literature on human and social capital. We use insights from these literature streams to develop a rationale for selecting company insiders and those with more firm-specific experience to be the CEOs of large diversified firms. We then empirically examine whether these firms are more likely than their smaller and less diversified counterparts to select insider CEOs, and whether insider CEOs and those with more firm-specific experience are associated with higher firm performance.

BACKGROUND AND THEORY DEVELOPMENT

Firms are much more inclined to hire insiders than outsiders as CEO. For many years, researchers at Booz Allen Hamilton have been tracking succession patterns in 2,500 large firms, and find that outsider CEOs tend to be hired in only 20 to 30 percent of all successions, though this percentage can vary considerably from year to year (Lucier, Kocourek, & Habber, 2006).

Many factors explain why insiders have an edge in CEO selection, but nearly all of the factors are consistent with human and social capital perspectives. For example, insiders are likely to have an advantage in understanding their company's competitive landscape and its strategic position (Shen & Cannella, 2002). Social capital theory suggest that insiders also benefit from their knowledge of and ties to other senior executives. And a more homogenous top management team composed largely of insiders is likely to be more cohesive, communicate more frequently, and achieve higher levels of integration (Zenger & Lawrence, 1989).

Studies also document that the selection of an outsider CEO is often accompanied by high rates of senior management turnover (Helmich & Brown, 1972). Thus, boards may fear that the selection of an outsider CEO could prompt an exodus of senior executives and a loss of management talent and knowledge (Kesner & Sebora, 1994;

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Pfeffer, 1981). In addition, boards often have difficulty evaluating outsider candidates, giving insiders, who are much more likely to be known quantities, a significant edge in succession decisions (Shen & Cannella, 2002).

Given the preference for hiring insiders, much of the research on executive succession has examined when and why firms chose to deviate from this tendency and hire outsiders (Finkelstein & Hambrick, 1996). Many studies have examined the role of firm performance as an antecedent to CEO succession decisions, and most, but not all, find that outsiders tend to be hired when firms are experiencing poor performance (Boeker & Goodstein, 1993; Dalton & Kesner, 1985), when they are implementing turnaround strategies (Bibeault, 1982), or when poor performance is equated with the need for a change in strategy (Cannella & Lubatkin, 1993). Lucier and colleagues found that more than 80 percent of the firms that hired outsiders as CEO were experiencing poor performance in the prior two years (Lucier et al., 2006).

Arguments supporting these empirical findings are quite intuitive. Outsiders are viewed as advantageous to firms suffering from poor performance because they are believed to be more likely to bring a new perspective. The hiring of an insider, on the other hand, is viewed as part of a maintenance strategy and an attachment to the status quo (Helmich & Brown, 1972). Thus, again, consistent with human and social capital arguments, boards face a paradox in selecting a CEO – insider candidates know the company and other executives, but may be unable to see the need (if it exists) for a change in strategy. On the other hand, outsiders may see the need for a change in strategy, but could face significant challenges in implementing strategic changes because they lack knowledge of the firm and its industry and do not have established relationships with the firm's senior executives (Bower, 2007; Fondas & Wiersema, 1997).

The Influence of Leader Experience on Organizational Performance

In her review of the executive succession literature, Karaevli (2007) notes its inconsistent findings and concludes: 1) that researchers need more refined measures of what it means to be an insider or an outsider, and 2) that researchers need to be more attentive to the contextual factors that moderate the relationship between managerial origin and performance. Karaevli's own research used a new measure of "outsiderness" based on the extent of CEO experience in both the firm and its industry, and she examined CEO successions only in the airline and chemical industries. Her study concluded that CEO background has no main effects on firm performance, but that it does have significant moderating influences on performance.

In an earlier review, Finkelstein and Hambrick (1996) highlight an important point made in an early study by Gamson and Scotch (1964) – that succession frequently follows a period of poor performance. As a result, an improvement in performance is more likely to follow the succession event, regardless of whether an insider or an outsider is chosen to lead. Thus, context matters a good deal, and succession studies that make use of panel design methodologies face the risk of being influenced by a regression to the mean phenomenon.

Virany, Tushman, and Romanelli (1992) studied the effect of CEO background in high-tech firms and found that performance improves following the hiring of either an insider or an outsider. Perhaps firms competing in high-tech contexts benefit from the perspectives provided by any new CEO, regardless of background. Another study of a wide range of industries showed near-term firm performance is nearly four times better when poor-performing firms hire an outsider to be CEO, but that insiders produced higher long-term results (Lucier et al., 2006). Other studies come to different conclusions, again depending on context. Denis and Denis (1995) report, not surprisingly, that performance improves following the forced resignation of a CEO. And, reflecting perhaps the regression to the mean phenomenon, Huson, Malatesta, and Parrino (2004) find that firm performance deteriorates in the years before CEO turnover and then improves, but that performance improvements are greater when the new CEO is an outsider.

The Value of Executive Experience in Diversified Firms

Because of their size and complexity, large diversified firms are a context in which human and social capital is likely to be especially valuable, abundant, and, because of its specificity, also very difficult to share or transfer (Prahalad & Bettis, 1986; Rajagopalan & Prescott, 1990). Finkelstein and Hambrick (1996) underscore that the executives of large diversified firms must manage not just a single business, but a portfolio of often quite varied businesses. CEOs and other top executives of these firms must acquire a broad understanding of the product and geographic markets in which their firms' businesses compete (Naveen, 2006), as well as knowledge of the different technologies and processes associated with the business units that make up their firms' portfolios of businesses (Pehrsson, 2006; Piscitello, 2004).

In addition to understanding their firms' unique portfolios of individual businesses – their competitive situation, positioning within the competitive environment, resources and capabilities, and cash flow characteristics – executives leading diversified firms must also have detailed understandings of how these businesses are related to each other and how they together are a part of the larger diversified firm (Porter, 1987; Stimpert & Duhaime, 1997). Based on these understandings, executives will develop elaborate mental models about how to derive synergies from their firms' diversification strategy, which will also become manifested in organizational processes, procedures, and routines (Goold & Campbell, 1987).

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For example, prior studies describe how diversified firms develop procedures to apply a common technology or set of technological capabilities across business or product lines (Miller, Fern, & Cardinal, 2007; Pehrsson, 2006; Piscitello, 2004). Other studies shed light on how diversified firms develop functional skills and organizational processes that can be applied across all of their businesses, even when those businesses may lack common product or service characteristics (Mason & Harris, 2005; Porter, 1985, 1987; Tanriverdi & Venkatraman, 2005). Still other studies show how firms, often those pursuing unrelated diversification strategies, develop elaborate financial reporting procedures and resource allocation processes to promote the efficient functioning of internal capital markets (Teece, 1982; Williamson, 1975). All of these approaches to deriving synergies require extensive firm-specific human capital that is likely to be difficult to acquire quickly or transfer easily.

Effective management of a large diversified firm also requires significant social capital. Moran (2005) emphasizes that social capital includes not only the configuration of social ties among key management personnel, but also the quality of those social ties. While the configuration of interpersonal relationships refers to “the presence or absence of network ties between actors, along with other structural features like connectivity, centrality and hierarchy,” the quality of those relationships is a function of the level of “interpersonal trust and trustworthiness, overlapping identities, and feelings of closeness or interpersonal solidarity” (2005: 1,132). Again, the diversified context is one in which higher levels of social capital are likely to be especially helpful in effectively managing the inherent complexity since social capital enhances communication among executives and managers. Enhanced communication will facilitate the effective management of individual businesses, and it will also be essential to the efficient coordination of business units and efforts to derive synergies from those businesses.

CEO Hiring Patterns in Large Diversified Firms

Given the challenge of understanding both the complexity and the vast amount of firm-specific knowledge that are associated with the management of a large diversified firm, it seems plausible that these firms would be more likely to opt for insiders and those with more firm-specific human and social capital when selecting their CEO. Stated formally:

> **Hypothesis 1a**: Large diversified firms are more likely to have insiders as CEO.

> **Hypothesis 1b**: Large diversified firms are more likely to have individuals with more years of company experience as CEO.

CEO Experience and the Performance of Large Diversified Firms

Regardless of whether large diversified firms are more likely to select insiders or individuals with more years of company experience as their CEO, our theorizing suggests that performance will be higher in those large diversified firms that do. Focusing on firms in a service industry, Kor and Leblebici (2005) note that outside executives are likely to offer their firm new and novel knowledge, while insiders are more likely to draw on their firm’s existing knowledge and capabilities. But the findings of their study also highlight the difficulties outsiders experience when attempting to share and implement their new ideas and when attempting to assimilate their firms’ specialized knowledge and skills. Given the elaborate routines, processes, and procedures that diversified firms will have in place to manage diversification, implement their corporate strategies, and derive synergies from their portfolio of businesses, insider executives who have obtained a sophisticated knowledge and understanding of these processes and procedures, as well as social and network ties and interpersonal trust, should be associated with higher firm performance (Zenger & Lawrence, 1989). Applying these human and social capital arguments to the management of large diversified firms suggests the following hypothesis:

> **Hypothesis 2**: Large diversified firms that have an insider as their CEO will enjoy higher performance.

Past studies have acknowledged that insider/outsider status is an overly simplistic dichotomy, and that it makes a good deal of difference whether an individual has no experience, two years, or 20 years of experience with a company prior to becoming a CEO (Karaevli, 2007). Going beyond whether a CEO is an insider or an outsider, it is also reasonable to hypothesize that as executives spend more time at large diversified companies they will have more opportunities to acquire an in-depth understanding of their companies’ processes, procedures, routines, and other types of firm-specific knowledge and become fully knowledgeable of the social and network ties and relationships within these companies. Thus, we would expect that less experienced executives will not be associated with high performance in large diversified companies, but that more experienced executives should be positively associated with performance outcomes. One previous study has found that the CEOs of more diversified companies tend to be older and have more years of education than their counterparts in less diversified companies (Berry et al., 2006). This finding also implies the importance of firm-specific human and social capital in successfully managing the organizational complexity associated with highly diversified firms. Thus, we hypothesize:

> **Hypothesis 3**: The number of years an executive spends with a large diversified company before

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becoming CEO will be positively associated with firm performance.

SAMPLE AND VARIABLES

The sample was composed of 250 firms chosen randomly from the 2004 Fortune magazine's "500 Largest Firms" in order to include firms that are both large and diversified in the study. Of the initial set of 250 firms, we excluded 11 firms for which complete data were unavailable or were presented in an inconsistent format. This resulted in a final sample for this study of 239 firms.

Firm performance is measured using average return on assets (ROA) for the three years 2004 through 2006. The use of ROA in this study is consistent with the performance measure used in many studies examining the influence of CEO background and experience. ROA is less influenced by capital structure than ROE, and it is not as subject to the volatility that is present in market-based performance measures. And, by using a three-year average, we minimize the impact of one-year swings in accounting performance that can be attributed to one-time factors. Firm performance data were obtained from the Mergent Online database.

We define insiders as CEOs who had tenures of two or more years with their company before their appointment as CEO (Chaganti & Sambharya, 1987; Datta & Guthrie, 1994; Davidson et al., 1990; Vancil, 1987). Outsiders were defined as CEOs who had less than two years experience with their company before their appointment as CEO. Data on insider/outsider status were obtained from Dun and Bradstreet's Handbook of Corporate Managements, 2004.

To explore in a more detailed way the value of firm-specific CEO experience (Karaevli, 2007), we include a measure of the number of years executives were with a company prior to becoming CEO. This is equal to the natural logarithm of one plus the absolute number of years individuals were with a company before their appointment as CEO. Data for this measure were obtained from Dun and Bradstreet's Handbook of Corporate Managements, 2004.

To examine the influence of size on the decision to select insiders and those with more firm-specific experience, and then later to control for the documented effect that firm size has on performance and a wide range of strategic decisions, we included the natural logarithm of the number of employees in 2004 in our statistical analyses. Data on firm employment levels were obtained from the Fortune database.

Diversification was assessed in 2004 using the continuous entropy measure of diversification (Palepu, 1985). This continuous measure uses SIC codes and business unit sales data to evaluate the extent of diversification, and tests of its validity have supported its use as a measure of diversification (Hoskisson, Hitt, Johnson, & Moesel, 1993). Data to compute our diversification measure were obtained from Mergent Online.

Industry profitability exerts a considerable influence on firm performance (Rumelt, 1991), so we control for industry effects by including a measure of industry profitability. Data on industry performance in 2004 were obtained from Fortune.

We control for the length of time an individual has served as CEO and measure CEO tenure as of 2004. Data were obtained from Dun and Bradstreet's Handbook of Corporate Managements, 2004.

RESULTS

Means, standard deviations, and correlations for all of the variables included in the study can be obtained from the authors. Hypothesis 1a suggested that large diversified firms would be more likely than smaller and less diversified firms to have insiders as CEO, and Hypothesis 1b proposed that large diversified firms would be more likely than smaller and less diversified firms to have executives with more firm-specific experience. Since the insider variable is dichotomous, we used Logit analysis to test Hypothesis 1a, and because the years with company variable is continuous, we used regression analysis to test Hypothesis 1b. The results of these tests are summarized in Table 1. Lending partial support to Hypotheses 1a and 1b, we found the firm size variable to be significant and positively associated with the decision to have an insider CEO and a CEO with more years of firm-specific experience. However, the diversification variable is not significantly associated with the decision to select an insider to be CEO and it is only modestly associated with hiring an individual with more years of firm-specific experience. Thus, it appears that firm size is a more significant influence than the extent of diversification on the selection of insiders and executives with more firm-specific experience as CEO.

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TABLE 1

Are Large Diversified Firms More Likely to Have Insiders and Executives with More Years of Company-Specific Experience As Their CEO? (standard errors in parentheses)

	Dependent Variable:	
	Insider CEO	Years with Company
Intercept	-2.06	.77
	(1.28)	(.57)
Firm Size	.27 *	.15 **
	(.13)	(.06)
Firm Diversity	.17	.20 +
	(.27)	(.16)
Chi-Square Likelihood Ratio	5.43 +	
R-Square		.04
F Statistic		5.4 **
N	239	239

+ $p < .10$
* $p < .05$
** $p < .01$
*** $p < .001$

Summaries of the results of regression analyses examining Hypotheses 2 and 3 are shown in Table 2. Model 1 summarizes the influence of the control variables on firm performance, showing that industry profitability and firm size are significant and positively associated with firm performance. Model 2 examines the influence of these control variables and the insider CEO variable on firm performance. Supporting Hypothesis 2, which proposed that firm performance will be higher when large diversified firms have insiders as CEO, the insider variable is both positive and significant. Model 3 examined the influence of the control variables and the years with company variable on firm performance. (CEO tenure is not included in this model due to its high correlation with the years with company variable.) Providing strong support for Hypothesis 3, the years with the company variable is highly significant and positively associated with ROA.

TABLE 2

The Influence of Insider CEOs and CEOs with More Years of Firm-Specific Experience on Firm Performance (dependent variable in all models is ROA, standard errors in parentheses)

	Model 1	Model 2	Model 3
Intercept	-6.53 *	-6.55 *	-6.54 *
	(2.83)	(2.81)	(2.78)
Industry Profitability	1.32 ***	1.35 ***	1.31 ***
	(.13)	(.13)	(.13)
Firm Size	.60 *	.50 +	.46 +
	(.27)	(.27)	(.27)
Firm Diversity	-.02	-.05	-.15
	(.57)	(.57)	(.57)
CEO Tenure	.06	.04	
	(.04)	(.04)	
Insider		1.62 *	
		(.69)	
Years with Company			.84 **
			(.32)
R-Square	.32	.34	.34
F Statistic	27.83 ***	23.81 ***	29.80 ***
N	239	239	239

+ $p < .10$
* $p < .05$
** $p < .01$
*** $p < .001$

To further explore the influence of insider/outsider status and years of firm-specific experience on firm performance outcomes in diversified firms, we conducted additional analyses examining performance differences across less and more diversified groups of firms. We first divided our sample of 239 firms into two groups by the median level of diversification. We then further divided these two groups into insider and outsider subgroups and calculated the mean ROA for these four subgroups as shown in Table 3.

As summarized in Table 3, the distribution of firms shows only a slightly higher number of the more diversified firms are led by insiders than their less diversified counterparts, and similarly, only a slightly higher number of the less diversified firms are led by outsiders than their more diversified counterparts. As predicted by the arguments summarized in this paper, however, the two subgroups of firms led by insiders enjoyed higher mean levels of ROA. And, as predicted, the subgroup of more diversified firms led by insider CEOs significantly outperforms the subgroup of more diversified firms led by outsider CEOs.

Second, we subdivided our groups of firms into four subgroups based on the extent of diversification and the CEO's years of firm-specific experience (as determined by the median values for diversification and the years with company variable). We then calculated mean ROA for these four subgroups as shown in Table 4. Again, the two subgroups of firms led by CEOs with more years of firm-specific experience enjoy higher levels of mean ROA than their counterparts that are led by CEOs with fewer years of firm-specific experience. Comparing the two more diversified subgroups of firms, those led by CEOs with more firm-specific experience significantly outperform the firms led by CEOs with fewer years of firm-specific experience.

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TABLE 3

Performance Differences in Less Diversified and More Diversified Firms Led by Insiders and Outsiders

	Less Diversified	**More Diversified**
Insider	N = 81 Mean ROA = 5.53 Variance = 46.16	N = 85 Mean ROA = 5.66 Variance = 23.39
Outsider	N = 39 Mean ROA = 4.52 Variance = 40.90	N = 34 Mean ROA = 3.79 Variance = 16.46
	ROA diff. = 1.02 df = 80 t-statistic = .80, n.s.	ROA diff. = 1.87 df = 72 t-statistic = 2.15 *

+ $p < .10$
* $p < .05$
** $p < .01$
*** $p < .001$

TABLE 4

Performance Differences in Less Diversified and More Diversified Firms Led by CEOs with More and Less Years of Firm-Specific Experience

	Less Diversified	**More Diversified**
More Years of Firm-Specific Experience	N = 53 Mean ROA = 5.99 Variance = 59.02	N = 65 Mean ROA = 6.05 Variance = 25.11
Less Years of Firm-Specific Experience	N = 67 Mean ROA = 4.66 Variance = 32.46	N = 54 Mean ROA = 3.61 Variance = 15.78
	ROA diff. = 1.34 df = 93 t-statistic = 1.06, n.s.	ROA diff. = 2.44 df = 117 t-statistic = 2.60 **

+ $p < .10$
* $p < .05$
** $p < .01$
*** $p < .001$

DISCUSSION AND CONCLUSION

Contributions to Theory and Practice

Though most strategy researchers would agree with Rumelt that "the critical resource of the modern, diversified, divisionalized firm is general management skill" (1974: 156), previous research includes relatively few studies that have explicitly incorporated human variables in an effort to understand the antecedents of firm performance in large diversified firms. For anyone who accepts the view that human and social capital is an important source of advantage, this study's findings are unlikely to come as a surprise. Yet, all too often management research tends to view the leadership of such firms as a "faceless abstraction" (Bettis & Prahalad, 1995: 6), and, aside from a few noteworthy exceptions (e.g., Michael & Hambrick, 1992; Stimpert & Duhaime, 1997; Wiersema & Bantel, 1993), the diversification and corporate strategy literatures have largely ignored the role of executives and top managers in formulating and implementing strategies and the importance of human and social capital as an influence on firm performance.

Our study finds that large firms are more likely to select insiders and those with more years of company-specific experience as CEO. On the other hand, we also find that more diversified firms are not more likely to select insiders and only somewhat more likely to select CEOs who have more years of firm-specific experience. These results suggest it is the complexity associated with firm size rather than the extent of diversification that primarily drives the decision to select insiders and those with more years of firm-specific experience to be CEO.

Our study supports our hypothesis that large diversified firms will enjoy higher performance when they have insiders as CEO. We also contribute to theory by suggesting a new, more refined measure of executive experience or background, the number of years of company-specific experience. Prior studies of executive experience that have employed the insider/outsider dichotomy have acknowledged that it is fairly arbitrary in the way it distinguishes among executives who have had varying degrees of prior experience before becoming CEO (Karaevli, 2007). Our development and use of the years of experience variable highlights the importance of human and social capital in large diversified firms. In addition, our finding that the number of years of company-specific experience is associated with higher firm performance suggests the importance of using this new measure and the insights that can be gained from it.

Our findings also have significant practical value. As boards develop succession plans and hire CEOs, they should be mindful of the firm-specific human and social capital possessed by company insiders and those with more company-specific experience. The value of this human and social capital may be too easily taken for granted but, as our study illustrates, it is highly valuable and is associated with significantly higher performance. Studies cited earlier in this paper suggest that boards may select an outsider CEO in response to poor performance, but many of these studies also indicate that this move may be a short-term expedient that will fail to insure longer-run success (Karlsson et al., 2008; Lucier et al., 2006).

Suggestions for Future Research

Previous studies have shown that firms have a tendency to hire outsiders during times of poor performance and that performance tends to improve following the hiring of an outsider CEO (although several researchers have suggested that this performance improvement may be unrelated to the choice of CEO and may, in fact, reflect a regression to the mean). While we did not examine the relationships among prior firm performance, choice of CEO, and subsequent firm performance, a study pursuing this line of inquiry would be a logical follow-up to our research. Similarly, it would be interesting to examine the performance consequences of hiring outsider CEOs who have prior experience in more diversified firms versus those who have either no or very little prior experience in diversified firms.

Likewise, it would be interesting to know something about the tenures of insider and outsider CEOs. For example, do insider CEOs have longer tenures than outsider CEOs and are outsider CEOs more likely to move on to leadership opportunities at other firms? It would also be interesting to determine if discernable differences exist between the strategies adopted by insider and outsider CEOs of large diversified firms. For example, it might be reasonable to hypothesize that outsider CEOs, in an effort to improve firm performance, are more likely to change their firms' diversification strategies since they lack a commitment to their firms' past strategies (Bigley & Wiersema, 2002; Wiersema, 1992). One recent study examining how CEO background influences the relationship between strategic change and firm performance offers some interesting parallels with this study. Zhang and Rajagopalan find that the long-run performance effects of major changes in strategy are enhanced when they are initiated by insider rather than outsider CEOs. They conclude that insider CEOs enjoy higher long-run performance because "they are more likely to initiate and implement strategic changes that build upon existing organizational capabilities" (2010: 343).

Another avenue for research that would have both theoretical and practical value would be to follow-up on Bower's (2007) idea of developing individuals with the capacity to be "inside-outside" executives, or executives who have the intimate firm-specific knowledge of insiders and the perspective of outsiders. We believe that executives are often too narrowly dichotomized as insiders linked to the status quo or as outsider change agents, when companies actually need CEOs who can simultaneously understand the importance of exploiting existing competencies while also

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anticipating the changes their companies will need to make in order to develop and sustain competitive advantage in the future (Lublin, 2009; March 1991).

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J. L. "Larry" Stimpert is Professor of Economics and Business at Colorado College. Professor Stimpert received his Ph.D. in Business Administration from the University of Illinois, and his research interests focus on top managers and their influence on strategic decision making and firm strategies. He has written on many strategy issues, including managerial responses to environmental change and organizational decline, business definition and organizational identity, the management of corporate strategy and diversification, company strategies following deregulation, and corporate governance.

Julie A. Chesley is an Assistant Professor of Organization Theory and Applied Behavioral Science at the Graziadio School of Business, Pepperdine University. She received her Ph.D. in Organization Theory and Management from the Leeds School of Business at the University of Colorado. Dr. Chesley's teaching, research, training, and consulting focus primarily on organization change, team development, leadership development and strategy implementation.

Amanda S. Ostrowitz graduated from Colorado College with a B.A. in economics in 2008. She is presently a law student at the Strum College of Law at the University of Denver.

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