

# Inside or Out?

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By: Michael O'Brien

*A new study finds organizations that appoint new CEOs from within their ranks are better off in the long term than organizations that hire from outside. But, General Motors, which recently installed an outside CEO, may be a role model for an exception to the rule, experts say.*

A few weeks ago, General Motors announced Ed Whitacre was dropping the “interim” from his title of chief executive officer, less than two months after he was hired in a temporary capacity to guide the search for a permanent CEO to replace Fritz Henderson.

The move was hailed by industry experts and other observers as a step in the right direction for the struggling automaker, which is trying to dig out from the worst economic conditions in a generation as well as pay back its large slice of the government bailout.

“The board looked at the potential candidates and decided this place needs stability. We don’t need any more uncertainty,” Whitacre told reporters at GM’s Detroit headquarters upon revealing his new title.

“We think it’s good news for the taxpayers, good news for the company,” Ron Bloom, a senior adviser on auto issues to Treasury Secretary Timothy G. Geithner, told the Los Angeles Times when the move was announced.

Prior to joining GM in last December, Whitacre was perhaps best known for his previous work in the telecommunications industry, specifically as chief executive at AT&T from 2005 through 2007.

Ironically, just six days before that announcement was made, a Rice University management professor announced the results of a study that looked at the achievements of 193 CEOs in the industrial sector between 1993 and 1998.

The study concludes that “inside” CEOs, or those hired from within the company’s ranks, fared better in the long term than “outside” CEOs.

The study, “Once an Outsider, Always an Outsider? CEO Origin, Strategic Change and Firm Performance,” was co-authored by Anthea Zhang, an associate professor of management at Rice University, and University of Southern California management professor Nandini Rajagopalan. It recently was accepted for publication in Strategic Management Journal.

“From the implications of this research, it’s clear that companies may be better off in the long term led by CEOs groomed from the inside, as opposed to CEOs from the outside,” Zhang said when announcing the study. “Boards of companies need to recognize that hiring an outside CEO poses greater risks to the company’s performance in the long term.”

The researchers found that, in the first few years of tenure, there is very little difference between the performance of CEOs promoted from within a company and CEOs hired from the outside. In later years, however, the researchers found that internally promoted CEOs outperformed the outsider CEOs.

“Newly appointed CEOs, both outsiders and insiders, tend to make changes, and it may take years to observe the performance impact of the changes,” she says. “Therefore, the relative advantage or disadvantage between ‘inside’ and ‘outside’ CEOs in initiating and implementing appropriate strategic changes is not seen immediately.”

After three years, however, Zhang says, the inside CEOs fared better.

“When it comes to strategic change, outsiders typically are good at doing the rapid cost-cutting and divestment,” she says. “As tenure increases, obvious opportunities for cost-cutting and divestment dry up. Inside CEOs, because of their

deep knowledge and roots in the firm, are more likely to initiate and implement strategic changes that can build the firm's long-term competitive advantage.”

In a telephone interview, Zhang says GM's decision to make the outsider Whitacre a permanent replacement at CEO was likely done out of necessity more than anything else.

“I don't think it was the best thing to do, but it's the best option they had,” she says. “It's not a question about whether he is the ideal choice. The issue is that GM needed stability, and that's the key. So from this perspective, it was a wise choice.”

Nancy Keene, a director in the Dallas office of retained executive-search firm Stanton Chase, says the GM decision may be an exception to the insider-promotion advantage.

“In the case of GM, the organization was homegrown and in-grown, in the opinion of many,” she says. “Doing things ‘the GM way’ was very ingrained in leaders who had never worked anywhere else. Stakeholders could not wait for improved results. Thus, going outside the company and infusing new talent and ‘tone at the top’ was the only option.

“Continuing the ‘promotion from within’ succession plan was only guaranteeing more of the same,” she adds. “Why not give [Whitacre] a shot? He's leading and mentoring a younger generation of GM talent that might be ready to break out of the old, outmoded ‘GM way.’ “

Companies are “living entities, they are not static,” she says. “They evolve through various stages of growth with a wide range of competitive challenges. A leadership team must be able to navigate with certainty and surety.”

However, long-term thinking is not necessarily something today's CEOs are even doing, says Ron Wince, president and CEO of Mesa, Ariz.-based Guidon Performance Solutions.

“The average tenure for CEOs today has continued to decline to less than four years,” he says. “This means, on average, there is no such thing as long term anymore.”

He says the best time for an outsider to be named CEO of an organization is “when a company needs to take a whole new approach to doing business. The ... outsider will not be invested in strategies and initiatives which may, in fact, need to be killed off.”

Ultimately, Zhang says, the GM example should make HR executives more aware of the need for “a constant plan for success.”

“You have to constantly have a pool of candidates -- and it doesn't have to be big -- so you can fill positions in the event of a change,” she says.

She cites both McDonald's and Wal-Mart as examples of companies that were able to quickly and effectively fill their CEO spots when unexpected vacancies occurred. But, she adds, succession plans should not be limited to the top position in a company.

“Companies need to have a succession plan for each key management position,” she says. “It's not just for the CEO position anymore.”

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866.986.4414 or 480.986.4414

[contact@guidonps.com](mailto:contact@guidonps.com)

[www.GuidonPS.com](http://www.GuidonPS.com)

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