Key Concept

When it comes to investment, CEOs are perceived to be the most risk tolerant, followed by CFOs and non-executives. However, recent research, measuring risk perception and return demands, shows that CEOs and CFOs are more aligned than previously thought, while non-executives are consistently risk-averse. CEOs will perceive more risk in an investment than CFOs, but don't act on this perception: they don't demand a higher minimum return on the investment, contrary to the minimum requirements demanded by non-executives.

Idea Summary

Corporate board of directors are composed of executives (CEOs and CFOs) and non-executives. In the U.S. and the UK, the executives and non-executives are grouped on one board. In Europe, the executives form one board, and the non-executive members form a distinct 'supervisory' board.

Together, the CEOs, CFOs and non-executive board members make up what some call the corporate 'elite'. A research team from Erasmus University in the Netherlands (where the two-board structure is in place) set out to explore the risk tolerance of this elite. Specifically, the team studied risk perception (how much risk they perceived in investments) and decision-making (whether or not to approve the investment).

Previous research on risk and decision-making was based on data, such as stock performance measures or compensation. Other research is based on laboratory experiments. To gain more real-world results, the Erasmus researchers used a questionnaire sent to CEOs, CFOs or non-executive directors in mostly Netherlands-based national, international, or multinational companies. Nearly 200 questionnaires were returned and analysed by the researchers.

The questionnaire was built around two vignettes: two hypothetical investment opportunities that detailed the size and type (for example, expansion of...
production capacity, new marketing expansion, R&D investment) of the investments. The hypothetical investments also included the estimated probability of success. The size of the hypothetical investments were tailored to the experience of the participant — specifically being a bit larger than the investments with which the participant had experience.

After participants read the vignettes they were asked a series of questions to determine:

- **Self-Perceived Risk Tolerance.** Participants were asked to rate their willingness to take risks. The results show that CEOs perceived themselves to be more willing to take risks than CFOs or non-executive board members.

- **Perceived Risk Tolerance by Roles.** Participants were asked to rate the willingness of the average CEO, CFO, and non-executive board members to take risks. The results were in line with the self-perceptions: CEOs were perceived to be the most risk tolerant, followed by CFOs and non-executives.

- **Return Demanded.** Participants were asked the minimum Net Present Value (NPV) they would demand before approving the investment in the vignettes. Results of the survey show that non-executives demanded a higher return than CEOs, whose return demands were close to CFOs.

- **Risk Perception.** Participants were asked how risky they believed the investment to be. CEOs joined non-executives in perceiving higher risks in their investments than CFOs.

According to the results, the perceptions and behaviour of the CFOs and non-executives are consistent: non-executives are more risk averse, both in terms of demanded return and risk perception. CFOs are more risk tolerant in both of those dimensions. For CEOs, the results are bit more muddled; on of the one hand, CEOs would perceive more risk in an investment than CFOs. In this dimension, CEOs were closer to the position of non-executives. However, CEOs would demand the same level of return as the CFOs, not as the non-executives with whom they shared the same risk perception. In short, CEOs perceived more risk but did not act on that perception.

In addition to role, other factors, such as age and experience, impacted return and risk perception. Older corporate elite became more careful, perceiving more risk in investments and asking for higher NPV. More experienced corporate elite will perceive less risk in an investment but still demand a higher NPV.

The survey also revealed that overconfidence can influence risk tolerance. Specifically, more confident board members are less risk averse, demanding a lower NPV and perceiving less risk.

**Business Application**

The most revealing take-away is that no matter how much risk CEOs, CFOs and non-executive boards members perceive in an investment, the non-executives are going to demand a higher return than the executives (CEOs and CFOs). This also means that CEOs and CFOs are much more closely aligned on risk-
taking than usually believed.

Why non-executives are more consistently risk averse than executives is an open question; part of the explanation may be in experience and age, which tends to make people more careful. At any rate, in the midst of formal investment discussions — as when the board is considering an important investment option — the three roles will benefit in remaining aware of the perceptions that each have of themselves and others concerning risk tolerance and aversion, and the general tendency of non-executives to be more cautious.

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References


Further Reading and Relevant Resources

Bert de Groot's profile at Erasmus School of Economics, Erasmus University
Sander Renes' personal website
Rene Segers' home page at Erasmus School of Economics, Erasmus University
Philip Hans Franses' profile at Erasmus School of Economics, Erasmus University
Rotterdam School of Management, Erasmus University, Executive Education profile at IEDP

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