Can companies resolve groupthink issues and improve their performance by turning over their boards more often, ask Mark Rogers and Amir Satvat.

The notion that members of a decision-making group may become overly cohesive and suffer from so-called ‘groupthink’ is commonplace in psychology and management. Equally, the recent corporate scandals in both the US and UK have drawn attention to the role of ‘hubris’ in distorting decision-making. Despite this, little attention has been devoted to assessing how corporate boards can guard against groupthink. This study puts forward an idea about the optimal rate of board turnover – the board rotation principle – as a result of testing the impact of groupthink by analysing data on a sample of US consumer firms (1994-98). The basic hypothesis used for the research was that low levels of board rotation may increase the chances of groupthink and, subsequently, poor performance for the companies involved. Intuition would also suggest that high board rotation may also have adverse effects, as experience and continuity may be disrupted. The empirical results confirm these thoughts: performance appears to be higher for those firms that have intermediate levels of board rotation. However, this result is only found when we use future profitability as a performance measure, using current Tobin’s q as a proxy for future performance does not uncover such a relationship.

LINKING BOARD ROTATION AND PERFORMANCE

Our study used empirical methodology to analyse the link between board rotation and performance in a sample of 37 consumer companies in the S&P 500 index. The test was motivated by the most basic solution to groupthink, namely, to regularly introduce new group members, which in the present context means new board members.

Using data on board size and board turnover, we constructed a measure of board rotation (the proportion of the board that is replaced each year). Since the possibility of groupthink should be lower when board rotation is higher, this provides a method of testing for the influence of groupthink.

Since there appears to be no previous empirical analysis on the link between board rotation and performance, the paper proceeded in a specific way. First, we considered only S&P500 consumer companies as these represent firms in an established and relatively stable industry which attract substantial stockmarket analysis.

Second, we analysed the years between 1995 and 1998, before a period of rapid share price growth. Third, we considered both a stockmarket measure of performance (Tobin’s q) and a forward looking profitability measure (the average Earnings Before Depreciation Interest and Taxes or EBDIT, margin over the next four years). Last, we used a range of empirical methodologies, varying from simple summary statistics to simultaneous equation models.

The data shows that the mean board rotation was 8.6 per cent, or one director, in any given year. However, there was substantial variation across firms, with around 40 per cent of companies retaining the same board over two years and one firm where 60 per cent of directors left within a year. This large variation is thought provoking, since one might expect such large differences in board structures to have some effect on decision-making and, in turn, performance.

An analysis of the mean and median Tobin’s q across firms reveals that firms with the lowest
board rotation have the highest $q$. This is most striking when we take a four-year average of $q$ for each firm, finding that firms in the lowest quintile of board rotation have a $q$ of 2.8 while firms in the top quintile have a $q$ of 1.4. This suggests that the sharemarket places a premium on board continuity, which implies that experience and stability are dominant factors in achieving optimal business decisions.

Put another way, the sharemarket appears unconcerned about the possibility of groupthink, at least to the extent that board rotation may be necessary to prevent its effects. The situation was, however, considerably different if we used future profitability as a performance measure. In this case the analysis showed that firms with relatively high board rotation, namely three directors a year (between 8.6 and 14.6 per cent over four years), achieved the highest EBDIT margin (as measured by the mean or median). Thus there is some evidence that the lack of board rotation, and by assumption the presence of groupthink, may adversely affect profitability.

A drawback of the simple statistical analysis discussed here is that it cannot control for third factors or potential reverse causation. The latter may be particularly important: this paper is based on the hypothesis that board rotation can affect firm performance, but performance could affect rotation.

In fact, there is a literature that finds that poor performance raises CEO turnover. We tested for a performance to board rotation effect in our sample and found that some reverse causation did occur, with poor profitability in previous years raising board rotation. However, the magnitude of this effect was relatively small. In addition, if reverse causation was present it would tend to reduce the magnitude of any positive effects running between board rotation and performance that we found (since the negative performance-to-rotation mechanism would tend to offset any positive board rotation-to-performance relationship).

The regression analysis finds that a simultaneous equations model performed poorly with the limited data available, although it did indicate that reverse causation was not an important mechanism. Given this, the analysis utilised a simple ordinary least squares (OLS) regression analysis in which we controlled for other potential determinants of performance (such as the number of external directors, firm size, intangibles and past growth).

The results indicated that there was no significant partial correlation between Tobin’s $q$ and board rotation. However, using future profitability as a performance measure the analysis again found that firms with relatively high board rotation between 8.6 per cent and 14.6 per cent performed better than average. The magnitude of the effect suggested that such firms had a 6 per cent higher EBDIT margin than average. This gives rise to the idea of a ‘board rotation principle’ where firms endeavour to replace board members at this rate.

While this paper has provided some important evidence of the role of board rotation in performance, future research needs to test a larger data set.

**What is groupthink?**

Irving Janis defined groupthink in 1982 as the “deterioration of mental efficiency, reality testing and moral judgment in the interest of group solidarity”. Most famously, in his 1972 study of US foreign policy, Janis noted that some of the worst decisions appeared to be linked to groupthink. Groupthink occurs when the members of the group become overly concerned about cohesiveness, rejecting dissent within the group and paying little attention to external views. In some ways, therefore, groupthink is ‘hubris’ of the group, rather than an individual.

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