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Market performance and deviance from industry norms: (Mis)alignment of organizational risk and industry risk

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Abstract

Much of the attention in the risk literature focuses on organizational risk. This research argues that industry-level risk indirectly influences firm performance in addition to the direct effects of organizational risk. We contend industry-level risk norms influence market performance. Our general hypothesis is that when managers pursue strategies that deviate from industry risk norms, the firm's market performance will decline. We also test for the moderating effects of performance relative to targets and managerial ownership. The general hypothesis was supported for market risk and returns risk, but not for strategic risk. In addition, performance relative to target moderates this deviation-market performance relationship for market and returns risk. These findings have implications for the risk literature, particularly a firm's risk premium, and institutional theory, in terms of the tradeoff related to conformity to norms.

Keywords: Risk; Industry norms; Market performance; Institutional theory

1. Introduction

Risk is a critical component of strategic management due to its influence on managerial decisions and organizational performance. Behavioral and agency explanations of the risk avoiding/seeking choices of managers have been supported by numerous scholars (Bromiley et al., 2001), providing evidence of strong linkages between firm risk, managerial choice and organizational performance (e.g., Bromiley, 1991; Miller and Bromiley, 1990; Miller and Leiblein, 1996; Palmer and Wiseman, 1999; Singh, 1986; Wiseman and Bromiley, 1996). These findings center on multiple dimensions of risk at the organizational level.

However, risk at the industry level also appears to be relevant to strategists. Prior research supports an indirect effect of industry risk factors on firm risk, managerial risk-taking, and performance (e.g., Bettis and Hall, 1982; Fiegenbaum and Thomas, 1986; Lubatkin and O'Neill, 1987; Palmer and Wiseman, 1999). Industry risk characteristics have also often been included as control or categorization variables.

Other perspectives suggest a direct effect of industry risk. Financial theory suggests investors' market risk assessments, i.e., systematic and unsystematic risk, are influenced by industry structure (Lubatkin and Chatterjee, 1994; Lubatkin and O'Neill, 1987). New conceptualizations of the risk premium, critical to the valuation of companies, involve the pressures and norms present in the industry (Chatterjee et al., 1999). Investors appear to form expectations of firm risk based upon the risk levels of industry participants.

These arguments related to the risk premium suggest that industry risk impacts the firm's market performance. Institutional theory indicates an important role for industry risk through the pressures faced by firms from the external environment that demand certain types of actions (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). Outside stakeholders can pressure firms to conform to industry norms. Conformity can lead to legitimacy and economic gains (Oliver, 1991), and superior performance (Chen and Hambrick, 1995; Deephouse, 1999;

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Geletkanycz and Hambrick, 1997), while non-conformity can lead to negative consequences.

We argue that industry norms exist for multiple dimensions of risk: strategic risk, returns variability, and market risk. Extending the arguments of Chatterjee et al. (1999), we suggest that investors form expectations for organizational risk based upon industry-level risk. Deviation from such norms may lead to shareholder losses, more difficulty garnering support from constituents, or higher resource acquisition costs (Geletkanycz and Hambrick, 1997; Deephouse, 1999; McNamara et al., 2003). Our main hypothesis is that firms will be penalized by investors with reduced market performance for pursuing strategies with substantially higher or lower levels of risk relative to industry norms. We use behavioral and agency arguments to demonstrate that performance relative to targets and managerial ownership may moderate our general alignment hypothesis.

The findings highlight the critical role that industry risk, in the form of norms, plays in determining market performance. Furthermore, our findings extend the model of risk premium proposed by Chatterjee et al. (1999) to include a broader conceptualization of the role of industry risk norms, with norms existing along multiple dimensions. Moving beyond industry risk characteristics as a control or antecedent, this research provides a more detailed picture of the role of industry risk in the risk-strategy-performance model.

2. Organizational- and industry-level risk

Risk in strategic management has developed into a multidimensional construct (Bromiley et al., 2001). Different measures have more salience to different stakeholders (Miller and Bromiley, 1990; Miller and Reuer, 1996). Bromiley et al. (2001) provide a comprehensive review, highlighting the focus on organizational risk as well as behavioral and agency theory perspectives.

Despite the focus on organizational risk, the notion of industry-level risk exists from earlier strategy discussions of risk (Baird and Thomas, 1985; Bettis and Hall, 1982; Lubatkin and O'Neill, 1987). However, these discussions do not measure industry-level risk. Empirically, scholars have focused on the impact of industry risk characteristics on organizational risk or managerial risk taking (Bromiley, 1991; Palmer and Wiseman, 1999; Wiseman and Bromiley, 1996). We argue for a greater role for industry-level risk, building on recent discussions by Chatterjee et al. (1999).

3. Industry risk and performance: the role of industry risk norms

3.1. Industry risk and investor expectations

Chatterjee et al. (1999) provide a conceptual framework for the firm's risk premium, suggesting four classes of risk to which the firm's returns are sensitive. First, "Like CAPM, our framework of risk premium consists of the sensitivity of a firm's expected returns to macroeconomic uncertainties" (Chatterjee et al., 1999: 568). Second, tactical risk involves the ability of the firm to minimize earnings surprises and information asymmetries between the firm and investors. Third, strategic risk reflects the firm's resource commitments, which can protect earnings from broad economic disturbances.

The fourth component, normative risk, is most relevant here. The actions to manage tactical and strategic risk are temporary, with competitive imitation over time. These actions become institutionalized and form a "source of variance about some baseline level of firm-specific risk" (562). The norms of actions impact the firm's risk premium: failing to follow the norms results in penalties through higher risk premiums and higher capital costs. Thus, Chatterjee et al. (1999) suggest the existence of industry risk norms and investor expectations.

3.2. Institutional theory implications for industry risk norms

DiMaggio and Powell (1983) highlight the importance of normative pressures. Organizations facing institutional pressures will tend toward similarity due to common conditions (Dacin, 1997). Conformity yields benefits of legitimacy and economic gains. However, firms do have a range of responses to norms, from conformity to acquiescence to defiance (Oliver, 1991). Conforming behaviors provide assurances to stakeholders (Chen and Hambrick, 1995). Norms also have a cognitive influence on managers, such as the use of benchmarking (Hill et al., 1996) and strategic conformity (Geletkanycz and Hambrick, 1997).

Deephouse (1999) and McNamara et al. (2003) expand upon conformity. They indicate a range of acceptability; falling outside this range can be dangerous due to legitimacy challenges, diminished ability to obtain resources and lower levels of performance. The lower levels of performance for violating industry norms can be due to stakeholder concerns about reliability and reduced constituent support (Chen and Hambrick, 1995; Geletkanycz and Hambrick, 1997), as well as greater risk premiums required from exchange partners (McNamara et al., 2003; Singh et al., 1986). Strategic conformity, however, can be beneficial to firm performance (Geletkanycz and Hambrick, 1997).

It is important to note that managers may be intentionally or unintentionally deviating from norms despite the reward/penalty that exists. Firms may want to adhere to norms, but may be unable due to resource constraints or other organizational issues (Oliver, 1991). Alternatively, managers may be focusing on a different reference group (Warren, 2003).

Following Chatterjee et al. (1999) we contend that industry norms of risk do exist. If a firm's competitors are able to protect their returns from economic pressures, then investors will expect the firm to do the same. If firms deviate from the industry risk profile, we would expect that investors will penalize the firms by increasing its risk premium (Chatterjee et al., 1999; McNamara et al., 2003; Singh et al., 1986), thereby reducing the firm's stock price.

H1. Investors will penalize firms for deviating from industry risk norms. Deviating firms will be associated with lower market performance relative to conforming firms.