Antecedents and Performance Outcomes of Diversification: A Review and Critique of Theoretical Perspectives

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Three theoretical perspectives summarize diversification antecedents and performance outcomes. The first perspective examines diversification under the assumption of relative market perfection where, within industries, firms and products are homogeneous. The second perspective discusses diversification where both market and firm imperfections are assumed to exist. The third perspective also assumes market and firm imperfections, but further assumes imperfect governance structures such that managerial motives for diversification are influential. These perspectives provide different explanations of antecedent resources and incentives that encourage (or discourage) diversification. This article reviews evidence associated with each perspective concerning the relationship between diversification and firm performance and offers suggestions for future research based on comparisons among these alternative perspectives.

Introduction

The diversification of business organizations has increased significantly in the United States, Europe, Asia and in other parts of the industrialized world (Berry, 1975; Chang & Choi, 1988; Channon, 1973; Chenall, 1979; Dyas and Thanheiser, 1976; Franko, 1974; McDougall & Round, 1984; Rumelt, 1974; Suzuki, 1980). Research by Rumelt (1974, 1982) found only 30.1% of the Fortune 500 U.S. industrial companies generated more than a quarter of their revenue from diversified activities in 1950, but by 1974 this figure had risen to 63%. Since 1974, firms have continued to diversify, primarily through mergers and acquisitions (Porter, 1987). Although in the late 1970s and the 1980s there was a trend toward deconglomeration or divestiture of units unrelated to core businesses (Hoskisson & Turk, 1990; Ravenscraft & Scherer, 1987; Williams, Paez & Sanders, 1988), most large firms remain quite diversified. Research examining di-

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versification and firm performance has been ongoing for three decades and has intensified over the last decade, but there still is no unified theoretical framework that explains the antecedents of diversification and the relationship between diversification and firm outcomes such as performance. Reed and Luffman (1986) indicated that confusion has grown concerning the nature of the diversification-performance relationship.

The purpose of this article is to begin development of a unified theory by presenting a framework for understanding previous research on the antecedents and consequences of diversification. This begins by suggesting that diversification cannot be expected by firms acting in perfectly competitive markets. Thus, if firms diversify, it follows that they are acting in markets that are imperfectly competitive. Three particularly important market imperfections and their relationship to diversification are examined: (a) firm resource heterogeneity, (b) external and internal firm incentives for diversification; and (c) managerial motives for diversification. The review herein offers three theoretical perspectives on these antecedents and outcomes of diversification.

The first theoretical approach offered assumes that markets are relatively perfect and that firms within an industry are homogeneous and thereby produce very similar or substitutable products. This approach is based on economic theory that generally assumes that firms are organized with a single product focus and have homogeneous factor markets (Scherer, 1980). Therefore, only limited diversification is rational from this perspective and firm performance is likely to be unaffected. The structure-conduct-performance paradigm from industrial organization economics suggests that industry structure drives firm performance such that, over time, firm performance is controlled largely by the market rather than firm actions (Schmalensee, 1985).

A second theoretical perspective suggests that because most large firms have a multiproduct focus (Kamani & Wernerfelt, 1985), external incentives such as public anti-trust policy, tax laws and market failure due to high transactions costs may compromise assumptions of relative market perfection. These market imperfections may encourage diversification through incentives external to the firm. Furthermore, it is assumed that firm idiosyncrasies (Barney, 1986a) and firm imperfections such as low performance, uncertainty of expected future cash flows and desire for risk reduction may create internal incentives for diversification (Rumelt, 1974). With the relaxation of market perfection assumptions, managerial decisions become prominent in explaining firm performance. Thus, strategic contingency theory, where the concept of fit (Venkatraman, 1989) is central, may become salient in the relationship of diversification to performance because strategic choice among contingencies is more consequential.

A third theoretical perspective also assumes market and firm imperfections but additionally assumes managerial motives for explaining increased diversification. The dominant underlying theory behind this perspective is agency theory (Jensen & Meckling, 1976), which assumes that managers are agents of owners. In agency theory, firms are described as a nexus of contracts, but the crucial contract is between top managers (agents) and owners (shareholders or principals).
In this contract, there are owner costs to monitor manager’s behavior (i.e., governance or agency costs). Because monitoring is incomplete, the focus is on imperfect governance mechanisms rather than imperfect managers. For instance, boards of directors don’t know which managers will take self-interested actions that may harm the firm; therefore governance devices must be in place to detect mismanagement. Thus, it is the assumption of self-interest among some managers that necessitates governance devices. However, because governance devices are imperfect, they may also affect managerial strategic decisions. As a result, we examine how imperfect governance mechanisms may create motives for managers to diversify the firm.

Following the explanation and definition regarding antecedents of diversification below, each theoretical perspective is described. Within each perspective the dominant assumptions and theories are presented followed by a review of the method and results of associated research. Each perspective is then summarized and critiqued with alternative explanations offered.

**Antecedents of Diversification: Markets, Resources, Incentives and Managerial Motives**

The subsections that follow provide definitions of markets, resources, incentives and managerial motives as antecedents of diversification.

**Markets**

Neoclassical economic theory of the firm assumes competitive equilibrium and zero transaction costs. Firms are assumed to be profit maximizing organizations in competitive product and capital markets. Thus, these product and capital markets are assumed to be perfect in regard to information flow, and managers are assumed to have the ability to take advantage of this information—that is, managers use optimal decision processes.

Teece (1980, 1982) argued, however, that multiproduct (diversified) firms could not be explained by the neoclassical view of the firm. Teece (1980, 1982) disputed the proposal that firm diversification could be explained by economies of scope (Panzar & Willig, 1981) because there is no reason under neoclassical assumptions why joint production has to be organized within one firm. Teece (1980; 1982) further contended that financial synergy does not justify diversification because it does not necessarily reduce the risk of the stockholders, who can better achieve risk reduction through diversification of their own portfolio of financial assets. There is thus no justification for diversification under economic and finance assumptions of perfect product and capital markets.

To explain further, there are no resources, incentives, or managerial motives to diversify under assumptions of market perfection. For example, under conditions of competitive equilibrium all resources are perfectly imitable, and thus provide no benefit for diversification. Furthermore, there is no uncertainty of future cash flows because no information asymmetries exist between firms. As a result, there should be no incentive for diversification.

Firm diversification, however, does exist on a large scale both within U.S. and international firms. This suggests that some level of market and firm imperfection exists. We categorize the theoretical arguments and research regarding diversi-
fication into three perspectives as explained in the introduction. The first perspective assumes relative market perfection, and the latter two perspectives assume greater market and firm imperfections. The attempt is aimed at comparing and contrasting the assumptions on which the research is based. Thus, each perspective is differentiated on the degree of market (and firm) perfection assumed as well as the type of resources, incentives, and managerial motives underlying firm diversification.

Resources

In order to diversify, a firm must have the necessary resources such that diversification is economically feasible (Penrose, 1959; Teece, 1982; Wernerfelt, 1984). Tangible, intangible and financial assets therefore may facilitate diversification (Chatterjee & Wernerfelt, 1988).

Resources vary in their utility for value creation because of differences in rarity and mobility (Barney, 1986a). For instance, Jensen (1986) indicated “free cash flows” (liquid financial assets for which investments in current businesses are no longer economically viable) may be used to diversify the firm. Because financial assets, such as free cash flows are more mobile (flexible) and less rare, they are likely to create less value than other types of resources. Although Porter (1985: 348) suggested that financial resources are tangible, Chatterjee and Wernerfelt (1988) argued that they may be more flexible for purposes of diversification than other types of resources.

Tangible resources of a firm usually include the plant and equipment necessary to produce a product and, therefore, such assets may be less flexible. Thus, any excess capacity of these resources (plant and equipment) often can only be used for very closely related products, especially those requiring highly similar manufacturing technology. Porter (1985) suggested that excess capacity of other tangible resources, such as a sales force, can be used to diversify. Again, excess capacity in a sales force would be more effective with related diversification because it may be used to sell similar products. The sales force would be more knowledgeable of related product characteristics, customers, and distribution channels. Furthermore, Porter (1987) suggested that tangible resources may create resource interrelationships in production, marketing, procurement, and technology. He referred to this as activity sharing. These tangible resources would, of course, be more flexible than actual physical assets in facilitating diversification. Although sharing of tangible resources may induce diversification, other more intangible resources could also encourage diversification.

Intangible resources are similar to what Gort, Grabowski, and McGuickin (1985) called “organization capital” or what Rumelt (1974) referred to as “core skills.” Porter (1987) suggested that intangible resources are skills that can be transferred to related products with the least amount of cost. The difference between tangible and intangible resources is based on “whether an activity is shared in some way on an ongoing basis, or whether know-how is transferred between essentially separate activities” (Porter, 1985: 351). Porter (1985) suggested, for example, that Phillip Morris was able to transfer marketing expertise built in the cigarette business to Miller Beer. The know-how built in one business
represents a prepaid cost, and thus the transfer cost is minimized. Know-how is transferred through interchange between managers or other personnel in the appropriate business units. Additionally, some skills may be more generally applicable (e.g., retail versus wholesale distribution; see Johnson, 1988) and thus more flexible for diversification purposes. For example, Capon, Hultbert, Farley and Martin (1988) found that firms focusing on a marketing skill (consumer or industrial) achieve better performance for a given level of diversification than firms without a particular focus. However, financial resources are probably the most flexible resource.

Porter (1985: 348) suggested that financial assets are tangible; however, Chatterjee and Wernerfelt (1988) argued that such assets are more flexible for purposes of diversification than other types of assets. In turn, Chatterjee and Wernerfelt (1988), suggested that different capital structures may support separate diversification strategies. The stock market has not valued the risk return tradeoff for unrelated diversification positively (Lubatkin & O’Neil, 1987), thereby lowering the probability of the use of equity capital for unrelated diversification moves. Therefore, Chatterjee and Wernerfelt (1988) argued, short-term liquid assets and long-term debt capacity are more likely to be used for unrelated diversification. These conclusions support Jensen’s (1986) argument that free cash flows lead to unrelated diversification.

On the other hand, Chatterjee and Wernerfelt (1988) noted that related diversification is supported more by internal funds due to asymmetric information between market investors and managers. They found that firms did not make significant use of equity (external) capital to fund related diversification when stock price was relatively low. Their findings may suggest that internal funds are preferred equally by related and unrelated diversifiers because information necessary to inform equity markets may reveal private sources of advantage to competitors, thereby jeopardizing the advantage. However, a large number of firms (regardless of diversification) are taking on increased debt and reducing cash levels to avoid hostile takeovers. As a result, though unrelated firms may use debt and liquid assets more frequently than related firms to diversify (Barton & Gordon, 1988), the difference may not be significant, especially where firms historically have created lower value for firm shareholders. These counterbalancing trends may nullify differences in capital structure between related and unrelated diversified firms. Thus, possibly because capital markets are relatively efficient, financial assets “are rarely the basis for creating significant competitive advantage, unless the size and credit ratings of competitors differ greatly” (Porter, 1985: 349).

Incentives to Diversify

Resources may not lead to diversification unless activated by incentives. The literature on incentives for diversification is multidisciplinary, including work from strategic management, finance, and economics. Incentives provide reasons to diversify and come from the external environment or from within the firm. The term implies that managers have some choice whether to pursue the incentive or
not. Incentives external to the firm include tax, anti-trust policy, and market failure due to transactions costs. Internal firm incentives include low performance, uncertainty of future cash flows, and overall firm risk reduction.

Managerial Motives to Diversify

Managerial motives for diversification may exist independent of resources and incentives. These motives include managerial risk reduction and desire for increased compensation. For instance, theory related to managerial motives for diversification suggests that diversification may reduce employment risk (risk of job loss or income reduction) of top executives (Amihud & Lev, 1981). That is, corporate managers may diversify the firm in order to diversify their employment risk, as long as profitability does not suffer excessively. Diversification also provides an additional benefit to managers that shareholders do not enjoy. Diversification and firm size are highly correlated, as are firm size and executive compensation (Dyl, 1988; Tosi & Gomez-Mejia, 1989). Thus, diversification provides an avenue for increased compensation and, therefore, may serve as a motive for increased diversification. However, the research suggests that governance structure mechanisms such as board of directors, ownership monitoring, executive compensation, and the market for corporate control may limit managerial tendencies to overdiversify.

Diversification and Performance Under Assumptions of Relative Market Perfection

Under assumptions of relative market perfection, markets generally determine prices for products and firms and, as such, managers are assumed to have some impact on the strategic direction of the firm, but this influence is limited. Under these assumptions, strategic homogeneity is presumed because products of firms in the same industry are assumed to be close but not perfect substitutes. As a result, firm diversification would be limited because managers, under these assumptions, would have little room to maneuver. These assumptions are similar to those of the population ecology model in organization theory where little or no strategic choice is presumed (Bourgeois, 1984; Hitt & Tyler, 1989).

In industrial organization economics, the structure-conduct-performance paradigm produces similar conclusions. In this paradigm, industry structure (the competitive relationship between firms in a specific industry) is the dominant force affecting firm performance. Under these assumptions, firm level actions, therefore, have minimal impact on performance. From this point of view, if firms have excess resources, they would likely lease them rather than diversify. However, some have suggested that limited diversification that produces economies of scope and thereby lowers costs may create value (e.g., Penrose, 1959). This is assumed because the resources used are specialized to particular products produced by the firm and may not be useful for other activities. However, in this case, diversification is quite limited. Similar assumptions about relative capital market perfection are assumed by Fama (1970) and lead to similar conclusions about diversification.

Another possible explanation is that some firm resources are heterogeneous
and inimitable. Following this logic, only certain resources may create value for diversified assets under the assumption of near market perfection. For instance, Barney (1988) suggests that diversification through acquisition may create firm value if "private and uniquely" or "inimitable" valuable cash flows exist between acquiring and target firms. Uniquely or inimitable cash flows exist when one bidding firm will benefit more than other bidding firms from the synergy created through merger. "Private" implies that information concerning this advantage is known by the acquiring firm, but not by other potential bidding firms. Therefore, only rare resources that are idiosyncratic to the firm may create value. As a result, intangible, and to a certain extent tangible, resources would be more useful to support diversification because they may be more ambiguous to other firms (Reed & DeFillippi, 1990) and, therefore, less imitable. Tangible resources such as specialized manufacturing equipment may also be less imitable, but such assets may not be as flexible in facilitating diversification.

Furthermore, the question of incentives to use those resources is important. Under relative market perfection, anti-trust and tax policies are not significant incentives. Also, because information asymmetries are less likely to exist in near perfect markets, transaction costs are minimal and, therefore, market failure is not a strong incentive to internalize assets (Williamson, 1975). Furthermore, internal incentives are minimal because firm profits are usually normal (in the economic sense of the term), although low (below normal economic) performance may represent an incentive to diversify if normal economic returns can be obtained through diversification.

Methods and Research Results

A number of researchers have examined the relationship between measures of diversification strategy and performance. The research that assumes near market perfection, however, has come from multiple disciplines, including industrial organization economics, finance, and strategic management.

Early comprehensive studies usually originated in industrial organization economics and showed only a minimal relationship between diversification and performance. For instance, Rhoades (1973, 1974) conducted two studies; the first one found some support for the diversification-performance relationship, but only a modest negative relationship in the second. Gort (1962) examined 100 of the largest 200 manufacturing firms and found no relationship between rate of return and two measures of diversification. Similarly, Berry (1975) found no significant relationship between firm profitability and firm diversity during the period 1960-1965.

There have been a number of studies from finance and strategic management that have examined the effects of diversification through acquisition on firm performance. Most of these studies have assumed that acquisitions are completed to maximize a firm's value (Salter & Weinhold, 1978). The dominant theory regarding how this value is created suggests that firms acquire other firms with some form of relatedness, thereby creating efficiency through synergy. Some suggest that synergistic efficiencies produce market power over competitors (Bradley, Desai, & Kim, 1983; Eckbo, 1985). Research results, however, indi-
cate that returns to acquiring firms do not support the dominant hypothesis that related acquisitions produce more value (Jensen, 1988). Lubatkin (1987), for instance, found no significant difference in returns for shareholders of related versus unrelated firms. Singh and Montgomery (1987), although meticulously controlling for type and degree of synergy, found that above normal returns were not generated for acquiring firms.

Another approach from strategic management that has used categorical methodology rather than Standard Industrial Classification (SIC) code count diversification measures assumes that market structure is more salient than diversification strategy for firm performance. This line of research parallels predictions that could be derived from the structure-conduct-performance paradigm. For example, industry characteristics have been purported to affect choice of diversification strategy and economic performance (Christensen & Montgomery, 1981). Originally, Rumelt (1974) found that performance differences existed across seven of his nine diversification strategies. In particular, Rumelt found that firms using constrained strategies (dominant-constrained and related constrained) were higher performers than firms using other strategy types (e.g., related-linked, single business, unrelated business). Subsequent research (Bettis, 1981; Hoskisson, 1987; Lubatkin & O’Neil, 1987; Montgomery & Singh, 1984; Palepu, 1985; Stubbart, 1983; Varadarajan & Ramanujam, 1987; Wernerfelt & Montgomery, 1988) largely supported Rumelt’s general findings. Although there are counterpoints (e.g., Michel & Shaked, 1984), the accumulated evidence suggests that the results hold for profit performance and for market risk and return as well (Barton, 1988; Lubatkin & O’Neil, 1987; Lubatkin & Rogers, 1987; Montgomery & Singh, 1984). However, as Lubatkin and Rogers (1989) admitted “we did not explicitly control for other influences, such as monopoly power, that might be driving the results” (464). Unfortunately, it is difficult to control for monopoly power because existing measures are, at best, an “imperfect representation of an unobservable construct” (Barton, 1988: 368).

However, Christensen and Montgomery (1981) found systematic differences in industry structure variables across Rumelt’s diversification strategy types. Specifically, they found that Rumelt’s constrained strategy types had more auspicious industry characteristics (high industry concentration, high industry growth, high industry profitability and high market share). They concluded that these characteristics and not the type of diversification strategy per se explained performance differences. Other research also supports this view (Montgomery, 1985; Wernerfelt & Montgomery, 1986).

Johnson and Thomas (1987) examined the U.S. brewing industry and concluded that their results “differ markedly from those of the stream of across-industry studies that focus on large firms and ignore industry effects” (359). Although previous studies indicated that related diversification strategies may outperform other types, Johnson and Thomas (1987) found no performance differences across the strategy types. Research by Hitt and Ireland (1985b) supported this finding. On balance, Johnson and Thomas (1987) argued that the results support Rumelt’s (1982) contention that diversification strategy should be related to

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industry structure and that appropriate product diversity is defined by a balance between economies of scope and diseconomies of scale. That is, "the regional, more focused type of diversification strategy is valued because it matches firm and environmental characteristics very closely" (359). Thus, Johnson and Thomas (1987) recommended that more fine-grained studies within industries are needed (as opposed to course-grained across industry studies).

Research in finance suggests that firm diversification does not create value for shareholders as an investment because personal portfolios can be diversified more effectively (e.g., Reid, 1968; Weston & Mansinghka, 1971; Weston, Smith & Shreives, 1972; Melicher & Rush, 1973; Smith & Weston, 1977). According to Logue and Sundaram (1990), the finance research found that diversification neither creates nor destroys firm value. Rather, the research suggested that firms earned returns consistent with their cash-flow risks. Logue and Sundaram concluded that the research results were quite similar to those in industrial organization economics. However, the results from finance assumes diversification and performance are unrelated because capital markets rather than other factor markets are relatively perfect.

Summary and Critique

Certain conclusions may be developed based on the theory and, to an extent, based on the empirical research. For example, under assumptions of relative market perfection, only certain resources, those that are private and unique or imitable, may support diversification. Furthermore, intangible resources may provide more support for diversification because they are less imitable. Under assumptions of relative market perfection, there would be few, if any, significant incentives to diversify.

The various streams of research provide general support for the assumptions of relative market perfection. They suggest that industry or capital market structure rather than diversification strategy are more prominent predictors of performance. At most, they assume that limited rather than extensive diversification is optimal. However, a notable body of the research generally concluded that no relationship existed between firm diversification and performance.

The assumptions underlying relative market perfection accord little or no discretion to executives. Thus, little strategic choice exists over time. However, Bourgeois (1984) and Hirsch, Friedman, and Koza (1990) strongly criticized this perspective. In fact, Bourgeois (1984) argued that the reductionism inherent in such an approach "eliminates much of the richness that characterizes strategic management" (586). Furthermore, though Hitt and Tyler (1989) found strong market influences on strategic decisions, they also found support for the strategic choice perspective. Therefore, though useful for theoretical and empirical purposes, the assumption of relative market perfection produces a highly deterministic view of strategic decisions. As noted above, markets have important and strong effects on firm performance; however, because of potential market and firm imperfections, firm performance cannot be fully explained by market forces.

Methodological problems also may exist, especially in regard to the general lack of findings supporting a relationship between diversification and performance. For instance, the main difference between procedures used by Rumelt
versus those used by Gort, Rhoades, and Berry rests in their measurement of diversification (Montgomery, 1982). Rumelt developed a carefully conceptualized categorical measure of firm diversification, whereas the latter group employed various forms of a continuous measure of diversification using SIC codes. However, Montgomery (1982) found these two types of measures to produce similar results, "although each appears to have advantages for particular research topics" (299).

Pitts and Hopkins (1982) suggested that "answers to between-group questions" have often come from studies using business count measures of diversification. That is, they concluded that business count measures generally are appropriate for investigating industry-level differences between diversified and non-diversified firms (i.e., between group differences), but not for examining firm specific variables among diversified firms (i.e., within group differences). They suggested that this is why "highly inconclusive results invariably have emerged when business count measures have been used" in studies of diversification and firm performance (Pitts & Hopkins, 1982: 626). Montgomery (1982) proposed: "Perhaps further work with continuous measures that differentiate between diversification within and between major industry groups will better address this issue" (306).

The entropy measure of diversification, originally developed by Jacquemin and Berry (1979), has been applied by strategy researchers in response to the need for continuous measures that address strategic differences (Amit & Livnat, 1988a, 1988b; Baysinger & Hoskisson, 1989; Palepu, 1985). Baysinger and Hoskisson (1989) found a correlation of \( r = .58 \) between Rumelt's categories and the related and unrelated continuous components of the entropy measure. Although there is some error in this measure, as with all measures, it produces an effective approximation based on archival data.

The inconsistent evidence may be due not only to the measurement of diversification, but also to performance measures used (Keats, 1990). The earlier studies by Gort (1962), Berry (1971, 1974) and Rhoades (1973, 1974) examined the effects of diversification on market structure and firm power. The intent was to evaluate and correct industrial policy where necessary; thus firm performance was not a central focus. The research from finance largely evaluated the effects of capital market structure on risk-adjusted stock market returns. The aim was to evaluate the relative merit of firm portfolio returns relative to other investor alternatives. A review of the strategic management literature reveals a number of studies using accounting returns, although, more recently, market-based performance measures have been adopted (Chatterjee, 1986; Dubofsky & Varadarajan, 1987; Hitt & Ireland, 1986; Lubatkin, 1987; Woo, 1984). Much of this research presupposes acceptance of the capital asset pricing model (CAPM) and assumes "semi-strong" market efficiency (Fama, 1970). However, a number of researchers have criticized the CAPM and market efficiency from both finance (e.g., Black, 1986; DeBondt & Thaler, 1985, 1987; Shiller, 1979, 1981, 1988) and strategic management (e.g., Oviatt, 1989). Thus, the various assumptions about performance might affect the diversification-performance relationship.

Although accounting measures have been the subject of much debate in eco-
omics (e.g., Bentson, 1985; Fisher & McGowan, 1983), they are still commonly used and have been defended (Bromiley, 1986; Jacobson, 1987; Long & Ravenscraft, 1984). Similarly Holzmann, Copeland, and Hayya (1975) felt that the exclusive use of market-based measures in studies of diversification (e.g., in finance) was problematic because managers relied most heavily on accounting-based performance in formulating diversification strategy. Rather than exclusively using one set of measures (and hailing these measures as most applicable), a more appropriate policy may be to pursue multiple measures of performance to foster accumulation of knowledge (Amit & Livnat, 1988b). For example, Keats and Hitt (1988) used both accounting and market measures in a time-ordered design. They found a positive relationship between diversification and market performance, but no relationship between diversification and accounting performance.

Ramanujam and Varadarajan (1989) examine the measurement issues in the diversification-performance research. They, along with Keats (1990), suggested that more time variant research is required because diversification is not stable over time and this instability may have created spurious results in previous research. Furthermore, notwithstanding the various measures that have been adopted, studies attempting to demonstrate the effects of diversification on performance remain inconclusive. Although there may be measurement difficulties associated with the evidence, it generally supports the assumptions of relative market perfection.

It is important to note, however, that the assumptions of this perspective may not be realistic. Most large industrial firms are diversified with a strong multi-product focus as opposed to a single or dominant product focus (Galbraith & Kazanjian, 1986). This perspective also assumes that resources and incentives to diversify are limited, but, in fact, given the actual diversity of firms, there appear to be both resources and incentives to diversify.

**Diversification and Performance Under Assumptions of Market and Firm Imperfection**

When markets are imperfect, managers have a larger impact on firm strategic direction. Under these assumptions, strategic heterogeneity is presumed because products of firms in the same industry are not perfect substitutes. Further, managers are assumed to be rational in pursuing at least satisfactory firm performance. Under these assumptions, firm diversification is more important because managers have much more discretion and choice. Further, this discretion becomes important because firms are also assumed to be imperfect: that is, managers may not always follow optimal decision processes. These assumptions are closer to the strategic choice model as outlined by Child (1972) and supported by Hitt and Tyler (1989).

The attributes of firm and market imperfections emphasize the importance of strategic contingency theory and the concept of fit (Venkatraman, 1989). From this perspective, higher relative performance is derived from better strategic fit with external and internal conditions. Therefore, diversification is a matter of creating fit with the most salient contingencies and the better the fit with these con-
tingencies the greater the overall performance of the firm. Because of managerial discretion, differences in strategy categories (e.g., related vs. unrelated and internal development vs. external acquisition) are more important than under assumptions of relative market perfection. As a result, firm level actions have much more significance for firm performance (Hitt & Tyler, 1989). There is also more variance in firm performance assumed than under the assumption of relative market perfection.

From this point of view, if excess resources are available, managers may not be limited to narrow levels of diversification. Because contingencies may be particular to the firm, a number of different resources may create value for diversified firms. All resource categories, tangible, intangible, and financial, may be used for diversification depending on the internal and external contingencies. These contingencies are equivalent to the external and internal incentives for diversification for any particular firm. External incentives include government policy—anti-trust and tax laws—and market failure. Internal incentives include low performance, uncertainty of future cash flows and firm risk reduction.

**Government Policy—Anti-Trust Policy and Tax Laws**

Anti-trust and tax laws are the main government policy that provide incentives to diversify (Auerbach & Reishus, 1988; Gilson, Scholes, & Wolfson, 1988; Ravenscraft & Scherer, 1987; Scherer, 1980). Summarizing the evidence on anti-trust constraints, Ravenscraft and Scherer (1987) suggest the following:

By the 1960s, antitrust constraints on horizontal mergers had become much more stringent, and perhaps in part as a result, the merger wave that peaked in 1968 was preponderantly "conglomerate" in character, that is, involving companies pursuing different, and often totally unrelated, lines of business. The mergers of the 1980s were different again. Antitrust enforcement ebbed, permitting more and larger horizontal mergers. In addition, financial intermediaries had become more free-wheeling in the kinds of mergers they would support, and as one consequence, hostile takeovers rose to unprecedented prominence (22).

Merger activity leading to conglomerate diversification was encouraged primarily by the Celler-Kefauver Act (which discouraged horizontal and vertical mergers). For example, in the 1973-1977 period, 79.1% of all mergers were conglomerate (Scherer, 1980). However, the conglomerates or highly diversified firms of the 1960s and 1970s have become much more "focused" in the 1980s (Lee & Cooperman, 1989; Williams et al., 1988) as takeover constraints have been relaxed.

Tax effects on diversification need to be examined from two points of view: shareholder taxation and corporate taxation (Auerbach & Reishus, 1988; Gilson et al., 1988; Turk & Baysinger, 1989). Turk and Baysinger (1989) noted that some companies may have activities generating more cash than they can reinvest profitably. Jensen (1986) argued that such "free cash flows" should be redistributed to shareholders in the form of dividends. However, dividends may be taxed more heavily than ordinary personal income. As a result, in the pre-1980s, sharehold-
ers may have preferred that companies retain these funds for use in buying and building companies in high performance industries. If the stock value appreciated over the long term, shareholders might receive a better return for these funds than through dividends because they would be more lightly taxed under capital gains rules. However, in the 1980s, the top ordinary individual income tax rate was reduced from 50% to 28% and the special capital gains tax was changed such that capital gains are treated as ordinary income. This suggests that shareholders would no longer encourage firms to retain funds for purposes of diversification. Turk and Baysinger (1989) also argued that, over time, the elimination of personal interest deductability and the lower attractiveness of retained earnings to shareholders have prompted the use of more leverage by firms (interest expense is tax deductible for firms). They also argued that these tax law changes led to an increase in divestitures of unrelated business units after 1981 and 1986. Thus, individual tax rates for capital gains and dividends may have created a shareholder incentive for increased diversification before 1981, but an incentive for decreased diversification after 1981 unless funded by debt. However, no current research examining the changes in individual tax rates on diversification levels has been undertaken (Turk & Baysinger, 1989).

Regarding corporate taxation, Auerbach and Reishus (1988) argued that acquisition of a firm typically increases depreciable asset allowances. Increased depreciation (non-cash flow expense) produces lower taxable income, thereby providing additional incentive for acquisitions. Gilson et al. (1988) argued that transaction and information costs may make acquisitions the most attractive means of securing tax benefits in real-world settings. The tax incentives are particularly important because acquisitions represent the primary means of firm diversification (Hitt, Hoskisson, & Ireland, 1990; Salter & Weinhold, 1978). Furthermore, in a study of 191 acquisitions completed in the 1970s and 1980s, Hitt, Hoskisson, Ireland, and Harrison (1989) found that 68% of the acquisitions involved target firms outside of the acquiring firm’s primary two-digit SIC code (diversifying acquisitions). Hayn (1989) found that tax effects of acquisitions may also build shareholder wealth. Kaplan (1989) suggested that leveraged buyouts, which account for 20% of all takeover activity between 1985 and 1987, significantly improve shareholder welfare primarily due to tax benefits. Of course, leveraged buyouts often result in a reduction of diversified scope. However, the 1986 Tax Reform Act (Steindel, 1986) has reduced some of the corporate tax advantages suggested by Hayn (1989) and Kaplan (1989) and thus post-1986 research is required. Over the years, government policy has provided incentives that vie both for increased and decreased levels of diversification.

Transaction Cost Theory and Market Failure

Williamson (1975) suggested that internal capital markets provide a rationale for diversification. Diversification may be a desirable alternative to selling off excess capacity when there is some failure in the market such as high transaction costs due to contracting problems associated with asset specificity. When uncertainty exists and markets fail due to high transaction costs, firms tend to internalize the assets in question rather than contract for services. As a result, the firm may create an internal capital market with the multidivisional structure to allocate
capital more efficiently to its constituent businesses than would have been done by the external capital market due to high transaction costs. That is, as long as transaction costs are higher than the costs of organization, there is "market failure" and diversification becomes a viable strategy (Chatterjee & Wernerfelt, 1988).

In addition to external incentives such as government policy and transaction costs, there may be incentives internal to the firm that increase the likelihood of firm diversification.

Low Performance

Rumelt (1974) conjectured that "high performance eliminates the need for greater diversification" (125). Conversely, low performance may provide an incentive for diversification. Bowman (1980) found a negative relationship between risk and return measures of performance, which conflicts with theory from economics and finance. He suggested later (Bowman 1982, 1984) that the negative relationship may result from higher risk taking in troubled firms. This hypothesis aligns with predictions from prospect theory (Kahneman & Tversky, 1979) that performance below a target or reference point creates incentives for greater risk taking, whereas performance above the target produces risk aversion.

Although empirical findings from prospect theory usually pertain only to individual behavior (Fishburn, 1977), more recent research has applied prospect theory to corporate strategic decisions (Crum, Laughhun, & Payne, 1980; Fiegenbaum & Thomas, 1988; Singh, 1986). For instance, Fiegenbaum and Thomas (1988) suggested that firms may refer to industry returns as a target to adjust risk taking according to prospect theory predictions. In particular, they found that firms with returns below industry averages undertook riskier strategies than firms with returns above industry averages. Additionally, Chang and Thomas (1989) found that low returns were related to greater levels of diversification, but that increased diversification did not necessarily reduce risk or increase returns. Grant, Jamine, and Thomas (1988) also suggested that relative firm performance was related to pursuit of diversification. They found that concurrent changes in profitability were associated with higher levels of diversity among British firms. However, in a dynamic (over time) test, only international diversity was found to increase as measures of cash flow increased; product diversity was not related to cash flow. In general, they concluded that a curvilinear relationship existed between returns and diversification.

Thus, poor performance may lead to increased diversification, especially if resources exist to pursue it. Furthermore, previous diversification may drive further diversification, especially if new multidivisional (M-form) structures evolve to manage this diversity (Keats & Hitt, 1988), until returns dissipate. Continued poor returns after further diversification, however, may slow the pace of diversification and even lead to restructuring divestitures (Ravenscraft & Scherer, 1987). Thus, research and theory (Baysinger & Hoskisson, 1990; Hoskisson & Turk, 1990) suggest an overall curvilinear relationship between performance and diversification, where antecedent performance affects diversification.

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Uncertainty of Expected Future Cash Flows

Rumelt (1974) and Leontiades (1986) suggested that there may be defensive reasons for diversification. For instance, Leontiades (1986) argued that firms in mature or maturing industries must diversify to survive over the long term. Beatie (1980) suggested that uncertainty can be derived from both supply and demand sources and that firms may diversify to deal with both of them.

Miles (1982) description of diversification by firms in the tobacco industry is illustrative of demand uncertainty as an incentive. Most large tobacco firms perceived decreasing expected cash flows from their dominant business. As the external threat of health consciousness was repeatedly flagged by successive Surgeon General reports, all major tobacco firms increased their level of diversification.

This argument also may be pertinent for firms in industries where foreign competitors with lower average costs due to supply differences (e.g., labor) have penetrated domestic markets (Buckley, 1989). Diversification in the steel industry during the 1970s may exemplify this type of supply side uncertainty as an incentive to diversify.

Also, petroleum firms in the mid to late 1970s experienced exceptionally high oil prices and expectations of increasing demand while forecasted reserves (supply) were expected to be depleted rapidly. Thus, development of alternative energy sources were predicted. Because of competition from alternative energy sources, fewer available revenues were expected from their dominant business, thereby creating uncertainty about future profits. In order to preserve present capital, most petroleum firms with excess liquid capital pursued a strategy of diversification. For example, Atlantic Richfield and SOHIO bought mining operations (Anaconda and Kennecott, respectively), and Mobil purchased Montgomery Wards. Thus, both supply and demand uncertainty about expected future cash flows seems to affect diversification strategy. Although diversification may build greater shareholder welfare in selected instances, the evidence generally indicates that it may decrease uncertainty, but at the expense of profitability.

Kay and Diamantopoulos (1987) examined a different aspect of the relationship between uncertainty and diversification. Their theory relates to firms that are already diversified more fully rather than with problems encountered by a dominant business. They suggested that because firms pursuing synergy often have asset-specific investments to realize synergy, several potential problems exist. For example, if technological change is stable, a firm may increase its relatedness between business units. In so doing, it increases its risk of corporate failure because synergy produces joint or interdependent profitability such that the firm’s flexibility of response is constrained. This threat may force two basic decisions: (a) reduce the level of technological change by operating in less uncertain environments or (b) reduce the level of activity relatedness and forego the benefits of synergy. Either or both decisions may lead to further diversification. The former would lead to related diversification into industries where more certainty exists. The latter result may lead to further, but unrelated, diversification.

Hoskisson and Hitt (1988) also found that firms pursuing a "hedging" strat-
egy (unrelated diversified firms), presumably to reduce uncertainty, are rewarded by the stock market for investing less in R&D than their industry counterparts. Thus, they are rewarded for being cautious about uncertainty. On the other hand, dominant business firms were valued more highly by the market if they had R&D expenditures above their industry counterparts. These results may be explained by analyzing managerial action. Expected future cash flows in the primary industry of a potential diversification target are likely evaluated relative to other industries that represent opportunities for diversification (Gort et al., 1985). If current expected growth rates in profitability are uncertain relative to other industries, the probability of diversification increases. The primary motive for diversification in these circumstances, then, is to preserve current capital.

**Firm Risk Reduction**

The notion of diversification to reduce risk is derived primarily from portfolio theory. The fundamental premise of portfolio theory in finance suggests that diversified investments balance risk. Whenever the separate cash flows of a multi-business firm are not perfectly correlated, the total risk, as measured by variability of consolidated cash flows, is reduced by diversification (Markham, 1973). If risk can be lowered without substantially reducing return, risk-adjusted return improves. However, this view was criticized by Levy and Sarnat (1970), who argued that a firm should not diversify without operating synergies because firm value would not be improved. Their argument was based on the capital asset pricing model (CAPM) with the assumption that there are no benefits to diversification that shareholders cannot obtain by diversifying their own portfolio of financial assets (common in the finance literature as noted earlier). Later, Lewellen (1971) and Higgins and Schall (1975) argued that purely financial rationales for diversification may exist through lowering the cost of capital, especially by obtaining cheaper debt because of a reduced threat of bankruptcy or by reducing taxes. However, these explanations assume less than perfect capital markets.

Aron (1988), however, argued that risk reduction may be directed at building stockholder wealth even though stockholders may, at times, prefer higher risk strategies (e.g., lower levels of diversification) than managers. For example, a firm might have to be more diversified than owners would prefer in order to achieve a level of employment risk acceptable to managers (Hoskisson & Turk, 1990). Thus, diversification may represent an additional agency cost sometimes necessary to resolve owner-manager conflicts. As a result, Aron (1988) argued that the residual loss due to diversification may be cheaper than monitoring managerial behavior because it appropriately shifts risk from managers to owners (as suggested by agency theory). The lower managerial employment risk resulting from diversification should facilitate lower managerial compensation.

Also, Amihud, Dodd, and Weinstein (1986) suggested that risk reduction through diversification may improve shareholder welfare in a way that cannot be diversified away through investment portfolios. Similarly, Marshall, Yawitz, and Greenberg (1984) suggested that this rationale for conglomerate mergers provides value for shareholders that cannot be obtained through structuring their own portfolios because of the attraction of quality managers without inordinate increases in compensation. Although this is contrary to the view held in finance (i.e., un-
systematic risk is not important because it can be diversified away by shareholders), it is relevant to strategic management because it allows managers to build shareholder value by strategic action (Bettis, 1983). Thus, through strategic foresight, managers can develop strong contingent relationships between strategic attributes in firms that create value for shareholders. In this case, value is created by actions reducing unsystematic risk in ways that cannot be affected by shareholders’ investment portfolios. Amit and Wernerfelt (1989) found that risk reduction via diversification may create shareholder value by reducing unsystematic risk. Furthermore, Chatterjee and Lubatkin (1990) found that diversifying acquisitions can create value by reducing systematic risk in a manner that stockholders cannot achieve on their own. If these positions are supported by further research, they provide a much stronger foundation for strategic management because managers may have an impact on (systematic and unsystematic) risk that cannot be obtained through standard approaches to investment portfolio diversification (Bettis, 1983).

Methods and Research Results

Much of the theory reviewed above suggests that firms have multiple incentives and resources to engage in diversification. However, there has been little research regarding the specific effects of individual incentives on diversification outcomes. The existing research generally suggests that there is little advantage in pursuing diversification for pure risk reduction without attention to appropriate strategic controls because lower risk is often accompanied by reduced profitability (Amit & Livnat 1988a, 1988b). For example, Hill (1983) found that riskiness of unrelated firms increases relative to single business and related business firms during economic downturns. Similarly, work by Barton (1988), Montgomery and Singh (1984), Lubatkin and O’Neil (1987), and Lubatkin and Rogers (1989) suggests that diversification reduces total market risk, but that unrelated diversification may increase systematic risk relative to related diversification.

There is another strain of research that fits into strategic contingency theory. Early research on the diversification-performance relationship suggested that cost-reducing synergy was a dominant goal of diversification (Ansoff, 1965). The importance of synergy in diversification has been supported by research in economics (Panzar & Willig, 1981) and strategic management (Chatterjee, 1986; Grant, 1988; Hitt & Ireland, 1986; Peters & Waterman, 1982; Porter, 1985; 1987; Prahalad & Bettis 1986; Wells, 1984). Implementation of a strategy has a major impact on the firm’s ability to achieve synergy; thus, implementation issues are likely to have a significant effect on the relationship between diversification and performance. Research in this area can be classified into at least two conceptual domains. One domain deals with the resources that accumulated within the firm and have been labelled “dominant logic” (Grant, 1988; Prahalad & Bettis, 1986) or distinctive competence (Hitt & Ireland, 1985a, 1986). The second domain is classified under the area of “fit” between strategy type and some aspect of strategic management such as structural controls (Hill, Hitt, & Hoskisson, 1990; Hill & Hoskisson, 1987; Hoskisson, 1987), management characteristics (Reed & Reed, 1989), or culture (Kerr & Slocum, 1988; Lauenstein, 1985). The central
idea in both domains is that managers create variance among performance outcomes by the way they implement strategies.

**Dominant logic and distinctive competence.** Prahalad and Bettis (1986) argued that managers develop a dominant general management logic or “dominant logic” based on operating requirements prevalent in the dominant business of the firm. This logic affects the attitudes, knowledge, and ability of top managers to manage diversification successfully. Similarly, Hitt and Ireland (1985a, 1986) found that corporate-level distinctive competencies exist among firms. They measured functional emphases such as R&D management and centralized marketing and found that these corporate competencies discriminate performance among competitors. Others have also pointed out that such competencies can greatly benefit newly acquired or internally developed businesses (e.g., Yavitz & Newman, 1982). For example, Kazanjian and Drazin (1987) note that the processes and competencies necessary to implement internal diversification are different from those required for acquisitive growth. They view the firm as a pool of resources similar to Penrose (1959) and Teece (1980). Similarity or relatedness in those resources between the new domain and the core business may create synergy. Relatedness is the degree of knowledge possessed from operating in the current domain relative to the knowledge needed to operate in the new domain being considered for entry.

Dissimilar but complementary competencies may also create synergy (Barney, 1986a). For example, Harrison, Hitt, Hoskisson and Ireland (1990) found that dissimilarity in R&D intensity or capital intensity between the acquiring and target firms was related to higher firm performance after the acquisition. Therefore, carefully managed diversification may exploit similar or dissimilar, but complementary competencies to achieve synergy between the core and new units.

Galbraith and Kazanjian (1986) also suggested that management orientations differ by the stage in the supply chain in which a business operates. They argued, for instance, that the pattern of resource allocation is different for capital intensive firms in upstream stage businesses. They assert that these firms are good at managing the engineering function that is critical among such businesses. Later stage businesses (“downstream” in the product to market chain) are better at implementing marketing skills because their focus is directed at the end consumer. Rumelt (1974) suggested that this may, in part, explain the lackluster performance of upstream vertically integrated firms that diversified into businesses outside their stage of origin.

Thus, these aspects (e.g., distinctive competencies) of strategy implementation may be critical for successful diversification. If the appropriate resources are lacking, diversification is unlikely to be successful and may result in poor performance. As a result, diversification may succeed only when the firm can capitalize on some core skill, dominant logic, or distinctive competence. The concept of fit, on the other hand, does not rest primarily on the approach to diversification, but rather on how it is implemented. Dundas and Richardson (1982) suggested, for instance, that unrelated diversification can be successful if implemented properly.

**The concept of fit.** The second theoretical domain focuses on the notion of fit
between the firm's strategy and its internal organization and/or environment. The concept of fit has received increasing attention in the strategy literature (e.g., Venkatraman, 1989; Venkatraman & Camillus, 1984) and in the organizations literature (e.g., Fry & Smith, 1987; Van de Ven & Drazin, 1985). These works suggest that consistency (fit) between internal firm attributes (e.g., strategy and structure) or between environmental attributes and firm attributes, has beneficial effects on firm performance. The vast literature on the fit between strategy and structure (e.g., Chakravarthy & Lorange, 1984; Chandler, 1962; Donaldson, 1987; Hill & Hoskisson, 1987; Hoskisson, 1987) is the primary research thrust related to fit in the strategic management literature. However, other areas of fit between managerial characteristics and strategy (Gupta, 1984; Hambrick & Mason, 1984; Hitt & Tyler, 1989; Reed & Reed, 1989; Song, 1982; Szilagyi & Schweiger, 1984) and between culture and strategy (Barney, 1986b; Kerr & Slocum, 1988; Lautzenstein, 1985) have been also argued to be of importance.

**Strategy and structure.** Chandler (1962) provided the first inductive description of the fit between strategy and structure. His rich historical description suggested that firms adopt different strategies at different stages of their life cycle. Furthermore, new structures followed the adoption of new strategies. Galbraith and Kazanjian (1986) indicated that the dominant path was from vertical integration to related diversification, though a minority of firms pursue unrelated diversification from the outset. Notwithstanding the path chosen, the main idea suggests that where an appropriate fit between strategy and structure exists superior performance results.

The works of Hill and Hoskisson (1987) and Jones & Hill (1988) elaborate on this basic model by indicating that different strategies are associated with different economic benefits. However, these economic benefits can only be realized if the appropriate controls are in place. Hill and Hoskisson (1987) denote valuable economies associated with unrelated diversification (financial economies), related diversification (synergistic economies), and vertical integration (vertical economies). However, they proposed that controls associated with unrelated diversification are different from controls associated with related diversification and that the performance suffers when there is a mismatch between strategy and controls. This hypothesis is supported by the research of Lorsch and Allen (1975) and Kerr (1985).

Similarly, using a transaction cost approach, Jones and Hill (1988) proposed that lower levels of diversification are required in related business firms to maximize value because of bureaucratic costs. The converse is true for unrelated diversification. A certain level of diversification is required to make the internal capital market function effectively, but this is facilitated because bureaucratic costs are lower in the unrelated firm.

Both Hill and Hoskisson (1987) and Jones and Hill (1988) also argued that environmental change or increase in environmental uncertainty can create problems for related diversification (increases bankruptcy risk). On the other hand, if barriers to entry increase, relatedness among the firm’s businesses is facilitated. Thus, these theories suggest that a firm’s strategy, structure, and environment need to be coordinated to realize superior performance.
Much of the research evidence related to fit addresses the structure-performance relationship without reference to strategy (e.g., Armour & Teece, 1978; Cable & Dirrheimer, 1983; Cable & Yasuki, 1984; Ezzamel & Hilton, 1983; Harris, 1983; Hill, 1985; Holl, 1983; Hoskisson & Galbraith, 1983; Steer & Cable, 1978; Teece, 1981 and Thompson, 1981). Most of this evidence supports a positive relationship between structure (M-form) and performance. However, Hoskisson (1987) found differences in firm performance upon implementation of the M-form structure, depending on the type of diversification strategy used. Unrelated firms had both increased returns and reduced risk, related firms had decreased returns and no change in risk, and vertically integrated firms had both lower returns and risk. Hill (1988) also found evidence of a contingency effect in that the M-form was closely aligned with higher performance among unrelated firms in the U.K. However, a centralized multidivisional structure, with corporate headquarters more involved in operating decisions, was associated with higher performance among related firms. These studies provide evidence that structural implementation is an important contributor to firm performance.

*Strategy and managerial characteristics.* A number of researchers have addressed the issue of fit between managerial characteristics and strategy (Gerstein & Reisman, 1983; Gupta, 1984; Hambrick & Mason, 1984; Hitt & Tyler, 1989; Kerr, 1982; Leontiades, 1982; Reed & Reed, 1989; Song, 1982; Szilagyi & Schweiger, 1984). For example, Song (1982), hypothesized that the chief executive officer’s (CEO) experience would be associated with the mode of diversification. He proposed that experience in operational functions like production or marketing would be complementary to internally developed diversification, whereas experience in staff functions like law or finance would facilitate diversification by acquisition. Song’s (1982) results showed a relationship between CEO experience and mode of diversification, but research by Reed and Reed (1989) found no support for this relationship. However, Reed and Reed (1989) showed that the interaction between CEO experience and mode of diversification affects performance. Additionally, Hitt and Tyler (1989) found that executive characteristics affected the criteria used to make strategic acquisition decisions. These studies imply that the fit between executive characteristics and strategy is important.

*Culture and strategy.* A number of researchers have addressed the relationship between strategy and culture (e.g., Barney, 1986b; Hill, Hitt, & Hoskisson, 1990; Hitt & Hoskisson, 1991; Kerr & Slocum, 1988; Luenstein, 1985; Schwartz & Davis, 1981). However, only a few address the issue of diversification strategy and culture (Luenstein, 1985; Kerr & Slocum, 1988; Hill et al., 1989). Luenstien (1985) suggested that if diversified firms outperform more focused firms, it is not due to size or market power, but rather to a distinctive culture. Kerr and Slocum (1988) outlined various cultures and reward structures among large diversified firms. Finally, Hill et al. (1989) proposed that related diversifiers emphasize a culture of cooperation among business units, whereas unrelated diversifiers emphasize a culture of competition among business units. Given that an unrelated diversifier represents an internal capital market where resources are allocated based on comparative means, the unrelated diversity is ex-
licitly competitive rather than cooperative. Hill et al. (1990) found the best performers were related firms that emphasized cooperation between business units and unrelated firms that emphasized measured competition between business units.

**Summary and Critique**

Under conditions of market and firm imperfections, firm strategic heterogeneity is assumed. Furthermore, the imperfections allow managers more discretion and thus result in some degree of strategic choice, although managers are considered rational. As a result, firms achieve higher performance where the strategy fits most closely with the firm's internal (e.g., structure, culture) or external (e.g., market) conditions. Excess resources may be used for diversification, but primarily where incentives exist for such diversification.

Incentives external to the firm include government policies (anti-trust and tax laws) and transaction costs/market failure. Incentives internal to the firm include low firm performance, uncertainty of future cash flows, and risk reduction. Enforcement of anti-trust laws prior to 1980 provided incentives to firms to diversify into unrelated businesses. However, after 1980, more related diversification is evident because of a relaxation of anti-trust enforcement. Changes in anti-trust policy not only provided incentives for related diversification but, along with changes in tax laws, prompted a large number of hostile takeovers. Although many finance theorists (e.g., Jensen, 1989) suggest that the great number of takeovers and restructurings (e.g., divestitures) have promoted much more efficiencies, they have not been without their costs. For example, fear of takeovers and the huge debt loads sometimes used to finance acquisitions or to fend off takeover attempts increased managers’ risk aversion and use of shorter time horizons (e.g., Hitt et al., 1990; Hoskisson, Hitt, & Hill, 1991). The lowering of the marginal income tax rates for individuals and the elimination of interest writeoffs against individuals’ taxable income have made the use of leverage by firms more attractive.

When transaction costs are high (e.g., with an important supplier), firms may acquire the transacting firm or develop an internal source of supply (both represent internalizing assets). However, there are sometimes ‘‘higher’’ costs when assets are internalized. For example, there are costs of coordination and control that are quite real, particularly in the case of vertical integration as noted above. As noted in the next section, because of governance costs and potential imperfections in the governance system, the advantages of an internal capital market may not be fully realized.

High performing firms are less likely to diversify, but, as indicated above, low performing firms may seek diversification opportunities in order to turn around firm performance. However, low performing firms are more likely to make risky diversification moves, as suggested by prospect theory (Bowman, 1982, 1984; Kahneman & Tversky, 1979), which may lead to continued poor performance. Work by Bromiley (1990) showed that not only do poor performing firms take greater risks, they also take risks with low expected payoffs.

Along the same lines, uncertain future cash flows may prompt diversification. As mentioned above, firms in a mature or declining industry often seek diversi-
fication into growth industries. As long as effective strategic choices are made, movement into growth industries may be successful if the risk involved does not have low expected value and if the strategy is implemented well (e.g., the firm competes effectively in the new industry). Such moves may well include international diversification. For example, Grant et al. (1988) found no relationship between product diversity and cash flow, but found a positive relationship between international diversity and cash flow. Mature or declining markets in a firm’s core business represent a rational reason for diversification. On the other hand, some moves to reduce uncertainty may not always be positive. For example, Hitt (1988) found firms following a hedging strategy by diversifying into unrelated businesses may be risk averse (e.g., invest less in riskier projects such as R&D). Such action could have negative long-term consequences for the firm, as noted by Franko (1989).

Similarly, the risk reduction motive for diversification has been debated in the literature and the subject of conflicting empirical research. Although much of the finance literature argued that firm diversification cannot produce value for the shareholder, some recent strategic management research disputed this claim (e.g., Amit & Wernerfelt, 1989; Chaterjee & Lubatkin, 1990). No definitive conclusions can be developed, but the recent research noted may signal that finance theory is misspecified. On the other hand, we can only conclude that the risk reduction properties of diversification are unclear.

This absence of clarity may in part be due to methodological deficiencies. Much of the research has been cross-sectional, from which causal inferences are weak or impossible. Furthermore, even the longitudinal designs (e.g., Bromiley, 1990) examined short causal time periods (e.g., 1 to 2 years). Finally, because most of the theory predicts a positive relationship between risk and return, we must examine further the basic reasons for the findings of a negative relationship. The results suggest further imperfections in the governance system and potential managerial errors in strategic choices.

Another reason for the ambiguity in the outcomes of diversification-risk-return research is that it often ignores the potential effects of strategy implementation. For example, good strategies may produce poor returns if ineffectively implemented; thus the notion of strategic fit becomes important. However, Venkatraman (1989) identified six perspectives of fit to include fit as moderation, as mediation, as matching, as gestalts, as profile deviation and as covariation. Furthermore, he argued that much of the research on fit in strategic management has used these perspectives interchangeably. As a result, Venkatraman concluded that the linkage between theory development and theory testing had been weakened.

The research examining the effects of dominant logic, distinctive competencies, managerial characteristics, culture, and structure on strategy is, for the most part, shallow. Although there are legitimate and, in some cases, compelling theoretical arguments, there has not been adequate empirical work to allow complete tests of these arguments. For example, there are no legitimate empirical studies of managerial dominant logics. More research exists on the notion of distinctive competencies, but there are measurement concerns. Much of this research mea-
sures competencies but not necessarily *distinctive* (relative to competitors) competencies. Also, importantly for our purposes, only a few have examined linkages to diversification strategies (Harrison et al., 1990; Hitt & Ireland, 1986). The research suggests that competencies (resources) may spur certain types of diversification (e.g., related vs. unrelated). Furthermore, the research suggests that certain competencies may be important for effective implementation of specific diversification moves. As a result, there is a linkage between competencies, diversification, and firm performance (Hitt & Ireland, 1986). However, much more research is required to understand the contingencies under which these linkages may be most important.

The research on the effects of managerial characteristics, though at a primitive stage, shows promise. For example, it may help sort out the effects that managers have on strategic decisions (e.g., Hitt & Tyler, 1989). This is a prominent but as yet unresolved issue because of the differing theoretical assumptions described herein. For example, the relative effects of industry or market structure, other important internal (e.g., resources) and external (e.g., government policies) and managerial characteristics/actions on the choice and ultimate performance outcomes of a strategy are unclear. To explore this important question requires integration of the various theoretical notions.

To date, there is little research on the relationship between managerial characteristics and diversification. The existing research suggests that managerial characteristics may be more related to the empirical model used than the type of diversification (e.g., Reed & Reed, 1989; Song, 1982). At this stage, the research is neither strong nor convincing. Most importantly, we should be more interested in the theoretical concepts that characteristics represent as opposed to the characteristics themselves. For example, interest in the effects of a manager's age may rest on its linkage to risk propensity (Hambrick & Mason, 1984). However, much of the research on executives' demography to date has failed to develop strong theoretical underpinnings, particularly in regard to strategic choice.

Although a number of scholars have argued that a relationship exists between firm culture and strategy, few have empirically tested such a relationship. One reason for the lack of empirical work relates to the problems of measuring culture. For example, the empirical work of Hill et al. (1989) used a surrogate (i.e., structural arrangements between business units) to examine the relationship between cooperative/competitive culture, diversification strategy, and performance. Other problems exist as well. Large diversified firms may not have a common culture (one set of ideologies and shared values); rather they may have multiple subcultures (Hitt & Hoskisson, 1991). Furthermore, culture may be affected greatly by the internal governance system used in a firm. Diversification (mode and type) may affect the governance system (Baysinger & Hoskisson, 1989, Hitt et al., 1989; Hitt et al., 1990; Hoskisson & Hitt, 1988) and the governance system may well affect the corporate culture. For example, Hitt et al. (1990) developed theoretical arguments that acquisitions are a primary mode of diversification. They argued that as a firm diversifies, a governance system of controls develops that promotes a culture of risk aversion. However, we do not know whether certain cultures promote or inhibit diversification. Furthermore,
we do not have a full understanding of the causal ordering of the culture-diversification relationship nor the specific nature of this relationship.

The strategy-structure relationship has received more attention in the research literature than any of the other topics noted above. In fact, Chandler's (1962) pioneering work served as a catalyst for such research. Although most of the work has focused on the use of the multidivisional structure (M-form) to help implement a diversification strategy (e.g., Channon, 1973; Rumelt, 1974; Suzuki, 1980), other research has focused on the economic effects on performance of the M-form structure (e.g., Franco, 1974; Armour, 1978; Hoskisson, 1987), and on the effects of the M-form on adoption of diversification strategies (e.g., Pitts, 1977; Keats & Hitt, 1988). We do know, from this research, that many firms that diversify also implement M-form structures. Furthermore, the M-form seems to facilitate more diversification. However, less clear from this research are the performance implications of a match between diversification strategy and structure and of the M-form structure alone. One reason for this ambiguity is that there are tradeoffs with both diversification and with the M-form structure. Although the M-form structure may provide a system for efficient allocation of resources similar to an internal capital market, it may also create a system of controls that produces unintended consequences, such as managerial risk aversion (Hoskisson et al., 1991). Therefore, the jury is still out on the M-form structure. More research is required to develop and understand the performance implications of modifications to this structure in order to overcome the costs or tradeoffs to the benefits (unintended consequences).

**Diversification and Performance Under Assumptions of Imperfection and Managerial Motives to Diversify**

As noted earlier, markets and firms are assumed to have some imperfections; however, under this perspective managers are also assumed to have personal motives for diversifying the firm. These managerial motives for diversification may exist independent of other external and internal firm incentives, but resources remain necessary. Although not all managers are driven by total self-interest in regard to firm diversification or strategic direction, owners (shareholders) and boards of directors don’t know who will abuse their stewardship over firm resources. Therefore, governance devices must be in place to detect mismanagement. The central motives to increase diversification include managerial employment risk reduction and increased executive compensation. Although governance devices are in place to control these motives, governance is imperfect and involves tradeoffs that may also affect level or type of diversification.

As indicated above, theory related to managerial motives for diversification suggests that diversification may reduce employment risk of top executives (Amihud & Lev, 1981). These theoretical arguments are largely based on agency theory (Jensen & Meckling, 1976). Thus, corporate managers may diversify the firm in order to diversify their employment risk, as long as profitability does not suffer excessively (Hoskisson & Turk, 1990). Unrelated diversification, therefore, may be motivated by managers who have a large firm-specific investment in human capital and find it necessary to diversify the firm to protect this investment. This
type of diversification usually stems from more flexible resources such as financial assets.

Diversification also provides a benefit to managers that shareholders do not enjoy. Diversification and firm size are highly correlated, as are firm size and executive compensation (Dyl, 1988; Tosi & Gomez-Mejia, 1989). Thus, diversification provides an avenue for increased compensation. Again, resources employed to pursue such diversification include financial assets such as free cash flows, but may also involve intangible assets (Wernerfeld & Chatterjee, 1988).

Methods and Research Results

Research in the area of managerial motives and diversification has been limited because managers do not readily admit that they seek to diversify the firm to maximize personal utility. Further, research has been scant because unambiguous indicators of the effects of governance devices on strategic behavior are difficult to isolate. For instance, the main indicator of board decisions has been measures of executive compensation on firm performance (e.g., Kerr & Bettis, 1987). Others have examined specific decisions such as golden parachute contracts (Lambert & Larcker, 1985b; Singh & Harianto, 1989a; 1989b), payments of greenmail to select stockholders (Kosnik, 1987; 1990) and types of resistance to tender offer (Turk, 1989). Still others have examined board characteristics (size, composition, etc.) to see if there is an indirect relationship to strategic outcomes (Cochran, Wood, & Jones, 1985) and performance (Baysinger & Butler, 1985). These later issues have been recently reviewed by Zahra & Pearce (1989).

Because of the sparse research examining the relation between managerial motives and diversification, more speculative theory and indirect research on governance structure mechanisms (board of directors, ownership structure, executive compensation) are examined in this section. Such mechanisms are designed to prevent managers from abusing their stewardship over firm resources. External governance devices such as the market for corporate control (Manne, 1965) are also discussed. Baysinger and Butler (1985) mentioned other less important governance devices such as corporate law, which will not be discussed here. It should be emphasized, however, that, because governance devices are imperfect instruments for monitoring managers, implementation may result in tradeoffs that affect strategic behavior of managers, especially diversification of the firm.

Board composition. The nature of incentives to diversify the firm due to governance by boards of directors is illustrated by Baysinger and Hoskisson (1990). They related the changing patterns of corporate governance to an emphasis on financial control in large publicly traded firms. Due to the potential for senior corporate managers to dominate their firm's boards of directors through personal ties and de facto power to select and compensate directors (Herman, 1981; Jones & Goldberg, 1982) critics of current practice advocate a public policy that would limit all, or the vast majority, of directorships to completely independent outsiders (Eisenberg, 1976). The New York Stock Exchange, perhaps to address this concern, now requires listed firms to have an audit committee of the board composed solely of outside directors (Kesner, 1988). Thus, though in 1969 the number of inside (management) directors generally exceeded the number of inde-
dependent outsiders, by 1984 this relationship had been reversed: outsiders now typically exceed insiders on the boards of large firms (Patton & Baker, 1987). However, this trend seems to be reversing somewhat in recent years (Kesner & Johnson, 1990).

Outside directors, however, can be deceived by managers through a number of means (Walsh & Seward, 1989). Managers may strive to be perceived by the board as having taken correct actions so that performance outcomes are seen as extraneous to the evaluation. Alternatively, managers may avoid careful board scrutiny by withholding germane information or by holding infrequent or ritualistic meetings. Also, managers’ may continually point out environmental influences and claim that they have little control over a declining situation. In this way, they can define low organizational performance expectations.

Furthermore, Baysinger and Hoskisson (1989) explained that, even if having a majority of independent outside directors on the board minimizes managerial discretion or opportunism, it may produce a tradeoff in managerial risk aversion because outside directors often emphasize financial controls. Outside directors usually are busy executives who frequently serve on the boards of a number of firms. Between managing their own businesses and serving on multiple boards, outside directors are unlikely “to understand each business well enough to be truly effective” (Patton and Baker, 1987: 11). Hence, these outsider-dominated boards may emphasize financial over strategic criteria in their evaluation of managers. In contexts where strategic rather than financial evaluation criteria are appropriate (Baysinger & Hoskisson, 1989; Gupta, 1987), a policy of outsider-dominated boards may affect strategic outcomes in ways neither intended nor desired.

In light of the board’s formal authority to set the premises of the strategic decision-making process, Baysinger and Hoskisson (1989) explored how outsider-dominated boards might affect strategic outcomes in large corporations. Specifically, they argued that the trend toward outsider-dominated boards has produced managerial risk aversion, as shown by increased corporate diversification beyond a point desired by shareholders. These arguments find support from Hill and Snell (1988, 1989) and Baysinger, Kosnik, and Turk (1991) who found a positive association between outsider-dominated boards and unrelated diversification. Outside directors often lack the expertise in establishing incentives and in evaluating the diversification-performance relationship of the firm. The diversification-performance relationship may be appropriately assessed with strong strategic controls, but if financial controls are emphasized, managers may be able to pursue diversification to the point where shareholder value is reduced.

Of course, the outcomes of recent changes in board structure have not been scrutinized by thorough research and thus the above arguments are speculative at this time. However, they do suggest that boards and their composition are imperfect mechanisms for monitoring managerial behavior and that they may actually create incentives for diversification.

Ownership structure. The amount of direct monitoring performed by owners who have significant positions in the firm represent another governance device. Firms without high concentrations of ownership may be susceptible to excessive corporate diversification because monitoring cannot be effectively pursued by

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diffuse owners (Hoskisson & Turk, 1990). Highly diffuse ownership encourages free-riding on the monitoring efforts of larger shareholders because small shareholders’ potential loss may be small due to poor management. Also, it is hard to delineate each stockholder’s individual contribution to the global monitoring process (Albanese & Van Fleet, 1985; Alchian & Demsetz, 1972). Jensen (1989) further suggested that a dominant reason for leveraged restructuring, in cases of highly diversified firms such as Beatrice, is to obtain more proactive owners and, therefore, more effective monitoring of large firms.

Although the arguments above focus on outside owners, it is important to examine the effects of managerial and board of directors ownership. Hill & Snell (1988, 1989) found that managerial ownership concentration is negatively related to the level of diversification. This suggests that high concentration of ownership among managers would align manager and outsider owner interests. However, Morck, Shleifer, and Vishny (1988) found that managerial ownership and firm performance are not monotonically related. They found that increases in managerial ownership increased up to 5% and then again above 25%. Firm performance, however, decreased when managerial ownership was in the 5 to 25% range. They suggested that within this range managers’ incentives may be reduced because of larger equity stakes. It is possible that significantly larger managerial ownership positions encourage managers to diversify the firm in order to protect both their employment and equity stake.

Furthermore, Kosnik (1990) concluded that when management equity was low, agency conflicts were high. She examined differences between firms that did or did not resist greenmail payments that were assumed to reduce shareholder wealth. When management equity was low, greenmail payments were resisted if outside directors on the board had higher ownership equity relative to their incentive compensation. These results suggest that board governance may become more critical when top manager equity positions are low.

Hill and Snell (1988) found that dominant business firms often have more concentrated outside ownership arrangements. Lloyd, Hand, and Modani (1987) also found that as ownership concentration decreased and the ratio of inside to outside board members decreased, diversification increased. This suggests that owners may provide greater monitoring in dominant business firms, but less monitoring in diversified firms. In diversified firms, therefore, the board may become a more important and the owners a less important monitoring device.

Although speculative, this explanation seems plausible because unrelated business firms frequently have more outside (versus inside) directors (Baysinger & Zeithaml, 1985; Lloyd et al., 1987) and less concentrated ownership (Hill & Snell, 1988, 1989). This may be due to higher than average levels of diversity in these firms. When high levels of diversity exist, board members have little operating knowledge of the separate businesses. As such, they often are unable to use informed, strategic criteria to evaluate managers’ performance and are, therefore, reliant on objective financial criteria. Thus, unlike the dominant business firm, unrelated firms have less strategic monitoring of operations by both managers and board members, have fewer inside managers on the board, and have more diffused ownership patterns.
In essence, the agency costs of the unrelated firms are likely to be higher for shareholders because more outside directors are required. Outside directors often fear liability and, therefore, must be compensated for or protected from this higher risk. Monitoring by key shareholders is reduced because ownership is more diffuse. The lack of strategic controls in unrelated firms forces more reliance on tying managerial rewards to both accounting and stock market performance. Moreover, corporate level managers may also require a golden parachute due to the market for takeovers. Thus, in unrelated firms, rewards are tied more closely to financial performance for managers at all levels of the organization, which, in turn, creates more risk aversion throughout the firm. These results further suggest that ownership structures are incomplete monitoring mechanisms and that managers may have motives to diversify the firm.

Executive compensation. Another governance device used to align managers’ and owners’ interests is executive compensation (Hoskisson, Hitt, Turk, & Tyler, 1989; Tosi & Gomez-Mejia, 1989). Executive compensation helps to align the interests of managers and owners by giving managers an ownership position in the firm (Hill & Snell, 1988; 1989). Commonly, this is accomplished by tying managerial pay to wealth outcomes of the firm.

However, incentive compensation has several complicating factors (Hoskisson et al., 1989). First, the strategic decisions made by top executives are typically complex and nonroutine. Eisenhardt (1985) argued that behavioral controls (e.g., supervision) are ineffective when the task is complex. In this situation, outcome controls (e.g., incentive compensation tied to performance) become more appropriate. Second, managerial decisions often affect firm performance over extended periods of time, making it difficult to assess the effect of current decisions on firm performance. Third, a number of variables intervene between management behavior and firm performance. Unpredictable economic, social, or legal changes make it difficult to distinguish ex ante desirable decisions from ex post unfavorable outcomes. Thus, although performance-based compensation may provide direct incentives to managers to make decisions benefitting owners, these benefits do not come without loss of control or transfer of risk. Furthermore, because of the factors discussed above (e.g., long-term effects, intervening variables) it is difficult for the owners to ensure that they are compensating managers for their distinct actions or decisions. In other words, it is difficult to link outcomes directly to managerial actions.

Although executive incentive compensation plans may increase firm value in line with owner expectations (Tehranian, Travlos, & Waeglelein, 1987), they are subject to managerial manipulation (Dyl, 1988, 1989). For example, annual bonuses may provide incentives to pursue short-run objectives at the expense of the long-term viability of the firm. Hoskisson, Hitt, and Hill (1989) found that managerial bonuses based on annual firm performance are negatively related to investments in R&D (which may be important for enhancement of long-term firm competitiveness). Although long-term performance-based incentives may reduce the temptation to underinvest in projects that have long-term payoffs, they increase executive exposure to risks associated with uncontrollable market fluctuations. The longer the term of the plan, the greater are the long-term risks born by
the executive. As a result, executives may remain risk averse. Similarly, annual incentive compensation plans shift risk to managers without preventing a bias against long-term expenditures.

One way for managers to compensate for this shift in risk is to propose higher levels of firm diversification as their risk increases. Napier and Smith (1987) and Lambert and Larcker (1985a) suggested that incentive compensation is positively related to diversification, thereby supporting this conclusion. Diversification reduces managerial risk especially where diffuse ownership reduces monitoring. Additionally, Gomez-Mejia, Tosi, and Hinkin (1987) found that firms with insider-dominated boards tended to rely less on performance-based compensation schemes for top executives. It may be that greater emphasis on fixed salary relative to bonuses provides an effective match between strategy and managerial requirements because fixed salary separates business risk from managerial employment risk.

Further discussion of executive compensation and diversification strategy may be found in Hoskisson et al. (1989). Suffice it to say that compensation as a governance device can be flawed and may be related to increased diversification (Napier & Smith, 1987). If internal governance devices fail, however, external control devices such as the market for corporate control may be necessary to correct over diversification.

External governance: Market for corporate control. The market for corporate control serves as a governance device, usually after internal control devices have failed. The theory suggests that the market for corporate control is activated by poor relative performance. This loss of adequate internal governance may result in poor relative performance, thereby triggering a threat of takeover. However, it is important to note that as the market for corporate control has become more lively, this activity has been accompanied by an increase in the sophistication and variety of managerial defense tactics against hostile takeovers (Kosnik, 1990; Walsh & Seward, 1989). Some tactics require asset restructuring such as divestitures, and others only require financial structure changes such as share repurchases. Still other tactics, such as change in the state of incorporation, require shareholder approval; others, such as targeted shareholder repurchase agreements (greenmail), do not. Many of these tactics function to thwart takeovers and further entrench management (Dann & DeAngelo, 1988). Interestingly, these defenses do not always drive down share prices. Lambert and Larcker (1985b) found that adoption of golden parachutes can have a positive effect on shareholder wealth. Also, voluntary restructuring initiated by managers (sell-offs, spin-offs of divisions or assets) may have positive wealth effects (e.g., Jain, 1985). In sum, external control devices do not always create effective change by replacing poorly functioning managerial regimes, and defensive managerial tactics do not always result in reductions in stockholder wealth. Therefore, external governance devices, although having a restraining influence on managers, do not provide flawless control of managerial motives.

Summary and Critique

Under the assumptions of this perspective, diversification is not only seen as associated with market and firm imperfections, but additionally motivated by
managers seeking to maximize their own utility. The two primary motives are reduced employment risk and increased compensation. Further, as suggested above, the governance structures in place to prevent managerial abuse are also imperfect and, under certain conditions, may even induce increased diversification. For instance, a board of directors with a majority of outsiders on the board may emphasize financial controls that shift risk to managers. Managers thereby may feel the need to reduce this risk through diversification of the firm, unless strategic control balances the emphasis on financial control (Baysinger & Hoskisson, 1990). Another governance device is ownership monitoring, but diffuse ownership structures, associated with large public enterprises, may provide inadequate monitoring because of freeriding by many smaller shareholders. In this situation, managers can diversify the firm as long as firm performance does not suffer excessively (Hoskisson & Turk, 1990). Also, boards of directors are increasingly relying on incentive compensation as a governance device. Incentives tie managers’ wealth to the wealth of the firm. This process, unfortunately, also ties managers’ wealth to uncertain events outside their control, such as major market advances or declines. This shifts risk to managers who may seek to reduce it by diversifying the firm.

Certainly, if the firm becomes overdiversified and firm performance drops to unacceptable levels, managers may be replaced through the market for corporate control. However, as indicated above, managerial defenses to tender offers and takeover strategies have become very sophisticated, elaborate as the strategies to displace incumbent managers (Walsh & Seward, 1989). Takeover attempts sometimes fail because of the defensive tactics of managers (Dann & DeAngelo, 1988). This does not suggest that managers diversify the firm without reason. In fact, many managers have sought to voluntarily restructure the firm to reduce the level of diversified assets (Hoskisson & Turk, 1990), albeit often in the face of a takeover threat. Nonetheless, the assumptions of this perspective suggest that managers are not only motivated to maximize their own utility, but also have the capability to overcome governance devices designed to prevent such self-interest.

However, the logic of agency suggests that managers are not only responsible for abuse, but also for successful performance. The majority of large publicly held firms are thriving and profitable because managers are positive agents and many of their strategic actions (e.g., diversification moves) contribute to this success. Both the previous two perspectives assumed that managers are rational with the assets entrusted to them. As mentioned above, governance devices are set up to deal with exceptions to the norms of rationality rather than total self-interest. Therefore, it is overly pessimistic to assume that managers will usually act in their own self-interest as opposed to firm-interest. However, it is important to note that contemporary reviews from different perspectives concluded that managerial motives are a reasonable explanation for high levels of acquisition and diversification activity (Roll, 1986; Trautwein, 1990).

Besides the internal and external governance devices in place, it has been argued that the reputation effects associated with failure may constrain managers to avoid misusing their agency (Fama, 1980). This issue has not only been ex-
plored by researchers in finance (Dejong, Forsythe, & Lundholm, 1985; Kose & Nachman, 1985), but management researchers have also suggested that reputation facilitates power in organizations (Gioia & Sims, 1983). If reputation facilitates power, poor reputation may also decrease power. Likewise, a market for managerial talent may also constrain managerial abuse of such power.

Additionally, some diversified firms have also provided policing of other diversified firms. Large highly diversified firms such as Hanson Trust seek out poorly managed diversified firms for acquisition to restructure the asset base. Although Porter (1987) suggested that restructuring is not likely to be a highly profitable venture (because it often provides only average returns across all industries), Hanson Trust has been quite effective at it and has maintained above average returns. Other firms may also be adroit at restructuring.

Even with the likelihood of reputation effects and self-regulation among diversified firms, managers still may continue to abuse their agency, as Loderer and Sheehan (1988) indicated in the decapitalization of railroad subsidiaries. However, other trends continue to evolve that may affect diffuse patterns of ownership among large firms. Institutional shareholders are increasing their concentration of stock holdings. Furthermore, they have organized the Council of Institutional investors as a proactive force against managerial abuse (Rosenberg, 1987). Also, these institutional investors have been more involved in the market for corporate control to provide additional discipline of managers (Heard, 1987). This is supported by the Baysinger et al. (1991) findings that institutional ownership concentration is negatively associated with diversification.

Alternatively, extensive diversification may be interpreted as managerial abuse, when in fact this diversification may have been encouraged by shareholders. As indicated earlier, anti-trust and tax policy have been shown to provide external incentives for diversification. Managers may have been motivated, therefore, by shareholders to invest free cash flows in such diversified assets. If these assets have continued to foster wealth, restructuring of these assets would not be necessary.

Although much of the restructuring activity (divestitures of diversified assets) has resulted in improved shareholder wealth for the restructured firm (Jain, 1985), Woo, Willard, and Daellenbach (1990) found that divested businesses (spin-offs) performed poorly on a number of dimensions. It is often assumed by financial economists that divested assets go to their highest productive use (Jensen, 1988), but such assumptions may not be warranted (Hirsch et al., 1990).

In summary, although managers may be motivated to increase diversification, there are governance devices in place to discourage such action merely for managerial utility. However, these devices are imperfect and may not always produce the intended consequences. Even when governance devices cause managers to correct the problem of overdiversification, these moves may not be without trade-offs. For instance, spin-off firms may not realize productivity gains, although it is in the best interest of the divesting firm. Therefore, the assumption that managerial motives need disciplining may not be entirely correct, and sometimes the
governance devices may create consequences that are worse than diversification motivated by managers' self-interest. Therefore, future research is required to identify and analyze accurately managerial and firm interests.

**Discussion and Future Research**

Although there has been considerable research on diversification beginning with the seminal work of Chandler (1962), there is much work that remains before definitive conclusions are possible. Many of the problems may relate to incomplete or inadequately specified assumptions. The relationship between diversification strategy, external and internal firm factors, and firm performance is more complex than assumed in most prior research. For example, we examined three different perspectives on the diversification-performance relationship. In each case, the assumptions differ and therefore the expected causes/moderators also differ. The major difference in assumptions is related to perfection of the market. Under assumptions of relative market perfection, there is little valid justification for firm diversification, thus, few resources and no incentives lead to diversification. Therefore, there should at least be no, and possibly a negative, relationship between diversification and performance (see Figure 1). However, the research regarding this relationship is mixed.

The latter two perspectives assume some level of market and firm imperfections. As a result, multiple contingencies may affect the level of diversification and its relationship with performance. Under conditions of market and firm imperfections, the notion of strategic choice becomes important, as do incentives and managerial motives to diversify. The basic assumptions of the last two perspectives are shown in Figure 2.

All three perspectives argue for the importance of capital markets and industry structure in the diversification-performance relationship (although the level of

![Figure 1](image_url)

*General Model for Perspective Which Assumes Relative Market Perfection in Diversification-Performance Relationship*
importance varies). The first perspective examines assumptions of relative market perfection, and thus the effects of capital markets or industry structure are dominant (see Figure 1). The second two perspectives assume market imperfections and focus on the effects of strategic variables (under the control of managers) such as diversification that become relevant because of the imperfections (see Figure 2). Interestingly, however, a reasonable amount of strategic management research, including that on diversification, ignores the effects of industry (Dess, Ireland, & Hitt, 1990). This variable is often assumed to be functioning, but has seldom been operationalized explicitly. Therefore, we do not fully understand the specific effects of capital market or industry structure on the diversification-performance relationship. As a result, more research is required to understand specifically how the capital market and industry structure affect the diversification-performance relationship.

Research also has examined the performance implications of related versus unrelated diversification. Much of this research has assumed relative market perfection. However, the research results do not allow definitive conclusions regarding whether and how the type of diversification affects performance. Hence, the relationship is likely more complex than assumed in prior research. In particular, future research is needed to examine how related versus unrelated diversification is affected by incentives and resources (see Figure 3).

For instance, we need to understand better how the interaction of resources and incentives affect the adoption of particular types of diversification strategy. Based on the research, we could hypothesize that the more resources and incentives present, the greater the extent of firm diversification. Financial assets (the most flexible) should have a stronger relationship to the extent of diversification than the other two types of assets [refer to Jensen’s (1986) free cash-flow hypothesis], whereas tangible assets (the most inflexible) would be useful primarily for related diversification.
Although much of the research and discussion herein has focused on type of diversification (related vs. unrelated), little has been said about the mode of diversification. The primary mode of firm diversification has been by acquisition (Hitt et al., 1990; Salter & Weinhold, 1978). There has been considerable research on acquisitions in the economics and finance literature, but most has focused on their performance outcomes. However, resources are likely to affect mode (internal development vs. acquisition) of diversification and how diversification affects performance. Jensen (1988) concluded, for instance, that acquiring firms tend to receive, on average, zero or slightly positive returns from acquisitions. One may question the popularity of this strategy if acquisitions produce zero returns on average. Much of the answer may lie in the preceding discussion on antecedents of diversification. For example, tangible resources are more likely to lead to internal development, whereas financial resources allow more flexibility in choice of mode. Therefore, financial resources would be more strongly related to acquisitive growth than the other resource types. But these resources are less rare and more mobile, therefore, they may create less value due to increased imitability. As a result, more research is required to understand why.
managers choose certain modes of diversification and better understand the differences in outcomes produced by these different modes.

Incentives such as anti-trust and tax laws, uncertainty of future cash flows, risk reduction, and transaction costs also likely affect diversification. However, there is little research establishing specific relationships of incentives to diversification strategy, and thus more work is required. However, it is particularly important to understand how resources and incentives interact to affect a firm's diversification strategy (as suggested in Figure 3). For example, it is unclear what diversification choice would be made for a firm that currently operates in a market with uncertain future cash flows, but yet had strong tangible and weak financial assets. The incentive for unrelated diversification might be strong, but the resources available would be much more effective for closely related diversification. Clearly, future research on diversification strategy should examine the interaction effects of resources and incentives.

Similarly, future research should also focus on the effects of strategy implementation on the diversification-performance relationship (see Figure 3). Although there is considerable research on the effects of the strategy-structure relationship on firm performance, there has been much less empirical work on the moderating effects of dominant logic/distinctive competence, managerial characteristics, and corporate culture on the diversification-performance relationship. Theoretical arguments exist to suggest that the relationships between type of diversification and structure, managerial dominant logic/distinctive competence, and culture may affect firm performance. In other words, certain types of diversification require specific structures, distinctive competencies, and cultures to produce higher performance.

In particular, more research is required to examine the effects of the interaction of these implementation characteristics. For example, conceptual research by Hill & Hoskisson (1987) and empirical work by Hill et al. (1990) suggest that a centralized structure, strategic controls, and structural devices promoting cooperation between business units lead to higher performance in a related diversified firm. Similarly, in an unrelated diversified firm, a decentralized structure, financial controls, and structural devices designed to promote competition between business units should lead to higher performance. However, other firm characteristics must be in alignment as well. For example, the firm's culture should be in alignment with the structure, such that cooperation is promoted in related and competition promoted in unrelated firms. Furthermore, the firm must possess the appropriate skills or distinctive competencies to develop and implement effective strategic (related) or financial (unrelated) controls. No research exists examining the effects of the interaction of these variables.

Additionally, much of the practitioner literature on acquisitions has emphasized the importance of another implementation issue, that of integrating the acquired firm into the acquiring firm (e.g., Ivancevich, Schweiger, & Power, 1986; Kerr & Slocum, 1988; Kitching, 1967). For example, at times strong integration is necessary where cooperation is critical; however, more autonomy is required if competition between units is desired. Although some empirical research addresses this issue (Datta & Grant, 1990; Stubbard, 1983) more research is nec-
ecessary to understand how to integrate acquired units effectively (Trautwein, 1990).

According to agency theorists, diversification is pursued not only because firm resources and external and internal incentives exist, but managers also may have personal motives for diversification of firms they manage. In particular, managers may seek diversification to reduce their employment risk and/or increase their compensation. As the third perspective suggests, however, there are external and internal governance devices designed to control managerial opportunism and incompetence, as shown in Figure 4. However, internal governance mechanisms are imperfect and managers have developed sophisticated defenses to tender offers and takeover strategies. As a result, they may successfully fend off attempts to replace them through the market for corporate control. Although these monitoring devices generally reduce managerial opportunism, they may also promote undesirable behavior (e.g., overemphasis on financial controls may lead to managerial risk aversion).

Much of the governance literature assumes that managers operate only in their own self-interest if not controlled and that diversification is inappropriate. There is little empirical research to support such notions, however. In fact, managers may (and should) have positive effects on firm performance. Furthermore, reputational effects of managerial actions may act to constrain managerial opportun-

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**Figure 4**

Specific Model of Diversification-Performance Relationship Posed by Third Perspective

![Diagram showing the relationship between external governance, diversification strategy, and firm performance.](image-url)
ism exclusive of explicit governance mechanisms. Additionally, the growing power and use of that power by institutional owners may keep managerial opportunism in check (Rosenberg, 1987). However, the fact that many firms have been restructuring in recent years, divesting unrelated assets (thereby reducing the level of diversification) suggests that firms may have been overdiversified and that governance devices are imperfect in constraining diversification. However, there is little empirical research to help us understand managerial behavior and the specific effects of governance mechanisms. More empirical research is necessary to develop an effective understanding of managerial motives and behaviors. More research is also necessary to understand the relative impact and interaction effects of internal and external governance mechanisms on managerial behavior and firm diversification.

The above suggestions for future research on antecedents, moderators, and outcomes of diversification suggest a need for a more integrative model of the diversification-performance relationship. In Figure 5 we offer a model that seeks to integrate the issues presented from the three perspectives discussed. Although the model is unavoidably complex, Van de Ven and Drazin (1985) and Keats and Hitt (1988) call for more holistic modeling and research in strategic management research. As shown in the critiques of the three perspectives of the diversification-performance research, each has deficiencies, largely because of ignoring relevant or more realistic assumptions. To date, the work accomplished represents mid-range theories. Hirsch et al. (1990) and Logue and Sundaram (1990) admonish scholars/proponents of specific perspectives described herein for ignoring the contributions from the other perspectives (often representing separate disciplines such as finance, economics, organization theory, strategic management). Therefore, we propose that more holistic research be conducted to integrate the assumptions of different perspectives focusing on the model presented in Figure 5. Only under these conditions can we develop a more effective theory on the antecedents and performance outcomes of diversification.

In testing a holistic, causal model, more emphasis should be placed on using appropriate (possibly multiple) measures of diversification. Furthermore, multiple performance measures should be used (Keats, 1989, 1990; Keats & Hitt, 1988). Finally, such research should entail the use of archival and field research along with quantitative as well as qualitative data. Thus, research to advance our knowledge of firm diversification will be highly complex. On the other hand, the preponderance of diversification among U.S. and international firms justifies major efforts.

Conclusion

The perspectives presented herein provide three incomplete views on the diversification-performance relationship. In order to build better theory, two additional polar criticisms bear recognition. First, our finance colleagues criticize much of the strategic management research on diversification as atheoretical (e.g., Logue & Sundaran, 1990). Although such a statement may be too strong, it is relevant. Much of the strategic management research assumes market imperfections (in opposition to much of the research from finance and economics); all

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too often strong theoretical arguments have not been offered for many of the relationships examined. As a result, the research leaves the impression that it is data driven (as opposed to theory driven). Therefore, more theory building is required.

The second criticism relates more to the assumptions of the finance and economics perspective. Hirsch et al. (1990) admonish strategy researchers to use economic theory to enrich the field of strategic management, but not to allow a paradigm shift. Of course, the assumption of potential market and firm imperfections does not promote a paradigm shift toward the powerful (yet sometimes unrealistic) economic assumptions. However, some researchers ignore the potentially rich contributions from economic theory. Thus, while assuming these imperfections, strategic management scholars should integrate economic arguments into their theoretical framework. Lessons can be learned from economics and finance in building more effective theory.
Both of these criticisms, though at polar extremes, argue for more theory building in the research on diversification antecedents and outcomes. In short, the relationship between diversification strategy and performance is more complex than assumed in a number of the studies. Future research must incorporate more complete designs that monitor background assumptions in order to capture effectively the nature of the diversification-performance relationship. To date, most research has provided incremental contributions to our knowledge, usually within one particular perspective. We now need a more revolutionary approach, integrating the various perspectives to build a more realistic and effective theory of firm diversification.

Given the amount of diversification sought and achieved by most large firms, it is important to have a better understanding of antecedents of diversification. Much of the previous research ignored the reasons for diversification or focused only on one or a few. As noted, there are many potential incentives that may well explain why diversification is so extensive among large U.S. and international firms. Additionally, firms must have the appropriate resources to diversify. Therefore, we concluded that the antecedents of diversification included a variety of incentives and resources. As a result, the relationship between incentives, resources, and diversification strategy is also complex.

The review and model development has been constrained to the examination of product diversification because of its importance, as shown by its decided popularity both in the scholarly strategic management literature and in practice. However, recent research suggests that some firms may experience tradeoffs between product diversification and another popular corporate strategy, international or global diversification (e.g., Buhner, 1987; Geringer, Beamish, & daCosta, 1989). For example, some firms may decide to expand into global markets as they experience more competition or saturation in domestic markets (Buhner, 1987; Geringer et al., 1989; Kim, Hwang & Burgess, 1989). As a result, global diversification (expanding into international markets with the current product line) may be sought to enhance returns instead of product diversification. Although global diversification allows firms to use effectively their strong knowledge of current products/markets and other core skills, it also introduces other complexities. Cultural and market differences among several countries suggests that such diversification is not as simple as extension into new but domestic markets. As a result, opportunities to diversify globally may moderate the effects of some of the incentives to diversify. For example, uncertainties in future cash flows may be lessened with expansion into new but potentially strong international markets. Current research suggests that some firms are simultaneously pursuing both global and product diversification. Therefore, corporate strategic decisions are quite complex, and we need a better understanding of the tradeoffs between global and product diversification along with potential synergies between the two strategies.

We also need a better understanding of the tradeoffs associated with internal development versus external acquisition. For example, Hitt et al. (1990) theorized that acquisitions serve as a substitute for innovation and because of greater diversification, size and debt, also produce lower managerial commitment to in-
novation. Therefore, firms that follow an acquisition strategy to diversify are unlikely to diversify (or even innovate in current product areas) through internal development. Clearly, most firms are not likely to use internal development to diversify except into highly related (related constrained) product markets. Furthermore, Hitt et al. (1990) suggested that internal development is more risky than acquisitions. Although acquisitions certainly carry risks, acquired firms currently operate in established markets. Thus, it is easier to project visible returns immediately, whereas internally developed ventures may require a number of years before returns are adequate (Biggadike, 1979). This particular tradeoff has implications for global competitiveness (Hitt & Hoskisson, 1991) and thus should be examined carefully.

To examine the complexity involved in the diversification-performance relationship and the associated tradeoffs may require complex modeling (theoretically and analytically) such as that used by Keats and Hitt (1988) to advance our knowledge in this arena. Although our knowledge on the complex relationships discussed herein remains incomplete, we are at least closer to understanding why corporate executives make decisions to diversify and what the outcomes of these decisions may be.

References


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