Managerial Style and Attention.

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August 22, 2014

Abstract

A large empirical literature has shown how firm behavior is correlated with the background and expertise of its managers. But managerial knowledge and expertise are largely endogenous. We analyze a model in which a manager selectively allocates attention to learn about two (non-exclusive) strategies. The manager then communicates about the chosen strategies to an organization, who must implement them. Both the manager and the organization have limited attention. We show that in order to facilitate implementation, the manager often communicates about only one of the two strategies. If managerial attention is constrained, this induces the manager to focus on one strategy when gathering information, making him more likely to select that strategy for implementation. This is true even when both strategies look equally attractive ex ante and the manager is a generalist and is equally adept at learning about either strategy. Ex post, it appears as if managers are (arbitrarily and inefficiently) biased towards one particular strategy. Furthermore, small differences in managerial background result in large differences in firm behavior. Finally, firm owners (e.g. boards) often appoint managers with strategy-specific expertise rather than generalist managers, even when they themselves have no preference for a particular strategy.

1 Long Abstract

Scholars in management have long emphasized the role of executive leadership on organizational outcomes. According to the "upper-echelons theory," as set forth by Hambrick and Mason (1984), a central requirement for understanding organizational behavior is to identify those factors that direct or orient executive attention. Organizational outcomes, such as strategies and performance, are expected to reflect the the values and cognitive biases of top managers in the organization. In this view, a chief executive's background in operations makes him more inclined to pursue a cost-reduction strategy, whereas a chief executive with a marketing and sales background is more likely to pursue growth strategies. A substantial body of empirical evidence supports this view. Barker and Mueller (2002), for example, find that CEO characteristics explain a significant

proportion of the variance in R&D spending even when controlling for industry and firm-level attributes. Among other factors, R&D expenditures are shown to be greater at firms where CEOs have significant carreer experience in marketing and/or engineering/R&D or at firms where CEOs have advanced science-related degrees. Similarly, following a seminal paper by Betrand and Schoar (2004), a growing literature in corporate finance has shown that managerial characteristics (referred to as "managerial styles") are strongly correlated with a variety of corporate policies, such as mergers and acquistions, debt levels and growth versus cost-cutting strategies.

The main conceptual concern about the above empirical findings is that managerial knowledge and expertise are largely endogenous. Managers allocate attention – and develop expertise – in order to learn about strategic choices. Similarly, firm owners and boards of directors decide whether or not to hire managers with expertise in certain areas. Thus, a board which has a clear view about the desired strategic direction of a firm may simply appoint or promote a CEO with the relevant expertise. The management literature has further suggested that managerial preferences or cognitive biases may drive the correlation between managerial characteristics and firm behavior. It is unclear, however, why the observed correlation cannot be consistent with profit-maximizing behavior. Unfortunately, the development of theoretical models which study the endogenous expertise of managers and the correlation between managerial expertise and firm behavior has lagged compared to the growing body of empirical work.

In this paper, we analyze a model in which a manager selectively allocates attention – and develops expertise – in order to learn about two (non-exclusive) strategic choices. How effective any given strategic choice is depends on how responsive it is to a strategy-specific shock (external alignment) and how well it is executed by the organization (internal alignment). Both the manager and the agents in the organization have limited attention. The importance of internal and external alignment has long been emphasized in the management literature and has also been very prominent in the recent organizational economics literature (e.g. Alonso, Dessein and Matouschek (2008), Rantakari (2008, 2013), Bolton, Brunnermeier and Veldkamp (2011), Van den Steen (2014)). *Internal alignment of a strategic choice* depends on how well the manager communicates this choice to the organization, who must take complementary actions to ensure effective implementation. The quality of implementation further depends on how closely a strategic choice adheres to 'business as usual'. Radical strategic choices require intensive communication to avoid poor internal alignment. In contrast, no communication is required to achieve internal alignment around strategic choices which are 'standard'. *External alignment of a strategic choice* depends on how well the manager understands the strategy-specific shock which, in turn, depends on her expertise and how much attention she devotes to learning about this shock.

We show that in order to facilitate implementation, the manager often communicates about only one of the two strategic choices. If managerial attention is constrained, this induces the manager to focus on one strategic choice when

gathering information, making him more likely to select that strategy for implementation. This is true even when both strategic choices look equally attractive ex ante and the manager is a generalist and is equally adept at learning about either strategy. Ex post, it appears as if managers are (arbitrarily and inefficiently) biased towards one particular strategy. Furthermore, small differences in managerial background result in large differences in firm behavior. Finally, firm owners (e.g. boards) often appoint managers with strategy-specific expertise rather than generalist managers, even when they themselves have no preference for a particular strategy.

Motivation: Managerial Styles

- Literature on **Managerial Styles** (Bertrand & Schoar 2003)
  - Manager fixed effects are correlated with a variety of firm policies and organizational practices.
- **Behavioral Theory of the firm** (Cyert & March '64)
  - Firm behavior reflects managerial biases. Complex decisions are result of behavioral factors rather than rational analysis.
- **What explains Managerial Styles?**
  - Preferences?
  - Specialization – managers have specialized expertise?
  - Bounded Rationality and biased information processing?

This Paper: Managerial Styles and Attention

This Paper: Optimal Allocation of Managerial Attention.

Understanding Firm Behavior

$=>$ Understanding how managers (optimally) allocate attention.

- *Manager gathers information/allocates attention*..
- Manager decides on key strategic choices, and communicates strategy to employees who help implement.

$=>$ When is it optimal to *favor certain strategic choices* when gathering information?

Outline Presentation

1. **Model**
2. Benchmark: No coordination frictions.
3. Preview of results
4. Managerial Style with Generalist Managers.
5. Managerial Style with Specialist Managers.
6. Discussion.

Model ingredients

- **Firm objectives:**
  - *External Alignment:* Actions should be adapted to (multi-dimensional) environment.
  - *Internal Alignment:* Actions should implemented in coordinated fashion.
- **Manager selects and communicates strategy** to employees
  - can communicate *complex strategy*, adaptive to all aspects of environment.
  - can communicate *simple strategy*, adaptive to select items of environment.
- **Manages must learn** about (multi-dimensional) environment:
  - can pay equal attention to all aspects of environment
  - *can focus attention* on a select few aspects.

The Model

One Manager and a continuum of Followers

- Two shocks, θ_1 and θ_2, i.i.d. $\sim N(0, \sigma_\theta^2)$.
- Manager selects strategy for the organization (a_{M1}, a_{M2}).
- Each follower $j \in [0, 1]$ chooses actions a_{j1} and a_{j2} to implement strategy.
- Pay-offs reflect need for
  - **adaptation/external alignment** of strategy to environmental shocks
  - **coordination/internal alignment** within the firm:

$$\pi = -\sum_{i=1,2} \left[(a_{Mi} - \theta_i)^2 + \beta \int_0^1 (a_{ji} - a_{Mi})^2 dj \right]$$

Model: Timing

- **Timing**

$$\pi = -\sum_{i=1,2}\left[(a_{Mi}-\theta_i)^2+\beta\int_0^1(a_{ji}-a_{Mi})^2dj\right]$$

1. Manager *chooses attention/strategic focus* (t_1, t_2) to learn about θ_1 and θ_2, where $t_1 + t_2 = 2t$.
2. Manager forms posteriors $\hat{\theta}_1$ and $\hat{\theta}_2$, and *chooses strategy* (a_{M1}, a_{M2}).
3. Manager devotes time r_i to *communicate about strategic choice* a_{Mi} to followers, with $r_1 + r_2 = r$.
4. Followers $j \in [0, 1]$ implement strategy by choosing actions $a_{j1} = \hat{a}_{M1}$ and $a_{j2} = \hat{a}_{M2}$.

The Model: Communicating Strategy

- **Communicating Strategy** (a_{M1}, a_{M2}).
  - Manager devotes time r_i to communicate strategic choice a_{Mi}.
  - Poisson communication process: Given r_i, follower j learns strategic choice a_{Mi} with independent probability

$$p_i = 1 - e^{-r_i}$$

  - **Communication constraint**: $r_1 + r_2 \leq r$

$$\Leftrightarrow (1 - p_1)(1 - p_2) \geq e^{-r}$$

The Model: Managerial Attention and Learning

- Managerial Attention and learning about (θ_1, θ_2)
  - Manager observes an *endogenous* signal s_i about shock θ_i, whose informativeness depends on managerial attention t_i.
  - Manager observes an *exogenous* signal S_i about shock θ_i whose informativeness depends on manager's specialization T_i.
- Define $\hat{\theta}_i = E(\theta_i | s_i, S_i)$, then $E((\hat{\theta}_i - \theta_i)^2) = \sigma_\theta^2 e^{-\lambda(t_i + T_i)}$.
  - see micro-foundation below.
- **Attention constraint:** $t_i \in \{0, t, 2t\}$ with $t_1 + t_2 \leq 2t$,

Managerial Attention: Micro-foundation

- Assume shock θ_i is sum of n i.i.d compenents:

$$\theta_i = \sum_{j=1}^{n} \theta_{ij}, \text{ with } \theta_{ij} \sim N(0, \frac{\sigma_\theta^2}{n})$$

- Each component is revealed with independent prob. $q(t_i)$

$$\begin{cases} s_{ij} = \theta_{ij} \text{ with probability } q(t_i) \\ s_{ij} = 0 \text{ with probability } 1 - q(t_i) \end{cases}$$

  where we assume poisson learning process: $q(t_i) = 1 - e^{-\lambda t_i}$.

- Then $\hat{\theta}_i = \sum_{j=1}^{n} s_{ij}$, and $\quad E((\hat{\theta}_i - \theta_i)^2) = (1 - q(t_i))\sigma_\theta^2$

Managerial Attention: Micro-foundation

- Assume both endogenous signals $s_i = \{s_{ij}\}$ and exogenous signals $S_i = \{S_{ij}\}$, where

$$\begin{cases} S_{ij} = \theta_{ij} \text{ with independent probability } q(T_i) \\ S_{ij} = 0 \text{ with independent probability } 1 - q(T_i) \end{cases}$$

- Probability manager learns θ_{ij} equals $q(t_i + T_i)$, and:

$$\begin{aligned} E((\hat{\theta}_i - \theta_i)^2) &= \sigma_\theta^2 \times (1 - q(t_i + T_i)) \\ &= \sigma_\theta^2 \times e^{-\lambda(t_i + T_i)} \end{aligned}$$

- **Attention constraint:** Define $q_i = q(t_i + T_i)$, then

$$t_1 + t_2 \leq 2t \Longleftrightarrow (1 - q_1)(1 - q_2) \geq e^{-\lambda(T_1 + T_2 + 2t)}$$

Model: Timing

- **Timing**

$$\pi = -\sum_{i=1,2}\left[(a_{Mi}-\theta_i)^2+\beta\int_0^1(a_{ji}-a_{Mi})^2dj\right]$$

1. Manager *chooses attention/strategic focus* (t_1, t_2) to learn about θ_1 and θ_2, where $t_1 + t_2 = 2t$.
2. Manager forms posteriors $\hat{\theta}_1$ and $\hat{\theta}_2$, and *chooses strategy* (a_{M1}, a_{M2}).
3. Manager devotes time r_i to *communicate about strategic choice* a_{Mi} to followers, with $r_1 + r_2 = r$.
4. Followers $j \in [0, 1]$ implement strategy by choosing actions $a_{j1} = \hat{a}_{M1}$ and $a_{j2} = \hat{a}_{M2}$.

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1. Model
2. **Benchmark: No coordination frictions.**
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Benchmark: No coordination frictions

- **Benchmark:** Assume no coordination frictions.
  - One person organization: Manager chooses all (a_{j1}, a_{j2}).
  - Manager can perfectly communicate his strategy (a_{M1}, a_{M2}).
  - Coordination irrelevant: $\beta = 0$
- **Proposition:** In absence of coordination frictions:
  - If $T_1 = T_2 = T$ (Generalist Manager):
    Manager spreads out attention evenly: $(t_1^*, t_2^*) = (t, t)$.
  - If $T_1 > T_2$ (Specialist Manager) and t is sufficiently small:
    Manager pays attention to less familiar task: $(t_1^*, t_2^*) = (0, 2t)$.
- **Intuition:** Decreasing marginal returns to attention.
  - $dq_2 / dq_1 < -1$ whenever $q_1 > q_2$.

Outline Presentation

1. Model
2. Benchmark: No coordination frictions.
3. **Preview of results.**
4. Managerial Style with Generalist Managers: $T_1 = T_2 = T$
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Preview Results

- **Coordination Friction:** If $r < \bar{r}(\beta)$:
  - *Strategy communicated* by manager to followers is simple and *only concerns one strategic choice*.
- When allocating attention:
  - **generalist manager** for whom strategic choices are symmetric:
    - *favors one strategic choice* in uncertain/complex environments, when coordination is important.
    - "favored choice" more likely to be communicated to followers.
  - **specialist manager** with more expertise in one area:
    - *focusses attention on area of expertise* in uncertain/complex environments, when coordination is important..
    - compensates for lack of expertise in more certain environments, when coordination is less important..

Outline Presentation

1. Model
2. Benchmark: No coordination frictions.
3. Preview of results.
4. **Managerial Style with generalist manager:** $T_1 = T_2 = T$
   - 4.1 **Selecting and communicating strategic choices**
   - 4.2 Allocating attention – collecting information.
5. Managerial Style with specialist manager.
6. Discussion.

Model: Timing

- **Timing**

$$\pi = -\sum_{i=1,2}\left[(a_{Mi}-\theta_i)^2+\beta\int_0^1(a_{ji}-a_{Mi})^2dj\right]$$

1. Manager *chooses attention/strategic focus* (t_1, t_2) to learn about θ_1 and θ_2, where $t_1 + t_2 = 2t$.
2. Manager forms posteriors $\hat{\theta}_1$ and $\hat{\theta}_2$, and *chooses strategy* (a_{M1}, a_{M2}).
3. Manager devotes time r_i to *communicate about strategic choice* a_{Mi} to followers, with $r_1 + r_2 = r$.
4. Followers $j \in [0, 1]$ implement strategy by choosing actions $a_{j1} = \hat{a}_{M1}$ and $a_{j2} = \hat{a}_{M2}$.

Selecting and communicating strategic choices

- For given posteriors $\hat{\theta}_1$ and $\hat{\theta}_2$, how does manager *choose and communicate* strategic choices (a_{M1}, a_{M2})?
  Assume $\left|\hat{\theta}_i\right| > \left|\hat{\theta}_{-i}\right|$:

- **Proposition:** *There exists a* $\bar{r}(\beta) > 0$ *such that if* $r < \bar{r}$*:*
  - *the manager only communicates about* a_{Mi} : $(r_i, r_{-i}) = (r, 0)$.
  - *the manager chooses strategies*

    $a_{Mi} = \frac{1}{1+\beta(1-p)}\hat{\theta}_i$ and $a_{M-i} = \frac{1}{1+\beta}\hat{\theta}_{-i}$, with $p = 1 - e^{-\mu r}$

  - **Hence:** When coordination is important (β large) and/or organizational attention limited (r small), the manager
    - only communicates about strategic choice with largest shock.
    - mainly adapts to largely shock, ignoring smaller shock.

Intuition

- Given decision rules $a_{M1} = \alpha_1 \hat{\theta}_1$ and $a_{M2} = \alpha_2 \hat{\theta}_2$ and communication probabilities $p_i = 1 - e^{-r_i}$, we have:

$$E(\pi|\hat{\theta}_1, \hat{\theta}_2)$$

$$\begin{aligned} = \quad & -E((\hat{\theta}_1 - \theta_1)^2) - (1-\alpha_1)^2 \left(\hat{\theta}_1\right)^2 - \beta(1-p_1)(\alpha_1)^2 \left(\hat{\theta}_1\right)^2 \\ & -E((\hat{\theta}_2 - \theta_2)^2) - (1-\alpha_2)^2 \left(\hat{\theta}_2\right)^2 - \beta(1-p_2)(\alpha_2)^2 \left(\hat{\theta}_2\right)^2 \end{aligned}$$

- **Direct observation:** p_i and α_i are *complementary choices*, but $-dp_2/dp_1$ increasing in p_1.

- **Result**: If $r < \bar{r}(\beta)$, then optimal to only communicate about largest shock: $p_i \in \{p, 0\}$.

Outline Presentation

1. Model
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4. **Managerial Style with Generalist Managers: $T_i = T$.**
   - 4.1 Selecting and communicating strategic choices
   - 4.2 **Allocating attention – collecting information**.
5. Managerial Style with Specialist Managers.
6. Discussion.

Allocating Attention – Collecting Information

- Assume $r < \bar{r}$, and assume **manager only communicates about strategic choice 1** (a^*_{M1}).
  - Manager's strategy is then more adaptive to $\hat{\theta}_1$ than to $\hat{\theta}_2$.
  - Expected profits given posteriors $\hat{\theta}_1$ and $\hat{\theta}_2$:

$$E(\pi|\hat{\theta}_1, \hat{\theta}_2) = -2\sigma_\theta^2 + \frac{1}{1+\beta(1-p)}\left(\hat{\theta}_1^2\right) + \frac{1}{1+\beta}\left(\hat{\theta}_2^2\right)$$

    where $E\left(\hat{\theta}_i^2\right) = q(T + t_i)\sigma_\theta^2$

  - Since variance in the posterior $\hat{\theta}_i$ is increasing in attention t_i, **optimal to pay more attention to** θ_1 **than** θ_2 (set $t_1 > t_2$).
  - But if $t_1 > t_2$, it is then likely that $\left|\hat{\theta}_1\right| > \left|\hat{\theta}_2\right|$, hence typically optimal to only communicate about a^*_{M1}.

Allocating Attention: Complementarities

- Thus three complementary choices
  - Mainly *communicating* about strategic choice 1.
  - Mainly *adapting* strategy to shock θ_1
  - Mainly *paying attention* to shock θ_1

Allocating Attention: Complementarities

- **Formally:** Distribution of posteriors $\hat{\theta}_1$ and $\hat{\theta}_2$:
  - Define $q_i = 1 - e^{-\lambda(T+t_i)}$
  - Given attention allocation (t_1, t_2) : $\hat{\theta}_i \sim N(0, q_i\sigma_\theta^2)$

- **Complementarities** *(rough intuition)*
  - more attention to θ_1 than θ_2
  - more likely that $\left|\hat{\theta}_1\right| > \left|\hat{\theta}_2\right|$
  - more likely that manager communicates a^*_{M1} than a^*_{M2}
  - optimal to focus attention on strategic choice 1 : $t_1 > t_2$.

- **Counterveiling force:**
  Decreasing marginal returns to attention: $dq_2 / dq_1 < -1$ whenever $q_1 > q_2$.

Optimal Allocation of Attention

Expected Profits with **perfect managerial knowledge:** $(\hat{\theta}_1, \hat{\theta}_2) = (\theta_1, \theta_2)$

$$\Pi = -2\sigma_\theta^2 + 2C$$

where C **equals**

$$4\int_0^\infty \left(\int_0^{\theta_2} \left(\frac{\theta_1^2}{1+\beta} \right) dF(\theta_1) + \int_{\theta_2}^\infty \left(\frac{\theta_1^2}{1+\beta(\mathbf{1}-\mathbf{p})} \right) dF(\theta_1) \right) dF(\theta_2)$$

- Expected profits with **imperfect managerial knowledge?**
- Manager adapts strategic choice a_{Mi} to posterior $\hat{\theta}_i$ with variance $q(t_i + T)\sigma_\theta^2$

Optimal Allocation of Attention (II)

- Expected Profits with **broad strategic focus** $(t_1, t_2) = (t, t)$:

$$\Pi(t,t) = -2\sigma_\theta^2 + 2q(t+T)C$$

- Expected Profits **narrow strategic focus** $(t_1, t_2) = (2t, 0)$:

$$\Pi(2t,0) = \underbrace{-2\sigma_\theta^2 + q(T)C + q(2t+T)C}_{<\,\Pi(t,t)} +$$

$$\underbrace{D\int_0^{\infty}\left(\int_{\sqrt{\frac{q_2}{q_1}}\varphi}^{\varphi} q_1\theta_1^2 dF(\theta_1) - \int_{\varphi}^{\sqrt{\frac{q_1}{q_2}}\varphi} q_2\theta_2^2 dF(\theta_2)\right) dF(\varphi)}_{>\,0}$$

where $q_1 > q_2$..

Optimal Allocation of Attention (III)

- **Proposition:** For t large (attention not scarce): $(t_1^*, t_2^*) = (t, t)$

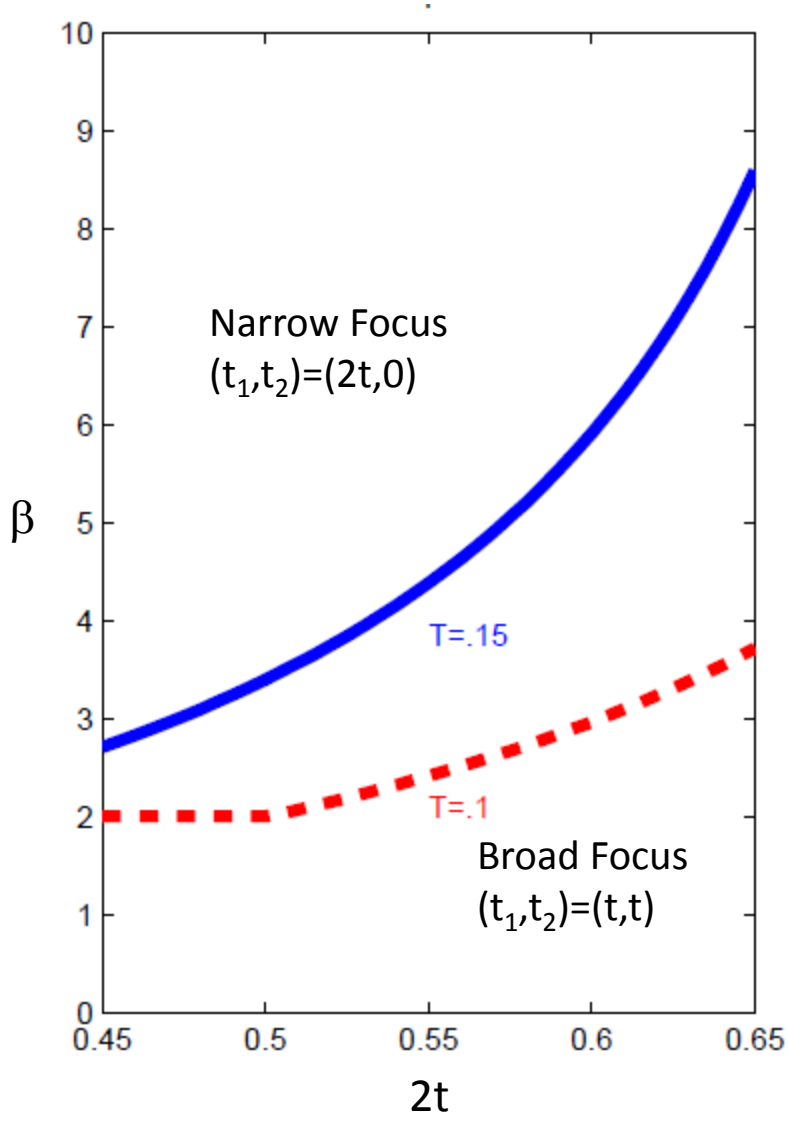
- **Proposition:** For t small (marginal allocation of attention):
  - There exists a $\bar{T}(\beta) > 0$ with $\bar{T}'(.) > 0$:

$$(t_1^*, t_2^*) \in \{(2t, 0), (0, 2t)\} \Longleftrightarrow T < \bar{T}$$

  - T **small**: limited knowledge, very uncertain environment
    - Narrow focus: (Arbitrarily) direct attention to one choice.
    - "Managerial Styles" are optimal: Different managers devote attention to different areas given same environment.
  - T **large:** lots of knowledge, mature environment:
    - Broad focus optimal, pick and communicate most important choice! No managerial styles.

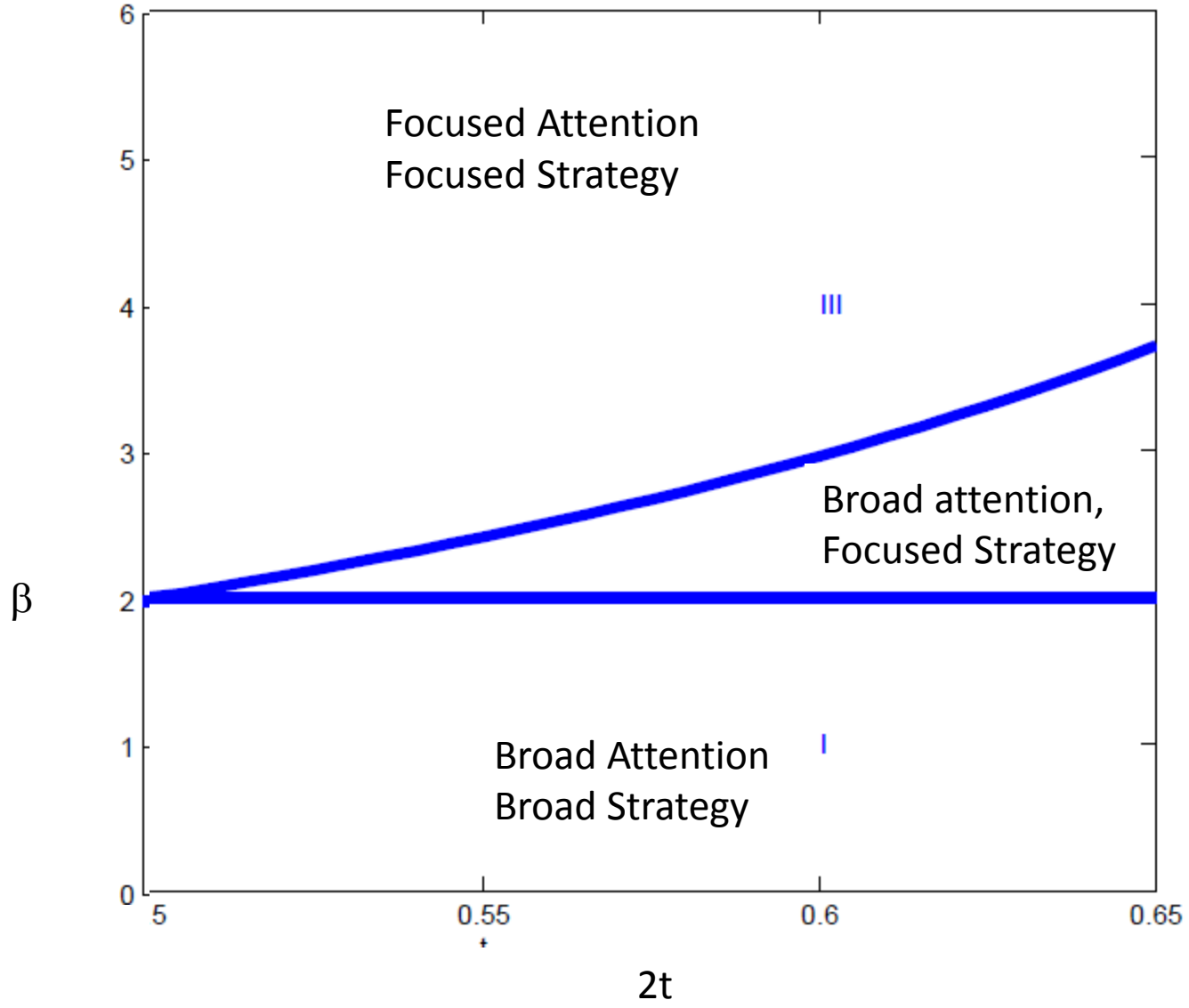
Optimal Allocation of Attention (t intermediate)

For *t* intermediate
(simulations, p=0.75)



Optimal Allocation of Attention (t intermediate)

T= 0.1
p= 0.75



Attention Allocation by Generalist: Style Interpretation

Even generalist managers will appear to have "a bias":

- pay more attention to one area (e.g. manufacturing)
- typically make strategic choices that are disproportionately responsive to shocks in that area
- typically communicate a strategy focussed on that area.

Source of "managerial style": Organizational need to have a simple strategy *ex post*, focused on a particular strategic choice.

- As a result, *ex ante optimal* to focus attention on one particular strategic choice, which then likely becomes focus of communicated strategy.

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Attention Allocation by Specialist Managers

- Assume managers have different "expertise" or are "more familiar" with one area.
- **Formally**:
  - Exogenous signal is more informative for θ_1 than θ_2 : $T_1 > T_2$.
  - One unit of attention $t : (t_1, t_2) = \{(t, 0), (0, t)\}$
- How should manager allocate marginal unit of attention t :
  - Re-enforce expertise $(t_1^*, t_2^*) = (t, 0)$: To area 1 with which manager is more familiar, will receive better information?
    - "Managing with Style"
  - Re-balance expertise $(t_1^*, t_2^*) = (0, t)$: To area 2 with which manager is less familiar, will receive worse information?
    - "Managing without Style"

Attention Allocation by Specialist Managers.

- **Define** $T_1 = T + \Delta > T_2 = T - \Delta$ and recall

  $\hat{\theta}_i \sim N(0, q_i \sigma_\theta^2)$ with $q_i = 1 - e^{-\lambda(T_i + t_i)}$

- **Proposition:** Fix Δ, there exists a $\tilde{T}(\Delta)$:

  $(t_1^*, t_2^*) = (t, 0) \Longleftrightarrow T < \tilde{T}(\Delta)$

  - T **small:** Manage with Style. Re-enforce/Direct attention to areas you are familiar with.
  - T **large**: Be balanced, direct attention to your weak area.

- **Proposition:** For Δ large enough: $(t_1^*, t_2^*) = (t, 0)$.

  For $T > \tilde{T}$ and Δ small enough: $(t_1^*, t_2^*) = (0, t)$.

Attention Allocation by Specialist: Discussion

Small differences in expertise between two $\neq$ managers may result in large differences in firm behavior!

- even for identical environment, realization of shocks.

How do boards select manager/CEO?

- **Trivial Case** *(not this paper)* Board knows what is important
  - If board knows strategic choice 1 is much more important than strategic choice 2, optimally choose expert in area 1.
- **This Paper:**
  Even if board has *no idea which strategic choice is important:*
  - Optimal to hire a specialist manager if uncertainty is large.
  - From ex ante perspective, does not matter what is style of manager (only that she has style!).
  - Ex post, style of manager highly predictive of firm behavior.

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Managerial Attention and Style: Questions

Are managerial characteristics predictive of firm strategies?

- ... even when controlling for the firm's environment
- .... even when controlling for the fact that top mgmt teams are endogenously chosen?

Managerial Attention and Style: This Paper

Small differences in expertise between two $\neq$ managers may result in large differences in firm behavior!

Even a board *with no idea which strategic choice is more important,* may hire a specialist manager if uncertainty is large.

- Ex post, style of manager highly predictive of firm behavior.

Even generalist managers may appear to have "a bias":

- optimally pay more attention to one area.

Source of "managerial style": Organizational need to have a narrow strategy *ex post*, makes it optimal to also focus attention *ex ante*.