Risk Aversion in the Family Business: The Dark Side of Caution

Structured Abstract

Purpose: Family businesses are broadly perceived as being more risk-averse compared with non-family businesses. However, a high level of risk aversion might also lead to severe downsides for the family business. This article sheds light on these downsides and provides measures on how to balance risk taking and risk aversion in family businesses.

Design/methodology/approach: The article first presents four "dark sides" of risk aversion in family businesses and then describes three groups of measures to balance risk aversion and risk taking. Both the dark sides as well as the measures to balance risk aversion and risk taking are derived from recent scientific research.

Findings: Family businesses may decrease risk aversion and foster risk taking and innovativeness by creating transparency on their risk profiles and including outside knowledge in the form of non-family managers, directors, or shareholders. Moreover, properly educating and integrating younger family generations might also alleviate an overly high focus on short-term risk aversion.

Practical implications: Family business leaders might find the approach and findings presented in this paper helpful for securing the longer-term survivability of their firms and for improving innovativeness.

Originality/value: This article is among the first to deal with the dark sides of risk aversion in family businesses, which might endanger their longer-term survivability.

Keywords: Risk aversion, risk taking, family business, family firm, threats, survivability

Article classification: Research paper

Introduction

Family businesses are known to not only focus on financial goals, but also strongly include non-economic goals in their strategic decisions. Non-economic goals might include the employment of family members, keeping the business in the hands of the family, sustaining family and workplace harmony or keeping up the family's social status associated with owning and managing the family business (Gómez-Mejía *et al.,* 2007; González *et al.*, 2013; Hiebl, 2013b). All these goals have in common that they would be endangered if the family business failed or the family lost control of it.

To avoid business failure or losing control, avoiding substantial risks is often regarded by family businesses as the proper approach. That is why family businesses are broadly conceived as being more risk-averse than other types of businesses. For instance, research has found that family businesses engage in fewer R&D projects because of their uncertain outcomes and aim for a low debt-to-equity ratio, as debt repayments and interest payments might not be met, which could lead to bankruptcy. Therefore, keeping the level of both R&D investment and debt low is frequently perceived by family business owners as securing the survivability of the firm (Hiebl, 2013a).

However, this view might be too short-sighted. Waiving growth opportunities because of the unwillingness to take risks and hampering innovation might actually compromise the longer-term existence of the family business, as market trends or developments may be missed. Missing adaptability might also be one cause of the high mortality rate of family businesses. Although family business owners may think of risk aversion as prolonging their enterprises, statistics show that actually only one-third of such businesses is successfully transferred to the second generation and only ten per cent make it to the fourth generation (Paisner, 2000). Thus, exaggerated risk aversion, far from securing the survival of family businesses, might cause the contrary—family business failure. In light of the foregoing, the present article explores the "dark side" of risk aversion in family firms. Furthermore, it suggests how family businesses might strike a balance between risk taking and risk aversion, which is still in line with the typical non-economic goals of controlling families outlined above.

The dark side of risk aversion in family businesses

Missed growth opportunities

As pointed out earlier, family businesses tend to commit fewer resources to R&D projects than non-family businesses. As a negative consequence, this parsimony might lead to less innovative products or services and thus to limited sales growth (Wang and Poutziouris, 2010). Moreover, family businesses also internationalize less than non-family businesses and may therefore deliberately surrender the growth options associated with foreign markets (George *et al.,* 2005). However, not all family businesses act this way. When family businesses do decide to aim for and actually foster sales growth, family business owners have been found to primarily rely on debt financing, despite their goal of a low debt-to-equity ratio. The preference for debt financing is associated with not letting non-family investors into the family firm and thus keeping full control (Croci *et al.,* 2011). However, this behavior also prevents family businesses from the valuable industry or internationalization knowledge that outside investors such as venture capitalists and institutional investors might be able to provide (González *et al.,* 2013). Because such outside knowledge might facilitate the success of growth or internationalization projects (George *et al.,* 2005), the preference for debt financing caused by risk aversion might actually harm the family business's growth opportunities.

Self-interested family members

When family businesses grow larger and older, ownership rights usually disperse due to inheritance. Thus, in such businesses the likelihood increases that a larger number of family members are no longer actively involved in managing the firm. However, because they might still rely on the family business's performance, for instance since they live off dividend payments or other cash distributions provided by the firm, such family members are likely to be primarily interested in the business providing reliable and stable payments to its owners and less so in its successful development. They thus may use their ownership rights to manipulate family business management against pursuing overly risky strategies that could endanger these regular cash payments (Le Breton-Miller *et al.,* 2011).

A connected issue can arise if family managers value their spare time and lifestyle higher than the sake of the family business. Such family managers may also be inclined to avoid substantial business risks due to (1) not wanting to devote too much time to risky and thus laborious business ventures and (2) aiming at securing their personal incomes needed for lifestyle activities, which might be at risk if the family business pursued ventures with unknown outcomes (Hiebl, 2013a).

Consequently, if such self-interested or lifestyle-interested family members are able to substantially influence the family business, this might again lead to a situation where the family business may be too focused on short-term risk aversion, thereby risking its longer-term survivability. Although this may be fine for the family members in question, from a business perspective (and from the perspectives of other family members), such behavior might threaten the family firm's future.

Private portfolio concentration

In contrast to the family members described in the previous section, another type of family business owner may be less interested in high regular cash payments. This type of family business owner rather retains as much earnings as possible in the family business and avoids dividend payments. Therefore, the family business can rely on family equity financing and does not need to take on (higher amounts) of debt, which was presented above as a synonym for risk in family businesses (Croci *et al.,* 2011). However, in the family business owner's private sphere, this typically leads to a situation in which the shares of the family business form the overwhelmingly largest part of the business owner's private portfolio. Thus, he or she may suffer from a high concentration of their private wealth being tied up in the prospects of the family business. If the family business fails, most—if not all—of the family business owner's private wealth is likely to deplete. Thus, paradoxically, risk aversion at the corporate level can lead to a higher level of risk at the private level (Hiebl, 2013a).

Irrational risk taking

In contrast to the findings of scientific research, which has mainly confirmed higher risk aversion in family than in non-family businesses, recent studies offer a finer-grained analysis of the risk-taking behavior of family businesses (e.g., Gómez-Mejía *et al.,* 2007; Le Breton-Miller *et al.,* 2011). For instance, Gómez-Mejía *et al.* (2007) demonstrated that a family business's behavior towards risk depends on its actual context. In situations in which the controlling family fears losing control of the family business, it may take higher risks than non-family businesses or even irrational or hazardous risks, because it wants to retain control of the family business at any cost. In such situations, the non-economic goals of business-owning families described at the outset of this article actually lead to behavior that endangers the family business's existence. Gómez-Mejía *et al.* (2007) also explain such irrational behavior by the socio-emotional wealth associated with owning and leading a firm. If the family sees this emotional wealth becoming endangered, it tries to defend it at all costs.

Measures to balance risk aversion and risk taking in family businesses

After presenting these "dark" aspects of a family business's risk aversion, the question arises of how business-owning families can avoid or alleviate these negative consequences. Recent research also offers insights into this question, as presented in the following section.

Create transparency

Research has shown that smaller firms and firms with higher degrees of family influence use fewer modern risk management techniques compared with larger firms and firms with lower levels of family influence (Di Giuli *et al.,* 2011). Thus, smaller family businesses might not have sufficient transparency on what risks the firm faces, how likely these risks are to materialize, and which impacts these risks might have. Such firms may therefore be risk-averse because of the uncertainty about their actual risk profiles. Applying systematic risk management may thus be a valuable addition to these firms. In this context, although "systematic risk management" may sound like a large (and expensive) project, simply systematically thinking about what risks the family business may face and afterwards writing these risks down and monitoring them may increase transparency for family business owners and potentially allow for more risk-taking behavior, which in turn could ensure the family business's longer-term competitiveness.

Another useful tool might be the balanced scorecard (for an introduction see Kaplan and Norton, 1992). A key element of the balanced scorecard is mapping strategic goals in various dimensions (such as financial, customer, internal processes, innovation and learning, or even family, see Craig and Moores, 2005) and their connections and interdependencies. This mapping exercise could create more transparency for family businesses on the relative importance of and relations between their strategic goals. For instance, this might reveal that their competitive advantages and financial successes in the end heavily depend on product innovation. Family business owners could then clearly see that depleting the innovation pipeline for the sake of higher risk aversion may place the family business's longer-term existence at risk. Subsequently, they might be aware that a balanced approach of risk taking and risk aversion could be crucial to success.

Include outside knowledge and advice

Another measure to create a more balanced relationship between risk-avoiding and risk-taking behavior in family businesses is including outside knowledge and advice. Specifically, family businesses may employ non-family managers or include non-family directors on their boards. If well selected, these non-family professionals are able to provide controlling families with different views on innovation projects or growth activities, often derived from extensive experience in the respective industry. Research confirms this notion by showing that the presence of non-family managers and directors fosters risk taking in family businesses (Casillas *et al.,* 2011; González *et al.,* 2013), but only if these outsiders are included voluntarily and not based on governmental policies (Su and Lee, 2012). At the same time, these non-family executives might also be able to prevent the controlling family from taking on irrational risks. As non-family managers and directors are typically not as emotionally tied to the family business as family members, in times of financial distress or when the family fears losing control of the firm, they can act as a critical counterpart to the family and thus possibly stop it from ruining the business (Hiebl, 2013b).

Moreover, as already indicated, outside investors can also share with the family their experiences and knowledge on the industry, on growth projects, or on internationalization (George *et al.,* 2005; Mitter *et al.*, 2012; González *et al.,* 2013). Even if these investors take a stake in the family business's equity, the family would typically still hold the majority and thus retain most decision-making power. Further, selling some shares in the family business could also help reduce the concentration risks of the private portfolios of family members.

Educate and include succeeding generations

Empirical research has also provided evidence that the integration of succeeding generations in family business management is able to reduce risk aversion and increase innovativeness (Zahra, 2005; Casillas *et al.,* 2011). These findings are explained by the fact that older family managers no longer want to take substantial risks (Zahra, 2005; Wang and Poutziouris, 2010), while younger family managers are more agile and connected with business trends and innovations (Casillas *et al.,* 2011).

However, before integrating younger family members in the family business's top management team, it seems advisable that they both enjoy proper outside education and gain working experience outside the family business in the same industry. This notion is substantiated by the empirical findings, which have shown that the same-industry tenures of managers and their longer education times foster the willingness to take risks and innovate (Hiebl, 2013a).

Conclusions

This article has shown that risk aversion in family businesses, which is traditionally considered to be a positive trait, may also lead to behaviors that endanger a family firm's longer-term existence. These dark sides of risk aversion include that family businesses might lack the willingness to invest in R&D projects and/or pursue growth strategies. Moreover, the private portfolios of family business owners could also be at risk, especially in situations where the family fears losing control of the firm and thus takes irrational risks.

The potential measures presented in this article to create a more balanced approach to risk taking are (1) creating transparency on the actual risk profile of the family business, (2) including outside knowledge as well as capital, and (3) educating and integrating younger family members in the management team to boost firm innovativeness. The uptick in research on the risk-taking behavior of family businesses provides further evidence for the topicality of this theme. However, we still need more research on how the above-presented measures develop in the longer term and whether family businesses that have managed to exist for several generations have actually followed this approach or taken additional actions to survive. Answering these questions could significantly help family businesses reach one of their most important non-economic goals, namely keeping the family business alive and in the hands of the family.

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