



Contents lists available at ScienceDirect

Finance Research Letters

journal homepage: www.elsevier.com/locate/frl



Reward for failure and executive compensation in institutional investors



Gino Loyola^{a,*}, Yolanda Portilla^b

^a Department of Management Control, University of Chile, Diagonal Paraguay 257, Of. 1903, 8330015 Santiago, Chile

^b School of Economics and Business, Catholic University of Chile, Chile

ARTICLE INFO

Article history:

Received 22 May 2014

Accepted 17 September 2014

Available online 28 September 2014

JEL classification:

D86

G11

G20

G30

J33

M52

Keywords:

Executive compensation

Portfolio management

Corporate governance

Golden parachutes

Non-monotone likelihood ratio property

ABSTRACT

We propose a model of delegated portfolio management specialized in alternative investments, i.e., those with a high-return and high-risk profile. It is shown that in this context, as a reward for risk-taking scheme is optimal, a counter-intuitive reward for failure can also be desirable. This property emerges because it can be optimal to compensate extreme returns (even low ones) to encouraging managers to shape highly innovative portfolios. It is argued that this structure resembles compensation practices questioned in the context of the last financial crisis, such as golden parachutes and golden coffins. Implementation via equity and bonuses is also analyzed.

© 2014 Elsevier Inc. All rights reserved.

1. Introduction

The last financial crisis has exposed executive incentive plans of investment banks and other institutional investors under a strong scrutiny, especially those compensation practices that seem to reward managers with generous benefits even though the performance of their institutions is clearly unsatisfactory.

* Corresponding author. Tel.: +56 (2) 2 9 78 37 68; fax: +56 (2) 6 35 16 79.

E-mail address: gloyola@fen.uchile.cl (G. Loyola).

In contrast to these criticisms, this article proposes an agency model under which rewarding managers for low performance may indeed be a desirable property stemming from an *optimal* incentive scheme. We argue that our framework is particularly applicable to institutional investors, whose delegated portfolio management activity involves searching and selecting *alternative* investments, that is, investments with a high risk-high expected return profile.

Although counter-intuitive, it is shown that this “reward for failure” property can emerge as an element being part of a more general optimal reward for risk-taking scheme that compensates *extreme* returns and punishes (in relative terms) moderate ones. As a result, the *ex ante* promise of a reward to even low results may be an effective mechanism to encouraging managers to shape truly innovative portfolios.

The model here proposed is consistent with the *optimal contracting approach* (Jensen and Murphy, 1990;ermalin, 2005; Cheng et al., 2013), and thus, their conclusions should be viewed as counter-acting the insights coming from the *managerial power approach*, summarized in Bebchuk and Fried (2004). Indeed, under the latter approach, practices such as golden parachutes, generous life insurance (golden coffins), entrenchment, and all-event bonuses are considered as evidence on weak corporate governance, and in particular, on the lack of independence between the board of directors and top executives (see also Bebchuk et al., 2010). Although we do not rule out that the managerial power approach can offer useful insights in some cases, we claim that in financial activities such as private banking (high-wealth investors), hedge funds and other alternative investments, a seemingly paradoxical practice like a reward for failure scheme can be, at least partly, understood under the lens of the optimal contracting approach.

Our paper is related to previous research on how other non-monotone and convex incentive schemes motivate managers to take desirable risk levels from the principal's standpoint, especially option-like schedules (Carpenter, 2000; Garcia, 2001; Goetzmann et al., 2003; Ross, 2004; Kadan and Swinkels, 2007; Feltham and Wu, 2001; Hemmer et al., 1999; Dittmann and Maug, 2007; Duan and Wei, 2005; Bolton et al., 2010; Coles et al., 2006; Hirshleifer and Suh, 1992) and bonus payment structures (Starks, 1987; Leisen, 2014). At first glance, the convexity involved in the payoff function of this class of compensation schemes should incentivize risk-taking. However, a more-in-depth analysis of these incentive plans has delivered three results that weaken such a convexity argument.

First, in the context of a delegated risk-taking environment, in general these option and bonus schemes do not necessarily correspond to the optimal contract (see for instance, Carpenter, 2000; Ross, 2004; Kadan and Swinkels, 2007). Second, it is not true that such schemes always induce more managerial risk-taking, as other effects—different from convexity—may make the manager even more risk-averse or lead him to undertake more conservative investments (Carpenter, 2000; Chen and Pennacchi, 2009; Ross, 2004). Third, research on bonus and option plans has raised concerns about whether their convex payoff functions may encourage managers to adopt *excessive* risk-taking or risk-shifting practices (Carpenter, 2000; Green and Talmor, 1986; DeFusco et al., 1990).

Rather than to study a given incentive scheme, and in contrast to most of the above cited literature, our main goal is to characterize what is indeed the *optimal* scheme when risk-taking is involved. As a consequence, two main contributions arise from the present article. First, from the principal's viewpoint, our reward-for-risk scheme effectively induces managers to choose the proper level of innovation (and risk), and thus, it is free from the concerns raised over option-like schemes as being ambiguous mechanisms to incentivize risk-taking. Furthermore, contrary to option and bonus payment structures, our optimal contract not only involves not to penalize low performance, but also to reward it. This property implies that, in contrast to the extant literature, we are able to provide an economic rationale for counter-intuitive managerial reward schemes, such as golden parachutes and other failure-compensation practices.

The present article is also related to research showing empirical evidence on how convex compensation schemes mitigate the incentive risk-taking problem faced by risk-averse managers, who have to invest in high-risk high-return projects on behalf of a risk-neutral principal. In general, this literature supports the idea that risk incentives involved in stock options do encourage managers to increase risk measures in profitable investments, such as exploration risk of oil and gas projects (Rajgopal and Shevlin, 2002); asset return variance after acquisitions by mergers and divestitures (Agrawal and Mandelker, 1987); and asset volatility in banking (Mehran and Rosenberg, 2007). In a complementary

Download English Version:

<https://daneshyari.com/en/article/5069390>

Download Persian Version:

<https://daneshyari.com/article/5069390>

[Daneshyari.com](https://daneshyari.com)