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Idiosyncratic risk and the manager[★]

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ABSTRACT

We develop a model to characterize and quantify the effects of stock, option, and fixed compensation on a manager's risk-taking incentive and investment choice. We find the average chief executive officer's (CEO) compensation contract incentivizes overinvestment by 1.3 percentage points per year, with significant variation across firms and over time. We estimate a value of CEO effort implied by compensation contracts and find it to be strongly related to firm intangibility. Finally, we assess the effects on investment of FAS 123R and a hypothetical ban on option grants and find heterogeneous responses that depend on firm volatility and the prior structure of compensation.

JEL classification: G31, G32

Keywords: Corporate investment; Executive compensation; Managerial incentives; Agency conflicts

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