Stock Market Tournaments

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Abstract

We propose a new explanation for excessive/insufficient (systematic) risk-taking by managers based on contractual externalities. In our model a firm's final output is influenced by its manager's hidden effort and the stock price reflects the effort choice of its manager relative to the average effort in the industry. In this context, we study the impact of the optimal contract between shareholders and managers of a continuum of firms within a given industry on managerial effort choices and resulting risk exposures. We find that when the productivity shock is systematic, stock-based incentives cause complementarities in managerial effort choices. However, shareholders are only concerned about incentivizing the manager of their own firm and do not take into account the impact of their incentive-provision on managers of other firms. During booms, they over-incentivise their own manager, triggering a rat race in effort exertion among all managers within the industry and resulting in excessive risk exposure relative to the second best. The opposite occurs during busts. By comparison, when the productivity shock is idiosyncratic, there is no incentive for managers to take suboptimal level of risk. Introducing counter-cyclical pay sensitivities or clawbacks to compensation contracts improve the equilibrium contract towards the second best. Journal of Economic Literature

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