



# Employment risk, compensation incentives, and managerial risk taking: Evidence from the mutual fund industry<sup>☆</sup>

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## ABSTRACT

We examine the influence on managerial risk taking of incentives due to employment risk and due to compensation. Our empirical investigation of the risk taking behavior of mutual fund managers indicates that managerial risk taking crucially depends on the relative importance of these incentives. When employment risk is more important than compensation incentives, fund managers with a poor midyear performance tend to decrease risk relative to leading managers to prevent potential job loss. When employment risk is low, compensation incentives become more relevant and fund managers with a poor midyear performance increase risk to catch up with the midyear winners.

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## 1. Introduction

We analyze mutual fund managers' risk taking decisions in response to the incentives they face.<sup>1</sup> In making

their investment decisions, fund managers face two main incentives. First, they want to earn high compensation. Second, they want to keep their jobs, i.e., do not want to be laid off. We examine how these incentives, which we term 'compensation incentives' and 'employment incentives', respectively, determine the fund managers' risk taking behavior. We show that it depends on the interim performance of the funds they manage: compensation incentives lead managers of funds with a poor interim performance to increase their fund's risk relative to managers of funds with a good interim performance. In contrast, employment incentives lead managers of funds with a poor interim performance to decrease their fund's risk relative to managers of funds with a good interim performance.

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<sup>1</sup> We focus on incentives for the person managing the fund, which we call 'fund manager,' rather than incentives for the fund management company, which we call 'fund family.' We focus on the fund manager

(footnote continued)

rather than the fund family, because it is the fund manager who ultimately makes the risk taking decisions at the fund level.

We start our discussion with an analysis of the incentives for poorly performing fund managers (“losers”), before turning to a description of the incentives for well performing fund managers (“winners”). Brown, Harlow, and Starks (1996) are the first to examine risk taking incentives of mutual fund managers in a yearly tournament setting. They exclusively focus on implicit compensation incentives that arise due to the positive convex relationship between the inflow of new money into the fund and its past performance (e.g., Sirri and Tufano, 1998).<sup>2</sup> As the fund family typically charges a fixed percentage management fee on its assets under management, the fund family profits from funds that reach a top position by the end of the year and eventually attract new inflows. However, the fund manager also benefits from reaching a top position by the end of the year since a fund manager’s compensation typically depends on past performance as well as on the size of the fund managed by her (see, e.g., Khorana, 1996; Farnsworth and Taylor, 2006). As fund size is mechanically linked to inflows, there is also a convex relationship between the fund’s past performance and the compensation of the fund’s manager. Such a convex relationship could lead to yearly tournaments among fund managers: midyear losers increase their funds’ risk in the second part of the year since they have not much to lose from a further deterioration of their position in terms of inflows and eventually compensation, while increasing risk increases their chance of catching up with the midyear winners (Brown, Harlow, and Starks, 1996).

However, there is an additional incentive that fund managers face and which is neglected in the previous literature on fund manager tournaments: fund managers are concerned about keeping their jobs. Fund managers care about employment incentives because losing their jobs would entail significant costs in terms of foregone income, loss in reputation, and loss of future job opportunities. We expect that these employment incentives are taken into consideration by fund managers in making portfolio risk decisions and thus, become vital in explaining risk taking strategies. If a manager takes on too high a risk (perhaps because of tournament incentives), then there is also a higher risk of poor performance and the probability of forced turnover is much higher for fund managers with poor past performance, i.e., particularly midyear losers face a serious threat of being laid off (Khorana, 1996; Chevalier and Ellison, 1999; Hu, Hall, and Harvey, 2000).<sup>3</sup> Thus, if midyear losers follow risky strategies in the second part of the year, they increase the probability of achieving a performance that is so bad that it would eventually trigger job loss (Bloom and

Milkovich, 1998). Consequently, employment incentives should cause midyear losers to decrease their risk, *ceteris paribus*.<sup>4</sup>

Consider now the incentives for midyear winners, which are markedly different from those of midyear losers described above. On the one hand, compensation incentives lead midyear winners to try to lock in their leading position and play it safe rather than to increase their risk. On the other hand, employment incentives are of much less, if any, relevance for them. They face no serious threat of dismissal due to poor performance. Thus, unlike midyear losers, they have no reason to change their risk due to employment incentives.

Our analysis so far shows that employment incentives and compensation incentives lead to diametrically opposite hypotheses regarding managerial risk taking. Compensation incentives should lead midyear losers to increase their risk relative to midyear winners. Employment incentives should lead midyear losers to decrease their risk relative to midyear winners. The relative strength of employment incentives and compensation incentives depends on the expected costs of job loss as well as on the expected increase in compensation due to reaching a top position.

Market returns are a simple but ideal proxy for the relative strength of these two incentives because they capture the market environment the fund managers face. The reasoning is as follows: after bear markets aggregate inflows into funds are generally low (e.g., Karceski, 2002; Breuer and Stotz, 2007). Therefore, the fund manager attracts little new money for her fund by reaching a top position. As a consequence, even the size of the best performing funds grows only slightly, the fund family earns little additional fee income, and eventually is not very profitable. Both effects lead to weak compensation incentives for fund managers in bear markets: as the fund manager’s personal compensation is positively related to fund size, the manager makes little additional income by reaching a top position. Furthermore, the bonus payments the fund manager receives depend heavily on the profitability of the fund family (Farnsworth and Taylor, 2006), which is low in bear markets. Based on these observations, Karceski (2002) argues that fund managers do not care much about outperforming other fund managers during bear markets, i.e., compensation incentives are weak in bear markets. In contrast, employment incentives are strong in bear markets. The low aggregate inflows into mutual funds after bear markets eventually lead to many fund closures, primarily of badly performing funds (Zhao, 2005b). Thus, the threat that the fund of a poorly

<sup>2</sup> Explicit incentive contracts are not very common in the mutual fund industry (Elton, Gruber, and Blake, 2003). The impact of changes in explicit incentive fees on portfolio decisions is analyzed in Golec and Starks (2004). The impact of explicit incentive contracts on risk taking in the hedge fund industry, where such contracts are very common, is examined in Agarwal and Naik (2004).

<sup>3</sup> There is also a large body of empirical research showing a negative relationship between performance and termination risk for managers of industrial companies (e.g., Coughlan and Schmidt, 1985; Gilson, 1989; Murphy and Zimmerman, 1993).

<sup>4</sup> For fund managers with extremely bad performance after the first half of the year, there might also be an incentive to ‘gamble for resurrection’ (Hu, Kale, Pagani, and Subramanian, 2008). However, the ‘gamble for resurrection’ argument is only strong if fund managers are myopic, i.e., if they do not take into account their chance of finding a new job after being laid off. If they are not myopic, they are less inclined to gamble for resurrection, because this increases the likelihood of a catastrophic performance (entailing a complete destruction of the manager’s reputation) and eventually of never finding a new job in the industry again. In order not to complicate the analysis, we refrain from including such extreme incentives.

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