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What determines the allocation of managerial ownership within firms? Evidence from investment management firms

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ABSTRACT

We show that the allocation of managerial ownership to individuals within firms varies depending upon the joint distribution of decision control and decision management rights. Using a unique dataset of institutional investment management firms, we show that ownership is higher for managers: with both executive and operational responsibilities; when benefits of cooperation are higher; and with large contributions to firm value. Consistent with career concerns, we find increases in a manager's ownership are associated with increases in unsystematic risk. Ownership dispersion within the firm is associated with the allocation of monitoring and operational roles and the potential benefits of cooperation.

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1. Introduction

Since the work of Berle and Means (1933) many studies have explored the agency conflict arising from the separation of ownership and control between external and internal owners. Typically these studies aggregate internal (managerial) ownership, and effectively treat managers as if they are a single entrepreneur. This approach ignores, however, the dispersion of ownership across managers within a single firm. Agency issues caused by the separation of ownership and control can still emerge in firms without any external owners. Within a single firm some managers are owners and others are not; two firms with identical levels of aggregate internal ownership often have vastly different distributions of ownership across managers within the firm. What factors determine the allocation of ownership to specific managers within a firm? Why does the concentration of managerial ownership vary across competing firms?

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We address these questions using a unique panel dataset containing individual managers' ownership positions in their firms. Our sample consists of institutional investment management firms, which provide long-only, delegated portfolio management services to accredited investors such as pension funds and high net worth individuals.[2] We focus on this industry because detailed information on individual managers' ownership positions is available through mandatory SEC filings, and because we can observe all executives and portfolio managers within firms regardless of their ownership status.[3] The sample includes a wide range of ownership structures: firms wholly owned by a single manager, partnerships, public and private corporations, and wholly and partially owned subsidiaries. In total, our sample includes 1365 institutional investment management firms that, in aggregate, manage more than $13.7 trillion across all asset classes.[4]

We begin by examining the determinants of individual manager's ownership positions in the equity of the firm for which they work (note, we examine ownership of the investment management *firm* and *not co-investment in the portfolios* managed by the firm). Of course, a manager's ownership is jointly determined along with many other factors and is affected by potentially unobservable characteristics of both the firm and the manager. Our identification strategy is based on exploiting the panel nature of the data, which allows us to include fixed effects to control for potentially confounding omitted variables. We use two specifications when estimating the determinants of individual managers' ownership positions. First, we include person-firm fixed effects, to remove individual specific characteristics such as ability. Second, we include firm-year fixed effects, to eliminate firm specific factors such as firm value.

Our empirical analysis is motivated by Fama and Jensen (1983a), who analyze management ownership in terms of two concepts: decision control and decision management. Decision control involves ratifying decisions and monitoring others actions (i.e. the tasks of firm level executives). Decision management involves the initiation of new projects and the implementation of ratified decisions (i.e. operational tasks, such as portfolio management). Fama and Jensen (1983a) argue that within firms, managers should also be owners if they hold both decision control rights and decision management rights. Consistent with this conjecture we find that within a firm the allocation of ownership to specific managers is strongly related to the allocation of decision control and decision management rights. Even after controlling for unobserved individual characteristics we find that changes in ownership are strongly associated with changes in decision control rights.

As expected, we find a strong positive relation between a manager's rank within a firm and her ownership. More so, we show that this relation varies with firm and individual characteristics. Firm executives who are also portfolio managers have substantially higher ownership than executives without decision management roles. This result is highly significant, even after including person-firm fixed effects to control for individual characteristics such as ability.

One of the benefits of ownership, relative to other incentives, is that it rewards cooperation within the firm. Kempf and Ruenzi (2008) extends the fund tournament model in Taylor (2003) to show that, even within a single firm, competition between portfolio managers distorts risk taking, and this effect is particularly strong among funds with similar investment styles. As Baker (1992) points out in such an environment, the difficulty in contracting over multiple tasks will result in allocation of effort towards those activities that they are directly compensated and away from uncompensated activities. In a tournament environment, this multitasking problem may even discourage information sharing. Pomorski (2009) shows that information sharing in mutual fund families positively affects performance and is concentrated among funds with similar styles. Consistent with the idea that ownership provides an incentive for cooperation, we find higher ownership by portfolio managers whose investment style is similar to other portfolios managed within the same firm.

While managerial ownership can substitute for external monitoring, the value of ownership is determined by the effort of all employees. For a manager whose effort has only a small effect on firm value the incentive from ownership is diluted, which may result in free riding. We find evidence that this moral hazard problem affects the allocation of managerial ownership. Individuals who manage a relatively high proportion of their firms' portfolios have significantly higher ownership, consistent with ownership having higher incentive efficiency for individuals who have a large impact on firm value. This result holds even after controlling for both person and firm specific characteristics using fixed effects.

While monitoring can partially substitute for managerial ownership, it is not a perfect substitute because decision managers cannot always credibly communicate their private information to decision controllers. As a result, decision managers may be penalized for an unlucky outcome of a good ex ante decision. Scharfstein and Stein (1990) and Zwiebel (1995) show that the separation of decision control and decision management can result in herding: decision managers may ignore private information because of career concerns. Chevalier and Ellison (1999) show that mutual fund managers with greater career risk herd, by holding less unsystematic risk in their portfolios.

We find evidence consistent with agency concerns leading to herding. Higher portfolio manager ownership is associated with significantly higher idiosyncratic risk. This result is robust to including both portfolio manager-fund fixed effects and investment style-year fixed effects to remove the potentially confounding effects of individual specific investment behavior. The combination of these fixed effects means that, relative to their own past risk levels, portfolio managers change their risk choices following changes in managerial ownership. Portfolio managers whose ownership increases partially offset the increases in their portfolios' idiosyncratic risk by reducing systematic risk (beta).

Next, we move from the determinants of individual manager's ownership to the concentration of managerial ownership within firms. Consistent with the Fama and Jensen (1983a) suggestion that managerial ownership is necessary when the

[2] For detailed studies of this industry see Berzins and Trzcinka (2005), Busse et al. (2010) and Lakonishok et al. (1992).
[3] We are also able to observe indirect managerial ownership through holding companies and trusts.
[4] Asset values measured as of December 2005.

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