

Management Research FRONTIERS

Corporate finance specialist ties equity compensation to investor decision making and company performance.



What is an optimum stock-incentive compensation plan for a top manager? What plan will keep a CEO a top achiever yet prove acceptable to both stock- and bondholders, distinctly different classes of stakeholders?

Such questions have arisen as Ashbel Smith Professor of Finance David C. Mauer and his colleagues have examined the effects of CEO pay incentives on company stock prices, bond prices and performance. In a study to appear in a forthcoming issue of *Financial Management*, Dr. Mauer, Dr. Matthew T. Billet of the University of Iowa and Dr. Yilei Zhang of the University of North Dakota predicated their

research on the assumption that it is good to give a CEO equity in order to align his interests with company owners — the shareholders.

Dr. Mauer and colleagues charted top managers' conduct in line with incentives they received, gauged shareholder reactions to incentives and assessed the consequences shareholder and CEO behaviors had on company performance. Results show incentive plans impact investor decision making and, ultimately, company valuation.

Top-Officer Options Influence Behaviors

STOCKHOLDER AND BONDHOLDER WEALTH EFFECTS OF CEO INCENTIVE GRANTS


By Dr. David C. Mauer, Dr. Matthew T. Billet and Dr. Yilei Zhang

This paper examines stock and bond price reactions to the first appearance of option and/or restricted stock grants to CEOs during the period from 1992 to 2005. We find large positive stock-price reactions and large negative bond-price reactions around the proxy filing date reporting the details of the new grants. The divergent stock- and bond-price reactions are consistent with the notion that equity-based compensation helps align manager-shareholder interests, and that doing so also aggravates stockholder-bondholder conflicts.

We then document the important linkages between the excess stock and bond returns and the changes in the CEO's pay-performance (delta) and risk-taking (vega) incentives induced by the new grants. Consistent with the predictions that high pay-performance

compensation can induce excessive managerial conservatism while more risk-sensitive compensation can encourage risky policy choices, we find that stock-price reactions decrease with CEO pay-performance sensitivity (delta) and increase with the sensitivity of CEO wealth to risk taking (vega).

In contrast, when the CEO has little or no equity ownership prior to the grant, we find that negative bondholder reactions are large. But they moderate in firms that have weak shareholder rights and greater managerial power.

Finally, we document that stock- and bond-price reactions are negatively related when stockholder-bondholder conflicts are likely to be more severe. Overall, the key contribution of our paper is that we are the first to establish direct links between equity and debt values and the incentives provided by equity-based managerial compensation. 



David C. Mauer