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Optimal Managerial Contracts and Equilibrium Security Prices: Discussion

Author(s): J. R. Ritter

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DISCUSSION

J. R. RITTER*: Over the past decade, a considerable literature has arisen dealing with what has come to be called the principal-agent relationship. An agency relationship exists whenever decision-making authority must be delegated, as in a corporation where stockholders and managers are not one and the same. When either managers are risk-neutral or if their actions can be monitored costlessly, the problem is simply resolved. It is the more interesting, and more realistic, case of a risk-averse manager whose actions cannot be costlessly monitored that is the focus of attention in Diamond and Verrecchia's innovative paper on optimal managerial compensation schedules.

With the cash flows of a corporation depending upon both the manager's actions and "luck," shareholders can gain by setting up a managerial incentive contract that uses mutually-observable information to separate the action and luck components. This follows from the result in the literature that information allowing a better decomposition of outcomes into effort and luck will improve social welfare when incorporated into an incentive contract. In the context of a top manager's contract, one piece of information that is potentially of use is the change in a firm's market value, for stock market prices can (at least partially) aggregate investors' diverse information about a firm's value, even if no investor would have an incentive to reveal his information directly in a noncooperative equilibrium.

Diamond and Verrecchia find that, by decomposing the change in a firm's market value into "systematic" and "non-systematic" components, a maximum amount of information about the manager's effort can be extracted. They associate the systematic component with luck and the non-systematic component with actions and derive the intuitively-plausible result that a manager's "bonus" should not be tied to industry-wide or economy-wide (systematic) factors, because by removing this element of variability from the manager's compensation, the risk-averse manager will be willing to accept lower expected compensation, making the shareholders better off. Furthermore, by reducing the noise in the link between actions and compensation, the manager is induced to work harder, once again to the benefit of the shareholders.

* University of Pennsylvania, Department of Finance.

In passing, one should note that the exogeneity of the systematic risks that Diamond and Verrecchia assume may be true only as an approximation on an economy-wide level, for the factor-sensitivity of firms' cash flows presumably would not be invariant to the compensation schedules that managers face.

Given the intuitive plausibility of their results regarding managerial compensation and changes in a firm's market value, it is puzzling why such forms of managerial compensation as stock options take the form of a fixed dollar exercise price, instead of an exercise price tied to, say, an index of the stock prices of other firms in an industry. Perhaps the reason is that option contracts are revised by the granting of new options as things change—the idea behind the long-term implicit contracting school. Yet, these long-term implicit contracts are at best crude approximations to the first-best solutions we might hope to see.

DISCUSSION

S. C. MYERS*: The financial side of public utility economics began to get interesting in the late 1960's when financial economists gave economic content to the legal concept of fair return. They did so by defining fair return as the opportunity cost of capital, the equilibrium expected rate of return offered in capital markets by comparable risk securities.

Brennan and Schwartz call this definition the "modern consensus." It is a near-consensus in rate of return testimony, although apparently not among regulators. Regulators often don't allow utilities to earn their true cost of capital, and investors don't expect them to. We know that because many utilities' stock prices are consistently below rate base value per share.

Nevertheless the definition is the cornerstone of the normative theory of rate of return regulation. Therefore, Brennan and Schwartz are right to ask, "How can you treat the cost of capital as exogenous, when risk depends on the method of regulation and the firm's response to it?"

Most rate of return analysts would take the point but downplay its practical importance. There's an implicit belief that, although regulation does affect risk and the cost of capital, the effect is stable. That is, regulatory policy and the firm's responses to it do not change rapidly enough to upset estimates or applications of the cost of capital.

Maybe risk is stable because allowed rates of return are sticky. Regulators do not seem to respond to obvious changes in the current nominal cost of capital, as reflected in nominal interest rates. Certainly they don't respond as fast as the normative theory instructs them to. Perhaps endogeneity of risk and the cost of capital is not a problem for the rate of return analyst because everybody knows the regulators won't take the analyst's advice.

The theoretical weakness of the consensus definition of fair return can thus be dodged more or less gracefully. Brennan and Schwartz, however, confront the issue and solve it in a simple but consistent economic model. The model allows us to ask better questions about how regulated firms behave and how regulators should behave.

* Sloan School of Management, M.I.T.