

## Employment Risk, Compensation Incentives, and Managerial Risk Taking: Evidence from the Mutual Fund Industry

*Alexander Kempf, Stefan Ruenzi, Tanja Thiele*

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Individuals who manage mutual funds (fund managers) are compensated largely on the basis of their contribution to the profitability of the fund management company (the fund family). As fund families earn their income primarily as a percentage of assets under management, fund managers can expect compensation increases as they make the funds they manage grow. Growing the size of the fund depends on inflows of new monies to the fund, which is directly related to recent fund performance. This relationship is especially strong in bull markets when funds are flowing into the equity market generally and flow disproportionately toward funds with recent success. The relationship is weaker in bear markets, because little new money is flowing into funds generally, irrespective of their recent performance.

The fund manager faces two main incentives—to earn high compensation (compensation incentives) and to keep his job (employment incentives). These incentives can be expected to affect the way in which a manager operates a fund. Consider a period of a year divided into two halves. Performance in the first half of the year can affect managerial decisions about fund management for the second half. A manager with poor first-half performance (a loser) has a compensation incentive to increase risk for the second half in the hopes of improving the fund's full-year performance, thereby attracting more investment funds and garnering higher personal compensation. However, increasing the risk of the fund for the second half of the year raises the prospect of creating a truly dismal performance for the full year, which can lead to the manager's dismissal. Thus, the manager has an employment incentive to reduce risk. For a fund with poor first-half performance, the manager's compensation incentive and employment incentive push in diametrically opposed directions.

Consider now the manager of a fund that enjoys a good first-half-year performance (a winner). The winner now

faces mid-year incentives that vary from those of the loser considered above, because the winner has a compensation incentive to lock in the good performance and play it safe, so such a manager might be expected to reduce the risk of the fund. Given the winner's good performance, the employment incentive loses most or all salience, because the winner faces little or no threat of dismissal on grounds of full-year poor performance.

In bear markets, with diminished fund inflows in general, the fund manager has little chance of earning a big bonus, so compensation incentives are low. By contrast, employment incentives are high. Low inflows lead to fund closures and poorly performing funds are those that fund families close, so the risk of dismissal is high. Also, the cost of dismissal in a bear market is high, because securing new employment will be difficult. In a bull market, by contrast, compensation incentives should be strong given the general environment of fund inflows and the concomitant likelihood of large bonuses. In bull markets, employment incentives are weak as few funds close and new employment is easier to secure.

Kempf, Ruenzi, and Thiele (KRT) test three hypotheses: in bull markets compensation incentives dominate employment incentives and losers increase fund risk more than winners; in bear markets employment incentives dominate and losers increase fund risk less than winners; and the more bullish the market the more pronounced is the increase in fund risk of losers relative to winners. KRT use data on U.S. equity funds from 1980-2003 and find support for all three hypotheses. These results persist over time after controlling for fund, fund family, and market segment characteristics. While KRT document the effects of compensation and employment incentives in mutual fund management, they believe that their analysis can be generalized to managers in corporate environments as well.