Study: CEO personality traits play role in incentive pay, compensation

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Companies appear to structure compensation contracts and incentive pay based on a manager's personality traits, and not just firm characteristics, according to a new study from The University of Texas at Dallas.

Dr. Vikram Nanda, O.P. Jindal Distinguished Chair of finance and managerial economics in the Naveen Jindal School of Management, said there are divergent views on the use of options and stock in CEO compensation contracts: do they appropriately incentivize managers and enhance shareholder value, and if so, why is there much variation in their use across firms?

The study, published recently in the *Journal of Financial Economics*, found that companies offer incentive-heavy compensation contracts to overconfident CEOs to "exploit" their positively biased views of the firms' prospects. The notion is that if managers and shareholders—represented by the board—have a different take on a firm's prospects and CEO talent, there will be greater use of incentive pay that the managers value highly, but the board regards as less costly.

"When you think about incentive contracts, you don't usually think about the personality of the individual being a factor in the contract," Nanda said. "You don't usually hear about how two profit-sharing agreements are going to look different because the personalities and the beliefs of the individuals are coming into play."

Using the compensation data of CEOs between 1992 and 2011, the

researchers identified managers who were exhibiting behavior that was overconfident compared to other CEOs. They conducted empirical tests to explore the relationship between CEO overconfidence and incentive compensation.

The study shows that incentive compensation for CEOs is driven by individual traits and not merely firm-level characteristics.

"Are CEOs being given these contracts because they are serving an incentive function—incentive contracts are supposed to say you'll get paid more if you do the right thing or work really hard—or are they just being paid more because these CEOs value these contracts more?" Nanda said. "If a CEO believes the firm is going to do very well, maybe he will take a lot of his compensation in options and stock."

The researchers found that:

- CEO overconfidence increases the proportions of total compensation that comes from both option grants and equity grants, compared to other executives.
- Overconfident CEOs receive even greater option and equity intensity in innovative and risky firms.
- Overconfident non-CEO executives also receive higher levels of options and equity.

"Incentive contracts are sometimes designed to be sensitive to these individual preferences," Nanda said. "Even at the same firm, I wouldn't necessarily give one manager the same contract that I would give to another manager who has a different belief about what's going on in the firm. Basically, one size doesn't fit all."

Dr. Mark Humphery-Jenner of UNSW Australia, Dr. Ling Lei Lisic of George Mason University, and Dr. Sabatino Dino Silveri of the

University of Memphis are co-authors of the paper.

Defining an Overconfident CEO

Overconfident CEOs are prone to overestimate returns to investments and underestimate risks, Dr. Vikram Nanda said. They may use extremely positive words in the media or tend to invest more than a typical manager in the industry.

"It's good to have your enthusiasm and your confidence," Nanda said. "The question is, if it's too strong, is there something the firm can do—such as giving you incentive contracts, or monitoring your behavior, or constricting what you can do—to bring out the good side and constrain the bad aspects?"

More information: Mark Humphery-Jenner et al, Executive overconfidence and compensation structure, *Journal of Financial Economics* (2016). DOI: 10.1016/j.jfineco.2016.01.022

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