CEO Compensation and Corporate Risk: Evidence from Product Market Threat

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Abstract

This paper examines the relation between CEO compensation and corporate risk by taking advantage of product market threats (PMT) as a source unanticipated business risk. Using the product market fluidity measure as proposed by Hoberg, Phillips, and Prabhala (2014), we are able to study how U.S. firms in different industry sectors adjust CEO incentives in response to firms' risk and how these incentives affect managers' risk-taking. Consistent with Gormley, Matsa, and Milbourn (2013), we find boards reduce CEOs' exposure to stock price movements and that CEOs with less convex payoffs tend to offset the unexpected increase in risk through diversifying acquisitions, reducing leverage and R&D activities, and building up greater cash holdings. Our findings have implications for firms in structuring executives' compensation packages by taking into account the potential changes in business risk environments which differ across different industries.