Why hold on to risk?

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Investors around the world are more diversified than ever, yet entrepreneurs, sole proprietors and managers of large corporations are surprisingly undiversified by virtue of their large stakes in the companies they manage.

For owners and entrepreneurs, bearing such diversifiable risk is a cost of going into business. However, bearing this risk appears to be just as important (and unavoidable) for managers of publicly traded companies.

Among the smallest third of publicly traded companies in the US the average fraction of equity held by top managers is over 30 per cent. For the largest third, the stake is closer to 13 per cent. Furthermore, the fraction has grown in the past 70 years.

Internationally, there are wide disparities in inside ownership. In financially sophisticated countries, managerial ownership tends to be low (1-2 per cent in the UK and US), whereas in countries with less-developed financial markets, concentrations tend to be high (70 per cent or more in Turkey and Peru).

It is likely that managerial ownership is a sign of a weak legal and regulatory environment that obliges entrepreneurs and managers to hold larger equity stakes than they would prefer. For example, if it is difficult to write and enforce contracts, entrepreneurs and managers may find it in their best interests to retain a higher fraction of the company.

Also, if investor protection is weak, entrepreneurs and managers cannot credibly convince investors that their money will be efficiently used and returned. This may reduce share prices at the time of any offer and, in the extreme, companies may choose not to go public.