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The Effects of Aligning Stock Option Horizon With Corporate Investment Horizon

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Despite questions raised by prior research, stock options have been considered a remedy for the agency problem and managerial short-termism. Prior literature typically treats stock options as monolithic, but firms attach conditions to their options—including specific vesting terms—that introduce firm-level variance. This paper theorizes that stock option horizon—the length of time between options being granted to managers and their first opportunity to exercise those options—will alter the relationship observed in prior research between firms' investment policy and outcomes. Using a custom database of stock option horizons in 535 manufacturing firms over the time period 1997-2016, I contribute a refined understanding of stock options as a mechanism for addressing short-termism, showing that the highest performance outcomes are obtained when firms align stock option horizon with the horizon of investment policy decisions. In doing so, I also demonstrate that the diminishing marginal benefits of a longer-term investment policy can be expressed more accurately as an "inverted-J" than the "inverted-U" previously theorized. By isolating the precise time mechanism associated with stock options, I contribute to a nuanced understanding of agency theory and establish how options alter executives' management of time as well as risk.