

Impact of Hurdle Rate Contracts on Risk Taking In Investing in Entrepreneurs

William Cunningham and Tim Salmon

The failure rate of entrepreneurial projects is known to be quite high which often leads to people wondering why entrepreneurs are willing to take such risks. We think this is the wrong question to ask. The reason is that these entrepreneurs are typically not risking their own money. It seems perfectly reasonable why they might be willing to pursue a start-up idea of theirs risking the money of others. The question should really be why others are willing to fund them given the high risk. We seek to answer that question by looking at the standard incentive contract design of investment fund managers. These contracts generally involve some sort of hurdle rate which is a rate of return their investments must surpass before the manager receives compensation. We will use a combination of simple theory and economics experiments to examine how such contracts might drive excessive risk taking and then try to explain why fund owners might find such incentives worthwhile.