

# Should executives hedge their stock options and, if so, how?

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## Abstract

Executives are not permitted to hedge their options directly but can increase the certainty-equivalent value of their ESOs by hedging with an imperfectly correlated asset, even in the presence of transaction costs. The size of the gain depends on the correlation of the hedging asset's and firm's share price returns, the size of the option grant, the executive's risk aversion and the time to vesting. We characterise the optimal hedging strategy and show that sub-optimal hedging can have little benefit. Optimal private hedging increases both executive value and shareholder cost; the difference (net cost of option-based compensation) generally decreases.

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