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Delegated Portfolio Management, Resource Allocation, and Social Welfare

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Investment management companies such as mutual funds or hedge funds have rapidly grown in size in the past few decades. What is the impact of this “institutionalization” on our society? The increased importance of institutional investors may have affected the formation and stabilization of asset prices, and thus may have had a significant impact on the allocation of resources and social welfare. The following two sub-projects explore this question.

The first project “Delegated Portfolio Management and Asset Prices” seeks to understand the relations between portfolio delegation (i.e., industry size, fund size, and funds’ investment strategy), asset prices (i.e., risk-return profile and price volatility), investor behavior (i.e., choice of funds and capital provision), and social welfare. The results so far indicate that the expected market return and the return volatility increase with the extent of portfolio delegation due to a “risk concentration effect.” That is, under portfolio delegation, a large amount of household wealth is concentrated in a relatively small number of fund managers, exposing each of these managers to a large market risk (through management fees that vary with fund performance). To compensate this risk bearing the managers demand large risk premia on stock returns, leading to a high expected market return. Moreover, the concentration of market risk to fund managers induces them to submit a demand schedule with low price elasticity because they try to reduce the variation of their stock holding across periods. This results in highly volatile market-clearing stock prices.

The second sub-project “Fund managers and Asset Bubbles” seeks to understand the role of institutional investors in bubble periods. It seems that bubbles have significant impacts on our society, given the roles of the U.S. housing bubbles before the financial crisis or Japan’s real estate bubbles prior to its long-lasting recession. How does the institutionalization of finance affect bubbles? Does it magnify or dampen them? The results so far imply that strategic interactions between institutional investors---who, unlike individual investors, care about their relative performance---can increase the persistence of bubbles because they try to “ride” bubbles in an effort to outperform their peers. Moreover, consistent with empirical evidence, fund managers whose compensation is highly sensitive to their performance pull out of bubble stocks quickly (i.e., adopt a contrarian strategy) because they try to outperform the market by deviating from the herd. Also, the impact of bubbles on social welfare is an important issue: Are bubbles good or bad for our society? This question seems to be nontrivial because some agents are better off by reaping the benefit of the price rise (while, obviously, the others are worse off by getting caught in the crash). To answer such a question, we need a proper economic model – this is one of the challenges to tackle in this project.

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Fields of Research

Financial Markets