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# Herding in delegated portfolio management: When is comparative performance information desirable?☆

Alexander Gümbel

*Saïd Business School and Lincoln College, University of Oxford, Oxford OX1 3DR, UK*

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## Abstract

We address the issue of investors' asset allocation decisions when portfolio management is delegated to an agent. Contrary to predictions from traditional financial theory, it is shown that investors may not induce their manager to allocate funds to the asset with the highest return. Instead they may herd in their asset allocation decision and induce trade in a particular asset, because another manager is trading in it and despite the presence of a more profitable alternative. Doing so allows investors to write an efficiency-improving relative-performance contract. On the other hand, herding leads investors to design wage contracts strategically, resulting in more aggressive and thus less profitable trade in equilibrium. We show that herding occurs, when the cost of information is high, information precision is low and when managers are sufficiently risk averse. Moreover, when investors can decide whether or not to disclose information about their manager's performance, they will not do so.

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## 1. Introduction

A large fraction of individuals' savings is managed and invested by professionals working for financial institutions and acting on behalf of those individuals. The type of institution ranges from pension and mutual funds over hedge funds to insurance companies. Allen and Gale (2000) report that pension funds and other financial institutions

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*E-mail address:* [alexander.gumbel@sbs.ox.ac.uk](mailto:alexander.gumbel@sbs.ox.ac.uk) (A. Gümbel).

constitute 61% of all shareholders in the UK in 1995. In the US institutional investors held US\$ 8.0 trillion in US equities at the end of 2000, which amounts to 45.8% of the total. This compares to 28.2% at the end of 1970 and 7.2% at the end of 1950.<sup>1</sup>

Delegating portfolio management to an agent creates conflicts of interest between the investor and his agent. This paper explores the effects of these conflicts on the asset allocation decision, trading behaviour and price formation in financial markets. The main finding is that the asset allocation decision affects the way in which agency problems can be resolved and that, as a result, investors may be inclined to herd on a particular asset or asset class, foregoing investment opportunities that would yield higher returns.

It is well known from contract theory (Holmstrom, 1982; Mookherjee, 1984) that contracting on relative rather than absolute performance may mitigate agency problems. But such contracts require comparative performance information. Investors may therefore prefer to allocate funds to assets or markets in which other active managers are also present. The resulting herding of informed traders in some assets while neglecting others, leads to highly informative prices in some assets and uninformative prices in others. We discuss the optimal design of compensation contracts taking into account that they serve not only to mitigate agency problems, but also affect financial market competition. Accounting for this provides conditions under which it is desirable to tie the manager's compensation to relative performance.

The setting is one of double moral hazard: it is costly for managers to learn about the future value of an asset, and managers maintain discretion over the trading strategy used to exploit this private information. Principals choose whether to invest in an environment where comparative performance information is available, by assigning their manager to an asset class dependent on whether another manager also trades in that class.

Relative performance-based contracts may be desirable, because they provide incentives to acquire information at lower risk exposure to the manager compared to absolute performance contracts. Moreover, the manager tends to compensate for risk exposure by taking less aggressive trading positions. This further agency cost can be reduced by relative performance contracts. In our model these benefits of relative performance contracts carry two costs.<sup>2</sup> Firstly, relative performance contracts can only mitigate the agency problem if managers who are compared to one another also trade in the same asset, so that their returns are correlated. Therefore, managers lose market power over their private information, and thus active management is less profitable.

Secondly, it is known from the Industrial Organisation literature that firms engaging in Cournot competition have an incentive to design managerial compensation contracts strategically. When one firm rewards aggressive behaviour of its manager by basing wage on profits *and* sales, the manager acts like a Stackelberg leader over the other manager whose best response is to reduce output (Vickers, 1985; Fershtman and Judd, 1987; Sklivas, 1987). We show that in a similar way relative performance contracts

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<sup>1</sup> See New York Stock Exchange Fact Book (2001).

<sup>2</sup> See Meyer and Vickers (1997) for a treatment of the cost of relative performance contracts in a dynamic contracting environment.

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