Benchmarking Asset Managers

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Abstract

We develop a framework for assessing the financial stability implications of paying asset managers based on their performance relative to a benchmark. In our model, some savers use agents to manage their money (while others do not). The asset managers' effort is not observable and they are paid based on their performance. Absent benchmarking, asset managers prefer to avoid risk and choose a portfolio that is inefficient. Shareholders therefore benefit from benchmarking their asset managers. The potential cost of benchmarking is that generates more demand for the benchmark portfolio and the extra demand lowers expected returns on stocks in the benchmark and generates more volatility in the benchmark portfolio. Thus, the private contract chosen when people hire asset managers to act on their behalf diverges from what a social planner would choose. In particular, the planner would internalize the spillover of the volatility associated with benchmarking on the other savers. There are various effects of benchmarking on prices. We isolate the volatility effects and show that the planner chooses less benchmarking to mitigate the volatility effects.