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Moral Hazard in Active Asset Management[☆]

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Abstract

We consider a model of active asset management in which mutual fund managers exert unobservable effort to earn excess returns. Investors allocate capital to actively managed funds and passively managed products. In equilibrium, investors are indifferent between investing an additional dollar with an active manager or with a passively managed product. As passively managed products become more attractive to investors, active managers' revenues from portfolio-management services fall, reducing their effort incentives. More-severe decreasing-returns-to-scale are also associated with reduced incentives and increased moral hazard. Performance-based fees and holdings-based data are all unlikely to mitigate moral hazard.

JEL classification: G11

Keywords: Mutual Funds, Moral Hazard, Active Management, Passive Management

1. Introduction

A large literature is devoted to evaluating the performance of active mutual funds, and in particular, attempting to identify skilled managers.[1] For example, recent research by Berk and van

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[1]For examples, see Jensen (1968), Carhart (1997), Daniel, Grinblatt, Titman, and Wermers (1997), Kacperczyk, Sialm, and Zheng (2005, 2008), Baker, Litov, Wachter, and Wurgler (2010), Fama and French (2010), Del Guercio