MARKET RISK AND EFFICIENCY

Efficiently Inefficient Markets for Assets and Asset Management

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This paper describes the joint dynamics of the markets for assets and asset management. The authors show that asset managers can increase asset price efficiency by letting investors essentially share information costs, but their ability to do so is limited by the frictions in the asset-management industry. Therefore, the authors contend, the efficiency of asset markets is fundamentally connected to the efficiency of the asset management market.

The authors consider a model where investors can invest directly or search for an asset manager, information about assets is costly, and managers charge an endogenous fee. The model illuminates the determinants of asset price efficiency, the fees in the asset management industry, the performance of asset managers before and after fees, the number of asset managers and their size, the drivers of asset management consolidation, the fraction of assets allocated to good managers, the effects of noise allocators, and the overall costs of intermediation to all investors.

These model predictions help explain a number of existing empirical facts and lay the ground for further tests.

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