

Offsetting the Incentives: Risk Shifting, and Benefits of Benchmarking in Money Management*

Suleyman Basak
London Business School and CEPR
Regents Park
London NW1 4SA
United Kingdom
Tel: 44 (0)20 7706-6847
Fax: 44 (0)20 7724-3317
E-mail: sbasak@london.edu

Anna Pavlova
Sloan School of Management
Massachusetts Institute of Technology
50 Memorial Drive, E52-435
Cambridge, MA 02142-1347
Tel: (617) 253-7159
Fax: (617) 258-6855
E-mail: apavlova@mit.edu

Alex Shapiro
Department of Finance
Stern School of Business
New York University
44 West 4th Street, Suite 9-190
New York, NY 10012-1126
Tel: (212) 998-0362
Fax: (212) 995-4233
E-mail: ashapiro@stern.nyu.edu

This revision: December 2002

*We would like to thank colleagues at MIT Sloan, NYU Stern, and LBS, Glenn Ellison, Lucie Tepla, and the seminar participants at Harvard University, London Business School, London School of Economics, MIT, New York University, Washington University in St. Louis, and Yale University for their comments. All errors are solely our responsibility.

Offsetting the Incentives: Risk Shifting, and Benefits of Benchmarking in Money Management

Abstract

Money managers are rewarded for increasing the value of assets under management, and predominately so in the mutual fund industry. This compensation scheme gives the manager an implicit incentive to exploit the well-documented positive fund-flows to relative-performance relationship by manipulating her risk exposure. It also provides her with an explicit incentive to manage the fund in accordance with her own appetite for risk. In a dynamic asset allocation framework, we show that as the year-end approaches, the interplay of these incentives induces the manager to optimally closely mimic the index, relative to which her performance is evaluated, when the fund's year-to-date return is just sufficient to cause a higher expected flow. As she falls behind, she gradually increases her risk exposure (via leverage or short selling), reaching an extremum at a critical level of underperformance. This policy results in economically significant deviations from investors' desired risk exposure, substantially impairing them. To better align investors' and managers' incentives, investors or regulators can impose a benchmarking restriction on the fund manager, prohibiting a shortfall relative to a certain reference portfolio to exceed a pre-specified level. The restriction tempers deviations from the investors' desired risk exposure in the states in which the manager is tempted to deviate the most, and hence is beneficial. The analysis reveals how this risk management restriction should be designed for the highest benefit to the investors. Our findings complement and refine results in the related literature on risk taking incentives of mutual fund managers, and are at odds with previous work arguing against benchmarking.

JEL Classifications: G11, G20, D60, D81.

Keywords: Fund Flows, Implicit Incentives, Risk Taking, Benchmarking, Risk Management, Investments.

1. Introduction

“The real business of money management is not managing money, it is getting money to manage.”¹ Indeed, with the number of mutual funds in the US exceeding the number of stocks, fund managers are increasingly concerned with attracting investors’ money.² Recent empirical evidence (e.g., Gruber (1996), Chevalier and Ellison (1997), Sirri and Tufano (1998)), offers simple insight to a manager: new money is expected to flow into the fund if the manager has performed well relative to a certain index. With her compensation typically increasing in the value of assets under management, this positive fund-flows to relative-performance relationship creates an *implicit incentive* for the manager to increase the likelihood of future fund inflows, distorting her asset allocation choice. There is, of course, also an *explicit incentive* induced by the manager’s compensation: managing assets in line with her own appetite for risk, which need not coincide with that of the investor. This is another source of conflict between a fund manager and her investors, originally pointed out by Ross (1973).³ Together, the manager’s implicit and explicit incentives shape her asset allocation policy. Understanding this policy is of utmost importance to fund investors who may be hurt by adverse incentive effects. Risk taking by mutual funds in response to incentives has been thoroughly investigated by Chevalier and Ellison (1997). We would like to revisit the discussion within a familiar dynamic asset allocation framework, as well as to establish in this framework a role for risk management restrictions (using benchmarking).

We consider a dynamic economy and focus on two agents: a fund manager and a passive investor, who delegates funds to the manager, both guided by risk-averse objectives. The investor is implicitly assumed to refrain from active investing due to various well-recognized imperfections including market participation or informational costs (Merton (1987)), behavioral limitations (Hirshleifer (2001)), higher transaction costs for retail investors, time constraints or some other form of bounded rationality (Rubinstein (1998)). Consistent with the dominant industry practice, the manager is assumed to be active as opposed to being a passive indexer. The manager’s compensation depends on the total value of the fund at some terminal date (e.g., end of the year). This fund value is determined by an asset allocation policy the manager chooses during the year and by non-marketable inflows/outflows of new money at the year-end. The rate of flows into the fund, simply low or high for most of our analysis, is driven by the manager’s performance over the year relative

¹As eloquently put by Mark Hurley in the famous Goldman, Sachs and Co. report on the evolution of the investment management industry (see WSJ 11/16/95 and e.g., <http://assetmag.com/story/20010601/10438.asp>).

²At the end of 2001, there were 7177 listed stocks in the US (based on CRSP), and 8307 mutual funds (2002 Mutual Fund Fact Book).

³Ross argues that an agency conflict arising due to differences in utility functions when the agent’s action is difficult to monitor is the most fundamental delegation problem. He stresses that no informational asymmetries are required. We concur with this point of view, especially in the context of money management, where investors cannot frequently monitor the trading strategies of a fund, and where empirical evidence in support of managers’ possessing superior information or ability relative to investors is particularly weak.

to an “index” – a reference portfolio of stock and money markets. If her relative performance is above a certain threshold, she gets fund flows at a high rate, otherwise a low rate. The manager’s optimal policy reflects the interplay between implicit incentives given by the flow-performance relationship and her “normal,” absent implicit incentives, policy driven by her attitudes towards risk. In particular, as the year-end approaches, if her year-to-date relative return is at the flow threshold, the manager chooses to closely mimic the index. As she starts outperforming the index, she tends to her normal policy. As she falls behind the index, however, she gains an incentive to drastically manipulate her risk exposure, the pattern of which is shown to depend on whether the manager’s normal policy is riskier than the index or not. When the index is less risky, she leverages her portfolio, well beyond the normal level, and keeps increasing the risk exposure further as she falls behind the index. When the index is riskier, she reduces her stock market holdings, eventually selling the market short as she continues falling behind the index. At some critical level of the relative year-to-date return, such large deviations from her normal policy become intolerable to the risk averse manager, and so her risk exposure reaches an extremum, beyond which the normal policy considerations start to weigh in, and her risk exposure tends to her normal.

The manager’s policy in the underperformance region near the flow threshold is related to the risk-shifting behavior often arising in corporate finance applications (Jensen and Meckling (1976)) in that she optimally engages in “gambling.” However, due to managerial risk aversion, the pattern of “gambling” is considerably richer. First, an incentive to gamble can force the manager to actually reduce the volatility of her portfolio. Second, risk aversion always counteracts the tendency to gamble (or manipulate the risk exposure). The manager would not optimally alter her risk exposure by any more than what is sufficient to ensure a high flow in the good outcome. Thus, the “gambling” incentive is the lowest when the manager’s year-to-date return is around the flow threshold, and is the highest at an interior point of the underperformance region.

Costs to the investor, resulting from such behavior, are shown to be significant. We compare the investor’s indirect utility when actively managing the portfolio himself with when delegating it to the manager. The difference is quantified in units of initial wealth. For example, if the investor’s relative risk aversion is 2 and the manager’s is 0.5, we find the cost to investor to be nearly 58% of his initial wealth. We demonstrate how the manager’s explicit and implicit incentives reinforce each other in harming the investor. The cost due to explicit incentives is particularly severe when the manager’s and investor’s attitudes towards risk differ substantially, and the cost due to implicit incentives is particularly high when the high and low flow rates deviate significantly or when the index is very risky. The magnitude of these costs motivates us to search for practical mechanisms on the part of investors and regulators aimed at counteracting the manager’s adverse incentives.

The standard theoretical approach to aligning the incentives of investors and managers is to offer the manager a contract that will induce the right level of risk exposure. Unfortunately,

the manager’s risk exposure over the year is not observable, making her asset allocation policy non-contractable. Alternatively, one may consider a dynamic contract based on the fund’s year-to-date asset value. However, such contracts are difficult to implement and monitor, leading to their absence in practice. In this paper, we take a fundamentally different approach. Instead of attempting to alter the manager’s compensation structure, we propose altering her investment opportunity set so as to temper undesirable swings in her risk exposure in the targeted states of the world. This objective can be achieved with appropriately specified risk management restrictions, of which we consider a simple constraint typically referred to as a “minimum performance constraint” or a “benchmarking restriction.” A benchmarking restriction prohibits the year-end shortfall in the manager’s return relative to a certain reference portfolio to exceed a pre-specified level.

The financial industry and regulators are, in fact, leading academia in mandating the use of risk management constraints in the United States, and to an increasing extent worldwide. Almazan, Brown, Carlson, and Chapman (2001) present ample evidence on the use of constraints in the mutual fund industry. The need for constraints was recognized shortly after the birth of the first mutual fund in the US, and formalized in the Investment Company Act of 1940. Since 1940, constraints remained popular with both regulators and mutual fund companies. The SEC’s Division of Investment Management oversees compliance of money managers with the Act, and takes an active role in the evolution of constraints over time. The benchmarking restriction we advocate is a very simple yet remarkably versatile constraint. It subsumes some popular risk management practices as special cases (e.g., portfolio insurance, pure indexing), and it involves no monitoring costs. We show that by selecting a benchmark that is less risky than the index, investors or regulators can temper deviations from the investors’ desired risk exposure in states where the manager is tempted to deviate the most, and hence are beneficial to investors. For example, as a result of imposing a benchmark consisting of 5% in the stock market and 95% in the money market, most of the loss of 58% in the earlier example can be recouped. Through tailoring the composition of the benchmark and the allowed shortfall, the recouped fraction can be increased further. Our results thus provide guidance for an optimal design of a benchmarking restriction.

Related to our work is the literature examining implicit incentive conflicts in money management. To study flows-induced risk taking by mutual fund managers, Chevalier and Ellison (1997) define risk-taking incentive as the sensitivity of a fund’s value to its volatility (as is standard in corporate finance). This risk-taking incentive captures the strength of the (value-maximizing) manager’s desire to increase her risk exposure relative to some fixed status quo asset allocation. Our measure of risk-taking is the optimal risk exposure as defined in the asset allocation literature: the fraction of the fund optimally invested in the stock market (not necessarily well-defined under risk neutrality). Therefore, our analysis is complementary to Chevalier and Ellison, as we offer considerably different implications for managerial risk taking (see Section 2.3).⁴ Within a dynamic

⁴A related area in corporate finance is the work on risk averse managers’ risk-taking incentives induced by executive

asset allocation framework like ours, Carpenter (2000) examines the risk taking behavior of a fund manager with a convex, option-based compensation. Although it may appear plausible to interpret such a model as reduced form for flow-performance-based implicit incentives, it would lead to the counterfactual implication that fund flows increase as the fund value deteriorates (see Section 2.3). Moreover by design, due to the safety net at poor fund performance, manager’s risk aversion considerations are suppressed in the underperformance region, implying unbounded risk exposure. This contrasts to our finding of an interior extremum at poor fund relative-performance, reflecting the tradeoff between the manager’s risk-shifting and risk-aversion. Also related are Brennan (1993), Cuoco and Kaniel (2000), and Gomez and Zapatero (2002) who study equilibrium asset prices in an economy with agents compensated based on their performance relative to an index, as well as the fund manager’s career concerns problem studied by Arora and Ou-Yang (2000). Hugonnier and Kaniel (2002) endogenize fund flows, which are marketable, in a dynamic economy with a small investor and a non-competitive fund manager. Under the derived flow function, however, the optimal policy of the manager does not depend on her risk aversion, and does not entail any risk-shifting. In the context of a fund-value-maximizing manager, whose ability is unknown, Berk and Green (2002) derive an empirically plausible fund flows-performance relationship. There is a strand of literature, growing out of Bhattacharya and Pfleiderer (1985), investigating optimal contracting (or explicit incentive problems) in the context of delegated portfolio management, where the manager typically has superior information or ability. In this vein, is Dybvig, Farnsworth, and Carpenter (2001), the first to include restrictions on the investment opportunity set (trading strategies) as part of an optimal contract. More recently, Ross (2002) investigates the interaction between the manager’s payoff and risk aversion within a general class of preferences and compensation structures.

Another strand of related literature investigates (adverse) consequences of benchmarking. In a mean-variance setting, Roll (1992) argues that benchmarking a money manager to an index results in her choosing a portfolio that is not mean-variance efficient. Admati and Pfleiderer (1997), in a similar context but with an asymmetrically informed investor and portfolio manager, also advocate against benchmarking the manager, and particularly linking compensation to the types of benchmarks observed in practice. Although this may appear as contradictory to our results, one should exercise caution. Our viewpoint is that there is a well-understood conflict of interest between fund managers and investors, which we accept as a fact of life. The role of our benchmarking restriction is to (partially) alleviate the adverse effects of managerial incentives, thus benefitting investors. There is also a recent literature examining benchmarking absent delegation.

stock options (Lambert, Larcker, and Verrecchia (1991), Hall and Murphy (2000), Hall and Murphy (2002), Lewellen (2002)). Here, a risk-taking incentive is given by the sensitivity of the manager’s certainty equivalent wealth to volatility. There are some similarities between the results obtained in this context and ours (see, especially Lewellen (2002)), however unlike in our model the manager is assumed to hold a pre-specified portfolio, and may affect risk exposure only through manipulating the company’s stock price. The notion of implicit incentives was introduced by Fama (1980) and Holmstrom (1999), and applied to other related problems in corporate finance by, for example, Zwiebel (1995) and Huddart (1999).

In a dynamic setting like ours, Tepla (2001), and Basak, Shapiro, and Tepla (2002) study the optimal policies of an agent subject to a benchmarking restriction.

The rest of the paper is organized as follows. In Section 2, we describe the model, solve for the optimal risk exposure of the manager, and compute costs of active management to the investor due to managerial explicit and implicit incentives. In Section 3, we specify the benchmarking restriction, derive the manager’s optimal policy under benchmarking, and evaluate investor’s cost/benefit due to risk management. Section 4 concludes, and the Appendix provides the proofs.

2. Fund Manager’s Implicit and Explicit Incentives

2.1 The Economic Setting

We adopt the familiar Black and Scholes (1973) economy for the financial investment opportunities. We consider a continuous-time, finite horizon, $[0, T]$ economy, in which uncertainty is driven by a Brownian motion w . Available for investing are a riskless money market account and a risky stock. The money market provides a constant interest rate r . The stock price, S , follows a geometric Brownian motion

$$dS_t = \mu S_t dt + \sigma S_t dw_t,$$

where the stock mean return, μ , and volatility, σ , are constant. Throughout, the notation σ^Z denotes the volatility (instantaneous standard deviation) of an Itô process Z satisfying $dZ_t/Z_t = \mu_t^Z dt + \sigma_t^Z dw_t$.

We focus on two economic agents: an investor, I , and a manager, M . The investor derives utility, u_I , from horizon wealth, W_T . We assume that he has constant relative risk aversion (CRRA) preferences, $u_I(W_T) = \frac{W_T^{1-\gamma_I}}{1-\gamma_I}$, $\gamma_I > 0$. The investor is passive in that he delegates all his initial wealth, W_0 , to the manager to invest. The decision to delegate, exogenous in this paper, captures in a reduced form the choice to abstain from active investing due to various imperfections associated with money management (participation and information costs, time required to implement a dynamic trading strategy, transaction costs, behavioral limitations).

The manager dynamically allocates the investor’s assets, initially valued at W_0 , between the risky stock and the money market. Her portfolio value process, W , follows

$$dW_t = [r + \theta_t(\mu - r)] W_t dt + \theta_t \sigma W_t dw_t, \tag{1}$$

where θ denotes the fraction of the portfolio invested in the risky stock, or the *risk exposure*. Consistent with the leading practice, the manager’s compensation, due at the horizon T , is proportional to the terminal value of assets under management. Tying of compensation to performance provides the manager with an *explicit incentive* to increase the final value of the portfolio W_T . Perhaps

just as significant to the manager's choices are *implicit incentives* underlying the money management industry. There, implicit incentives come in the form of the well-documented fund-flows to relative-performance relationship (see e.g., Chevalier and Ellison (1997)). If the manager does well relative to some index (e.g., the stock market), her assets under management multiply due to the inflow of new investors' money; if she does poorly, a part of assets under her management gets withdrawn. We model this relationship in the simplest possible way. The index relative to which the implicit incentives are evaluated, hereafter the *index*, Y , is a value-weighted portfolio with a fraction β invested in the stock market and $(1 - \beta)$ in the money market, following

$$dY_t = (1 - \beta)rY_t dt + \beta(Y_t/S_t)dS_t = [(1 - \beta)r + \beta\mu]Y_t dt + \beta\sigma Y_t dw_t.$$

The (continuously compounded) returns on the manager's portfolio and on the index over the period $[0, t]$ are denoted by $R_t^W = \ln \frac{W_t}{W_0}$ and $R_t^Y = \ln \frac{Y_t}{Y_0}$, respectively. There are two fund flow rates: high, f_H , and low, f_L ; $f_H \geq f_L > 0$. At the terminal date, the manager receives fund flows at rate $f_T = f_H$ if $R_T^W - R_T^Y \geq \eta$, and at rate $f_T = f_L$ otherwise. The pivotal difference in returns η , which we will call the *flow threshold*, can be either positive, zero, or negative. The flow rate f_T is understood in the proportion-of-portfolio terms; for example if $f_T > 1$, the manager gets an inflow, otherwise if $f_T < 1$, gets an outflow. It turns out that this simple way of modeling fund flows is able to capture most of the insights pertaining to risk taking incentives of the manager. In Section 2.3, we discuss how our results extend to a general fund-flows to relative-performance relationship. The manager is guided by CRRA preferences, defined over the overall value of assets under management at time T :

$$u_M(W_T f_T) = \frac{(W_T f_T)^{1-\gamma_M}}{1-\gamma_M}, \quad \gamma_M > 0, \quad (2)$$

where f_T directly enters through the utility, and not through the budget constraint, because future (time- T) fund flows are non-tradable. We note that this payoff is consistent with a linear fee structure, predominantly adopted by mutual fund companies (e.g., Das and Sundaram (2002), Elton, Gruber, and Blake (2002)).⁵ The manager intertemporally chooses a risk exposure process θ and terminal portfolio value W_T so as to maximize her expected utility (2) subject to the budget constraint (1). Note that when γ_I and γ_M are not equal, the manager's compensation structure makes her objective different from that of the investor, even when implicit incentives are not present.

Absent implicit incentive considerations, the manager's optimal risk exposure, θ^N , henceforth the *normal risk exposure*, is given by (Merton (1971)):

$$\theta_t^N = \frac{1}{\gamma_M} \frac{\mu - r}{\sigma^2}.$$

⁵In particular, the manager may be given a linear contract, $\alpha W_T f_T$, $\alpha > 0$. Such a contract would be optimal in our model absent explicit and implicit incentives, i.e., $\gamma_I = \gamma_M$ and $f_T = 1$. However, the presence of incentives leads to a considerable cost to investors, as demonstrated in Section 2.4. Our specification does not capture the case of fulcrum fees, which are less common, but the model can be extended to incorporate them. Moreover, our implicit incentive component in the manager's payoff could be reinterpreted as an explicit performance-based fee.

Although the investor is not making any investment decisions, we find it useful in the sequel to sometimes refer to the investor's *optimal risk exposure*, $\theta_t^I = \frac{\mu-r}{\gamma_I \sigma^2}$. By analogy, we define the risk exposure of the index portfolio, θ^Y , as the fraction of the index invested in the risky asset:

$$\theta_t^Y = \beta.$$

2.2 Manager's Risk Taking Incentives

The optimization problem of the manager is summarized as:

$$\begin{aligned} & \max_{\theta, W_T} E[u_M(W_T f_T)] \\ \text{subject to} & \quad dW_t = [r + \theta_t(\mu - r)] W_t dt + \theta_t \sigma W_t dw_t, \quad W_0 \text{ given,} \\ \text{where} & \quad f_T = \begin{cases} f_L & \text{if } R_T^W - R_T^Y < \eta, \\ f_H & \text{if } R_T^W - R_T^Y \geq \eta, \end{cases} \quad 0 < f_L \leq f_H, \eta \in \mathbb{R}. \end{aligned} \quad (3)$$

This problem is non-standard in that it is non-concave over a range of W_T , where the range is dependent on the performance of the stochastic index Y . The empirical literature on fund-flows to relative-performance relationship clearly indicates that non-concavities are inherent in the mutual fund managers' problems. As is well known (e.g., Karatzas and Shreve (1998)), the driving economic state variable in an agent's dynamic investment problem is the so-called state price density. In the complete-markets Black and Scholes (1973) economy, this state price density process, ξ , is given by $d\xi_t = -r\xi_t dt - \kappa\xi_t dw_t$, where $\kappa \equiv (\mu - r)/\sigma$ is the constant market price of risk in the economy. Proposition 1 characterizes the solution to (3) in terms of the state variable ξ .

Proposition 1. *The optimal risk exposure and terminal wealth of a fund manager facing implicit incentives are given by*

(a) *for economies with $\theta^N > \theta^Y$, letting $\xi_a > \hat{\xi}$ satisfy $g(\xi_a) = 0$, we have*

$$\begin{aligned} \hat{\theta}_t &= \theta^N + \left[\mathcal{N}(d(\hat{\kappa}, \xi_a)) - \mathcal{N}(d(\hat{\kappa}, \hat{\xi})) \right] (\gamma_M/\hat{\kappa} - 1) A \theta^N Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} / \hat{W}_t \\ &+ \left\{ \left[\phi(d(\hat{\kappa}, \xi_a)) - \phi(d(\hat{\kappa}, \hat{\xi})) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} \right. \\ &+ \left. \left[\phi(d(\gamma_M, \hat{\xi})) f_H^{(1/\gamma_M-1)} - \phi(d(\gamma_M, \xi_a)) f_L^{(1/\gamma_M-1)} \right] Z(\gamma_M) (\hat{y}\xi_t)^{-1/\gamma_M} \right\} \frac{\gamma_M \theta^N}{\kappa \sqrt{T-t} \hat{W}_t}, \\ \hat{W}_T &= \frac{1}{f_H} J_M \left(\frac{\hat{y}}{f_H} \xi_T \right) 1_{\{\xi_T < \hat{\xi}\}} + e^\eta Y_T 1_{\{\hat{\xi} \leq \xi_T < \xi_a\}} + \frac{1}{f_L} J_M \left(\frac{\hat{y}}{f_L} \xi_T \right) 1_{\{\xi_a \leq \xi_T\}} \end{aligned}$$

(b) *for economies with $\theta^N < \theta^Y$, letting $\xi_b < \hat{\xi}$ satisfy $g(\xi_b) = 0$, we have*

$$\begin{aligned} \hat{\theta}_t &= \theta^N + \left[\mathcal{N}(d(\hat{\kappa}, \hat{\xi})) - \mathcal{N}(d(\hat{\kappa}, \xi_b)) \right] (\gamma_M/\hat{\kappa} - 1) A \theta^N Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} / \hat{W}_t \\ &+ \left\{ \left[\phi(d(\hat{\kappa}, \hat{\xi})) - \phi(d(\hat{\kappa}, \xi_b)) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} \right. \\ &+ \left. \left[\phi(d(\gamma_M, \xi_b)) f_L^{(1/\gamma_M-1)} - \phi(d(\gamma_M, \hat{\xi})) f_H^{(1/\gamma_M-1)} \right] Z(\gamma_M) (\hat{y}\xi_t)^{-1/\gamma_M} \right\} \frac{\gamma_M \theta^N}{\kappa \sqrt{T-t} \hat{W}_t}, \\ \hat{W}_T &= \frac{1}{f_L} J_M \left(\frac{\hat{y}}{f_L} \xi_T \right) 1_{\{\xi_T < \xi_b\}} + e^\eta Y_T 1_{\{\xi_b \leq \xi_T < \hat{\xi}\}} + \frac{1}{f_H} J_M \left(\frac{\hat{y}}{f_H} \xi_T \right) 1_{\{\hat{\xi} \leq \xi_T\}}, \end{aligned}$$

where in all economies \hat{y} solves $E[\xi_T \hat{W}_T] = W_0$, $J_M(\cdot)$ is the inverse function of $u'_M(\cdot)$, $\mathcal{N}(\cdot)$ and $\phi(\cdot)$ the standard-normal cumulative distribution and density functions respectively, $\hat{\kappa} = \kappa/(\beta\sigma)$, $\hat{\xi} = (\hat{y}A^{\gamma_M}/f_H^{1-\gamma_M})^{1/(\gamma_M/\hat{\kappa}-1)}$, $A = W_0 e^{[\eta/T+(1-\beta)r+\beta(\mu-\sigma^2/2-(r+\kappa^2/2)\sigma/\kappa)]T}$, $g(\xi) = \left(\gamma_M \left(\frac{\hat{y}}{f_L} \xi\right)^{1-1/\gamma_M} - \left(\frac{\xi^{1/\hat{\kappa}}}{Af_H}\right)^{\gamma_M-1}\right)/(1-\gamma_M) + yA\xi^{1-1/\hat{\kappa}}$, $Z(v) = e^{\frac{1-v}{v}\left(r+\frac{\kappa^2}{2v}\right)(T-t)}$, $d(v, x) = \left(\ln \frac{x}{\xi_t} + \left(r + \frac{2-v}{2v}\kappa^2\right)(T-t)\right)/(\kappa\sqrt{T-t})$, and \hat{W}_t is as given in the Appendix. The knife-edge economies with $\theta^N = \theta^Y$ are described in the Appendix.

Proposition 1 reveals that the manager's optimal behavior is distinctly different depending on whether the index is riskier than her normal policy (economies (a)) or not (economies (b)). We note that both types of economies, (a) and (b), are empirically plausible since each economy is identified by conditions involving managerial risk aversion γ_M , which need not equal that of a representative agent. The implications for optimal risk taking are best highlighted by plotting the manager's state-dependent risk exposure as a function of her performance relative to the index.⁶

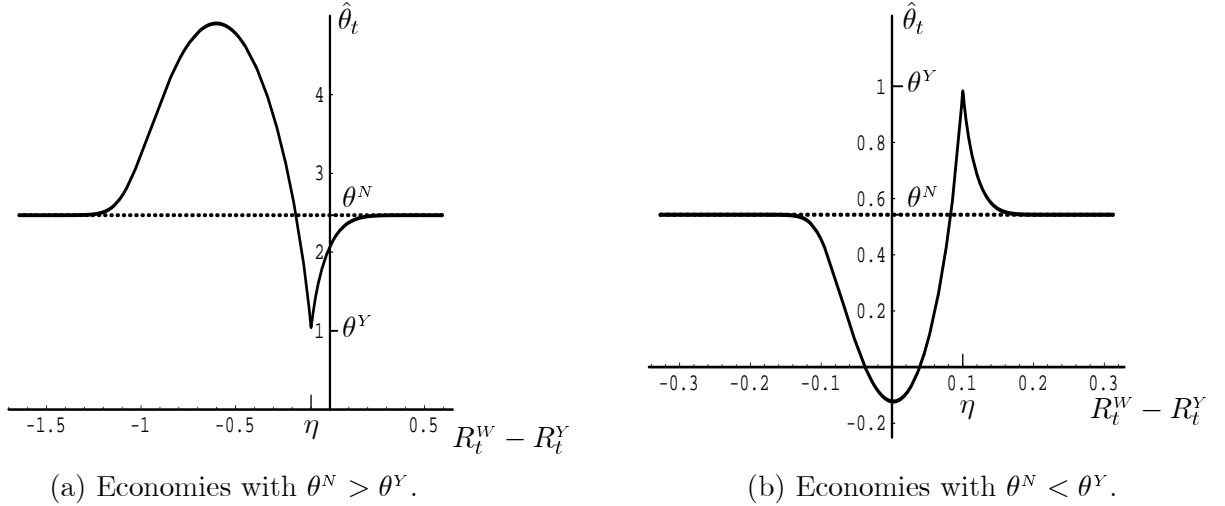


Figure 1. The manager's optimal risk exposure. The solid plots are for the optimal risk exposure, and the dotted plots are for the manager's normal risk exposure.⁷

There are two considerations affecting the manager's behavior. First is her attitude towards risk, driving the normal policy, second is the risk-shifting incentive induced by fund flows. To understand the latter, it is useful to note that the non-concave payoff to the manager can be expressed as

$$W_T f_T = f_L W_T + (f_H - f_L) W_T \mathbf{1}_{\{R_T^W - R_T^Y \geq \eta\}},$$

⁶Although in Proposition 1 the optimal risk exposure is expressed as a function of the state price density ξ , we can draw such a plot parametrically provided that the manager's outperformance $R^W - R^Y$ is monotonic in ξ . This monotonicity property holds for all parameter values we employed. Our way of presenting the results of the proposition is reinforced by observing that $R^W - R^Y$ is a natural state variable in the manager's optimization (3).

⁷The figure is typical. Parameter values are chosen for demonstrative purposes. In economies (a) the parameter values are $\gamma_M = 1.0$, $f_L = 0.85$, $f_H = 1.15$, $\beta = 1.0$, $\eta = -0.1$, $\mu = 0.1$, $r = 0.02$, $\sigma = 0.18$, $W_0 = 1$, $t = 0.75$, $T = 1$, and in economies (b) $\gamma_M = 1.8$, $f_L = 0.99$, $f_H = 1.01$, $\beta = 1.0$, $\eta = 0.1$, $\mu = 0.12$, $r = 0.02$, $\sigma = 0.32$, $W_0 = 1$, $t = 0.96$, $T = 1$.

where the first term is a linear function of terminal wealth, and the second is a position in $f_H - f_L$ “asset-or-nothing” binary options with a stochastic strike. When the manager is following her normal policy, her optimal wealth process is a geometric Brownian motion, and hence the exact pricing formula for the binary option is readily available. In particular, the volatility of the underlying, W/Y , depends on the volatility of the index, and is given by $|\sigma_t^W - \sigma_t^Y| = \sigma|\theta_t^N - \theta_t^Y|$.⁸ As emphasized in the vast risk-shifting literature (originating from Jensen and Meckling (1976)), to increase the value of her compensation, the manager has an incentive to deviate from her normal policy by boosting the volatility of the underlying. Note that an increase in the volatility (or risk exposure) of the manager’s portfolio W , $\sigma\theta_t$, does not always result in an increase of the volatility of the underlying W/Y .

Let us focus first on the manager’s optimal policies at the year-end, right before her receiving fund flows in reward for her performance. We start with economies (a) (Figure 1a), in which the manager’s normal risk exposure is higher than that of the index ($\theta^N > \theta^Y$). When the return on the manager’s portfolio exceeds the index return by exactly the flow threshold η (the manager’s option is at-the-money), she chooses to closely match the index. In these states, the benefits to the manager of a small deviation from following the index, are very small as compared to the potential cost of ending up with an out-of-the-money option. As the manager’s portfolio starts outperforming the index, the normal policy considerations weigh in more, and the manager starts taking more and more risk, converging to her normal risk exposure in the limit. The pattern is quite different in the underperformance region. For the states in which her option is slightly out-of-the-money, the manager has an incentive to increase the volatility of the underlying (gamble) for a chance to end up in-the-money. Since the manager’s normal policy is riskier than the index, the manager has an incentive to increase her risk exposure above normal. As the underperformance widens, the manager’s option dips deeper out-of-the-money, where its value and the likelihood of finishing in-the-money is less sensitive to volatility. For a chance to end up in-the-money, the manager needs to increase the volatility even higher (take a bigger gamble). As the underperformance reaches a critical level where the benefits of increasing risk exposure are equal to the cost due to risk aversion of deviating from her normal policy, the risk exposure achieves the maximum point. Beyond that point, the manager’s risk exposure starts to decrease as the underperformance widens, converging to her normal. Analogous intuition is applicable to economies (b) (Figure 1b), in which the manager’s normal risk exposure is lower than that of the index ($\theta^N < \theta^Y$). She matches the index when her option is at-the-money, and gradually decreases her risk exposure converging to her normal in the outperformance states. In the underperformance states, again, the manager has an incentive to gamble. However, since $\theta^N - \theta^Y < 0$, to increase the volatility of the underlying, the manager

⁸The binary option with the payoff $W_T \mathbf{1}_{\{R_T^W \geq R_T^Y + \eta\}} = W_T \mathbf{1}_{\{W_T \geq e^{\eta} Y_T\}}$ is essentially an option on the ratio W/Y . The properties of such an option closely resemble those of an exchange option. For discussion of binary and exchange options, see Hull (2002).

needs to *decrease* her position in the risky stock. As she falls behind the index more and more, her position decreases further. The manager may even optimally choose to *short* the risky stock. Again, due to a tradeoff between risk aversion and the payoff-induced incentive to gamble, the risk exposure does not go to (negative) infinity: it reaches an extremum at some point where the option is sufficiently deep out-of-the-money. Beyond that, the risk aversion considerations prevail, and the manager's policy starts converging to her normal.

The described optimal policy finances the manager's terminal portfolio value which displays three distinct patterns depending on the state of the world. In the extreme states (low ξ_T or high ξ_T), the manager behaves as if the fund flows were constant at the low f_L or high f_H rate. In addition, there is an extended intermediate region in which the manager mimics the index. The nonconcavity of the manager's problem gives rise to a discontinuity in the optimal wealth profile at $\xi_T = \hat{\xi}$. This discontinuity is due to the fact that over the range where her preferences are nonconcave in the terminal portfolio value (or returns), the manager exhibits a risk-loving behavior. That is, she will always prefer adding a gamble to her portfolio over a certainty equivalent portfolio value falling into this (suboptimal) range (see Section 2.3 for further elaboration).

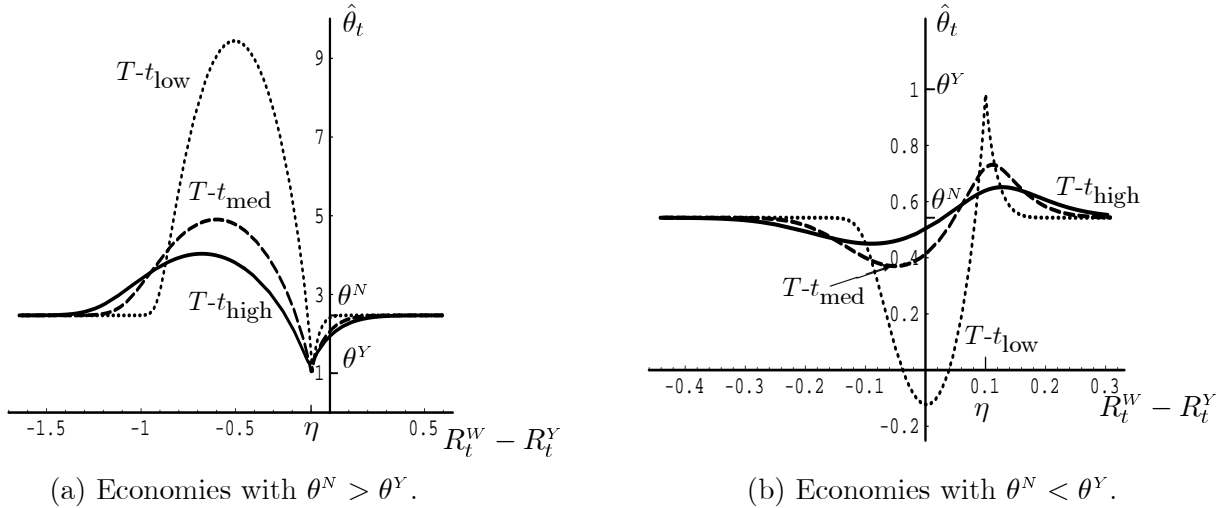


Figure 2. Dynamics of the manager's optimal risk exposure. $T-t_{\text{high}} = 0.5$, $T-t_{\text{med}} = 0.25$, and $T-t_{\text{low}} = 0.04$. The remaining parameter values are the same as in Figure 1.

The manager's optimal trading strategy earlier in the year reflects the anticipation of the year-end drive to avoid the suboptimal range of the terminal portfolio returns. She does not wait till the year-end to see how her returns play out, to then take a gamble right before the terminal date if necessary. Rather, she starts tilting her risk exposure around the suboptimal range well in advance, displaying a hump in the risk exposure as in Figure 1. However, the more opportunities she has to adjust her portfolio in the future, the less risk exposure she is willing to bear today. The risk aversion (normal policy) considerations dominate early in the year, substantially temper-

ing the risk-shifting considerations and bringing the optimal policy closer to normal, but as time progresses, the risk-shifting motive grows stronger, and hence the magnitude of risk taking around the suboptimal range of portfolio returns grows. Additionally, the range over which the risk exposure displays a risk-shifting-induced hump is wider early in the year, and shrinks monotonically as the horizon approaches. The manager starts engaging in risk shifting when her option is deeper out-of-the-money, and reduces deviations from the index (locks in gains) even if she is still in the outperformance range. For reasonable parameter values, the difference between the outperformance point, at which the manager minimizes her deviations from the index, and the flow threshold η is positive but very small, often not distinguishable to the eye on a plot. The plots in Figure 2 illustrate this discussion.

2.3 Further Discussion and Generalizations

This section offers further insight into the manager’s optimal behavior and attempts to generalize our intuition to alternative specifications of the fund-flow to relative-performance relationship.

A. Risk-Taking in Corporate Finance versus Our Analysis

We think it is useful to contrast our results on the manager’s optimal risk taking to measures of risk-taking incentives as defined in the corporate finance literature, typically under the assumption of agents’ risk-neutrality. For example, Green and Talmor (1986), in the context of the asset substitution problem, define the risk-taking incentive as the sensitivity of the value of the equity-holders’ option-like payoff to “changes in investment risk” (variability of the underlying cash flow). A similar measure is adopted by Chevalier and Ellison (1997) whose focus is the closest to ours. In option pricing, this measure is typically referred to as vega, the partial derivative of an option’s (portfolio) value with respect to the volatility of the underlying. The risk-taking incentive, as defined in corporate finance, then captures the strength of the (value-maximizing) manager’s desire to increase the volatility of her portfolio (risk exposure) relative to some fixed status quo asset allocation. This risk taking incentive will be the strongest (weakest) when vega of the manager’s payoff achieves its maximum (minimum).

Our measure of risk taking is the manager’s optimal risk exposure: the fraction of wealth she optimally invests in the risky asset in response to her incentives. This quantity allows us to formalize an important interaction of the manager payoff’s vega with her risk aversion. Risk aversion induces the manager to take as little risk (as small a gamble) as necessary to cross over into the moneyness in the good states of the world. Thus, a small increase in the risk exposure is sufficient near the money, and a much larger increase is needed when the option is deep out-of-the-money. Note that our endogenous gamble-then-lock-in pattern of risk exposure does not converge to the corporate-

finance measure of risk-taking incentives even as the risk aversion of the manager tends to zero. This is because the proper limit of the preferences of our manager is a linear function over the range of positive values of terminal wealth, coupled with a restriction that wealth cannot fall below zero (the negativity of wealth is ruled out by the Inada conditions). This function is (weakly) concave, so we do not get a risk-neutral (linear) objective even in the limit.

B. Alternative Specifications of Flow-Performance Relationship

Below we discuss how our analysis applies more generally than just to a two-state fund flows.

(i) *Flow-performance specification of Chevalier and Ellison (1997)*. Consider a functional form for the flow-performance relationship along the lines of Chevalier and Ellison:

$$f_T = \begin{cases} f_L & \text{if } r_T^W - r_T^Y < 0, \\ f_L + r_T^W - r_T^Y & \text{if } 0 \leq r_T^W - r_T^Y < \eta, \\ f_H = f_L + \eta & \text{if } \eta \leq r_T^W - r_T^Y, \quad 0 < f_L \leq f_H, \eta > 0, \end{cases}$$

where $1 + r_t^Z = e^{R_t^Z}$ denotes the simple (holding period) return on Z . Chevalier and Ellison highlight the following feature of the flows-performance relationship: a convex “kink” for slight underperformance, followed by an approximately linear segment, then a concave “kink” in the overperformance region. They argue that the manager’s risk taking incentives (defined by vega) at time t are (locally) the highest at the first kink and the lowest at the second.⁹ Note that we can express the manager’s payoff as a linear function of the terminal portfolio value W_T and a portfolio of two call options with stochastic strikes Y_T and $Y_T + \eta W_0$:

$$W_T f_L + \frac{W_T}{W_0} \max\{W_T - Y_T, 0\} - \frac{W_T}{W_0} \max\{W_T - Y_T - \eta W_0, 0\}.$$

Of interest to us, is the first call option. Unlike the second call, it introduces a non-concavity in the manager’s payoff. The local behavior around this non-concavity will resemble that described in Proposition 1. In particular, since the volatility of the underlying is again given by $|\sigma_t^W - \sigma_t^Y| = \sigma|\theta_t - \theta^Y|$, the patterns of manager’s behavior will be distinctly different depending on whether the index is riskier than the manager’s normal policy or not. The kink at $r_T^W = r_T^Y$ gives the manager an incentive to increase the riskiness of the underlying. Thus, the way she will do this depends on whether the economic environment is of type (a) or (b). Managerial risk aversion will act to counteract the option-induced incentive to increase risk. The risk exposure will display a local maximum and a local minimum in the neighborhood of $r_T^W = r_T^Y$.

⁹Of course, our form of f_T is an overly simplified version of the specification revealed by Chevalier and Ellison’s estimation. For example, to simplify exposition we abstract away from two other “kinks” corresponding to the regions of extremely good and extremely bad performance relative to the index. This is because, similarly to Chevalier and Ellison, we are interested in identifying the manager’s behavior locally around a given kink. The functional form we adopt thus suits this purpose.

(ii) *Flow-performance specification of Carpenter (2000)*. Carpenter studies the risk taking of a risk-averse manager paid with a call option on the assets she controls. As Carpenter highlights, such a convex compensation structure could potentially arise from the documented fund flow-performance relationship. Here, we attempt to interpret Carpenter’s model as reduced form for such an implicit incentive. The closest way to obtain Carpenter’s “safety net” at poor fund performance within our model, is to set $f_L = K/W_T$, guaranteeing the floor K for portfolio values below K , and a payoff linear in W_T for levels above K . The index Y is non-stochastic ($\theta^Y = 0$) for most of Carpenter’s analysis. Note that this form of fund-flows to relative-performance relationship entails a counterfactual implication that fund flows increase as the fund value decreases when performing poorly (for low W_T , $f_L > f_H$), and tends to (positive) infinity at zero fund value. This behavior highlights the incentive effects of a “safety net”, along the lines of the risk-shifting story of Jensen and Meckling (1976). Our manager, who is not rewarded for poor performance but is effectively penalized instead (by low fund flow for low W_T), behaves considerably differently. The risk aversion considerations play an important role in the underperformance region in counteracting risk-shifting, thus ruling out unbounded risk exposure. This feature will also be present in a model where a manager can get fired when the fund return is low, since the manager would optimally choose to limit the size of the gamble she takes to avoid the states in which she gets fired. Another finding of our analysis is uncovering of economies (b). Although a stochastic benchmark is considered in Carpenter, her model is able to uncover only economies of type (a). Our analysis distinguishing between the two economies underscores the fact that the manager’s behavior is in part driven by an incentive to manipulate the distance between the risk exposure of the fund and that of the index in across states of the world. This provides an alternative explanation for Carpenter’s finding that the manager’s optimal risk exposure may drop below normal.

(iii) *General flow-performance specification*. We now consider a general payoff structure $W_T f_T$. We conjecture that the bulk of our results holds locally for every region in which $u_M(W_T f_T)$ is non-concave. If such a region includes $W_T = 0$ or $W_T = \infty$, then at the global maximum (or minimum), the manager’s risk exposure can be infinite (a corner solution) or not well-defined. Otherwise, the manager’s risk exposure is bounded from above and below for each t , and the pattern of risk taking incentives is along the lines of that described in this section.

Remark 1. (Alternative applications) Anticipating possible applicability of our intuition to the areas in corporate finance, where non-concavities are inherent in the payoff structure of a risk-averse manager (e.g., the asset substitution problem, executive compensation), it is worth pointing that a riskless index is a special case of our analysis. The pattern of optimal risk exposure will resemble that in our Figure 1a.

C. A Further Illustration of Nonconcavities and Risk Shifting

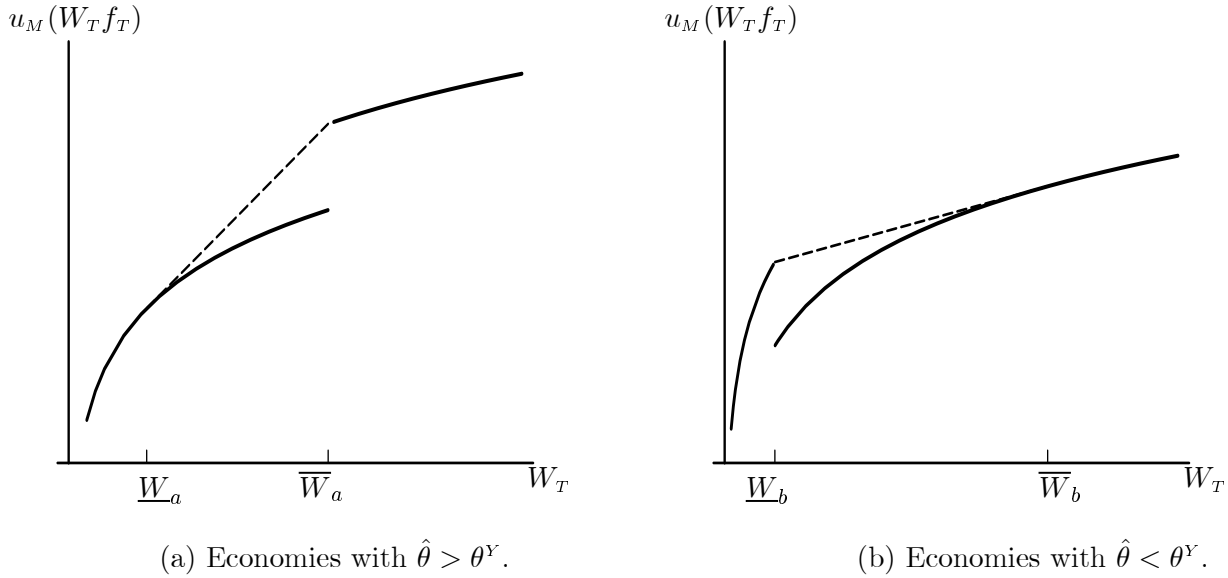


Figure 3. The manager’s terminal utility. The solid plots are for the manager’s utility, with its concavification superimposed with the dashed line. Quantity $\hat{\theta}$ denotes the risk exposure, which is assumed constant in the plots.

Figure 3 depicts the manager’s utility function, with its concavification superimposed on the plot.¹⁰ The solid plot represents the manager’s utility under a given constant risk exposure $\hat{\theta}$. The figure illustrates the effects of correlation of the fund portfolio with the index. In panel (a) ($\hat{\theta} > \theta^Y$), the fund receives flows at the low rate for low fund values and at the high rate for high values ($W_T > \bar{W}_a$). Conversely, in panel (b) ($\hat{\theta} < \theta^Y$), fund flows are high for low fund values and low for high values ($W_T > \underline{W}_b$). This is because the driving factor in receiving flows is not absolute performance, but relative. In panel (a), the fund risk exposure is higher than that of the index, and hence a percent return on the index is accompanied by more than a percent return on the fund. So, in relative terms, the fund beats the index in good states (high W_T) and lags in bad states (low W_T). In panel (b), the fund risk exposure is lower than that of the index, and hence a percent return on the index is matched by less than a percent return on the fund. Then in good states (high W_T), the fund is actually underperforming the index, while outperforming in bad states (low W_T). Accordingly, the incentives to adjust risk exposure relative to the status quo level $\hat{\theta}$ are distinctly different in the two scenarios, akin to the two distinct behavior presented in Proposition 1.

The figure highlights the existence of a finite range of portfolio values over which the utility is nonconcave, and hence the manager has an incentive to gamble. That is, she would always

¹⁰The role of the figure is to illustrate our results by appealing to a simple two-period intuition. To construct the figure, we fixed the manager’s risk exposure, $\hat{\theta}$, to be a constant above that of the index, θ^Y in economies (a), and to be below in economies (b). This is as in Proposition 1, where $\hat{\theta}_t$ is above (below) θ^Y in economies (a) (economies (b)).

prefer adding a zero present value gamble $\{+\varepsilon_1$ with probability 50%, $-\varepsilon_2$ with probability 50%\} to her status quo portfolio (defined by fixed $\hat{\theta}$) over ending up with a value in the suboptimal $(\underline{W}_a, \overline{W}_a)$ or $(\underline{W}_b, \overline{W}_b)$ ranges. An additional layer of complexity in our setup is that the nature of the nonconcavity changes dynamically, and the mapping from Figure 3 to 1 accounts for that. Correspondingly, the optimal terminal fund portfolio value derived in Proposition 1 features a discontinuity, responsible for the manager’s risk-shifting behavior. How would the manager, whose investment opportunity set consists of assets with continuous distributions, achieve a discontinuous optimal wealth profile? Simply, by taking advantage of continuous trading and thus synthetically replicating a 50/50 gamble, or its close substitute, a binary option. One can see from the expressions for the optimal trading strategies that they indeed contain binary option-type components. What if, perhaps more realistically, the manager is unable to synthetically create a binary option, as would be the case, for example, in the popular two-period model with continuous state space but with a finite number of securities available for investment? The above argument indicates that in such an economy the manager would clearly benefit from introduction of specific securities into her investment opportunity set: binary options. We note that this discussion applies generally to any preferences exhibiting a nonconcavity, and is not driven by the fact that in our setting the manager’s payoff essentially includes a binary option.

2.4 Costs of Active Management to Investors

Implicit and explicit incentives that the manager faces make her adopt a policy that deviates from the optimal policy of the investor, θ^I . In order to evaluate the economic significance of this deviation, we compute the utility loss to the investor of delegating his money to the manager. Following Cole and Obstfeld (1991), we define a cost-benefit measure, $\hat{\lambda}$, reflecting the investor’s gain/loss quantified in units of his initial wealth:

$$V^I((1 + \hat{\lambda})W_0) = \hat{V}(W_0),$$

where $V^I(\cdot)$ denotes the investor’s indirect utility under his optimal policy θ^I , and $\hat{V}(\cdot)$ his indirect utility under delegation. In order to disentangle the implications of explicit and implicit incentives of the manager, we decompose the total cost-benefit measure into two components: λ^N and λ^Y . The former captures the effects of the manager’s attitude towards risk driving her normal policy, while the latter the effects of implicit incentives. In particular, λ^N solves $V^I((1 + \lambda^N)W_0) = \hat{V}(W_0; f_T = 1)$, where $\hat{V}(W_0; f_T=1)$ denotes the investor’s indirect utility under delegation absent implicit incentives, and λ^Y solves $1 + \hat{\lambda} = (1 + \lambda^N)(1 + \lambda^Y)$.

The main parameter governing the gain/loss due to explicit incentives is the manager’s risk aversion, γ_M . Absent implicit incentives, the further γ_M deviates from the investor’s risk aversion, γ_I , the larger the discrepancy between the optimal risk exposure of the manager, θ^N , and that

desired by the investor, θ^I , and consequently the higher the loss to the investor. As reported in Tables 1a and 1b, the loss due to explicit incentives, λ^N , is zero when the manager and the investor have the same attitude towards risk, $\gamma_M = \gamma_I (= 2)$. However, for $\gamma_I = 0.5$ such a loss can be quite significant: 33.87% in economies (a) and 10.20% in economies (b).¹¹

The strength of the implicit incentives is dependent upon the value of the option component due to fund flows relative to the total value of the compensation package of the manager. Absent explicit incentives, the more important this option component is, the more the manager engages in the gambling behavior in the underperformance region, deviating further from the investor’s desired risk exposure. The value of the option component is increasing in the implicit reward for outperformance, $f_H - f_L$. Accordingly, the loss to the investor due to implicit incentives, λ^Y , increases with $f_H - f_L$. For the largest implicit reward we consider in Table 1, $f_H - f_L = 1.0$, the loss is 7.35% in economies (a) and 8.26% in economies (b). Additionally, this value inherits the properties of the binary “asset-or-nothing” option with a stochastic strike Y . In particular, the value is sensitive to the volatility of the underlying $\sigma|\theta_t - \theta^Y|$. This observation renders insights into identifying economic environments, in which the effects of implicit incentives would be most pronounced. For example, in Table 1a we report the cost due to implicit incentives of 12.92% for the highest risk exposure of the index we consider ($\theta^Y = 1.5$), and in Table 1b a corresponding cost of 9.16%.

The explicit and implicit incentives effects reinforce each other in harming of the investor. Table 1 reports the total cost due to both explicit and implicit incentives, $\hat{\lambda}$ ranging from 0.95% to 57.60%. Invoking mutual funds as our leading example, this begs for an action on the part of mutual fund investors or regulators aimed at better aligning the incentives of mutual fund managers with those of investors.

3. Unwinding the Manager’s Incentives with Benchmarking

As argued in the previous section, explicit and implicit incentives sway mutual fund managers away from adopting asset allocation policies that are optimal for investors. A natural question to ask then is what investors or regulators can do to better align the incentives of fund managers. One approach is to design an appropriate compensation contract. While arguably a cleverly-designed contract may achieve superior benefits to the investor over the mechanism we propose below, it

¹¹The values reported in Table 1 are for the model parameters, calibrated to conform with the observed market dynamics and roughly capturing the observed flow-performance relationship for mutual funds. The market parameters in economies (b) represent “unfavorable” market conditions designed to temper the manager’s normal risk exposure below that of the index assumed to be the stock market. Although we do not frequently observe mutual fund managers holding a leveraged portfolio, the standard argument (Merton (1971) applied to parameter estimates based on historical data) predicts that they should. This observation is related to the equity premium puzzle (Mehra and Prescott (1985)).

may not be very practical. This must be part of the reason why the real-life fund managers are primarily compensated based on net asset value of the fund (have linear contracts). Our approach, on the contrary, is quite easy to implement and is in the spirit of a widespread practice.

3.1 A Benchmarking Restriction

We would like to design a risk management restriction, which if imposed on the fund manager, will reduce her implicit-incentives-induced risk taking behavior as well as bring the manager's effective risk aversion closer to that of the investor. Such a restriction has to be state-dependent: we would like it to affect the manager's risk exposure in the underperformance states, in which she engages in gambling to a greater extent than in the outperformance states where her risk exposure is within well-defined bounds. Unlike, for example, a simple solution such as a short sale constraint, which will work towards this goal in economies (b) but not in economies (a), where the manager optimally never wants to short the stock, we would also want our restriction to apply uniformly to all economies. We propose *benchmarking* the manager to a value-weighted portfolio X , with a fraction δ invested in the stock market and $(1 - \delta)$ in the money market. Anticipating our results, to achieve reduction of the effects of implicit incentives, we require that the risk exposure of the benchmark, $\theta^X = \delta$, is less than that of the index, θ^Y . To simplify presentation in the proposition below, we further restrict the risk exposure of the benchmark to be below the manager's normal exposure. In the sequel, we comment on the manager's optimal behavior when these two conditions are violated. The *benchmarking restriction* can be formally stated as

$$R_T^W - R_T^X \geq \varepsilon, \quad \theta^X \leq \min\{\theta^N, \theta^Y\}, \quad (4)$$

where ε is the manager's *allowed shortfall*. For example, $\varepsilon = -5\%$ means that the maximal shortfall of the manager's return over that of the benchmark may not exceed 5%. This restriction nests several popular risk management practices, including portfolio insurance ($\delta = 0, \varepsilon < 0$) and stock market indexing ($\delta = 1, \varepsilon = 0$). Absent delegation and implicit incentives, such a dynamic investment problem has recently been studied by Tepla (2001) and Basak, Shapiro and Tepla (2002). The advantage of this restriction is that the contracted quantities are easily observable. In that, a benchmarking restriction has a clear advantage over constraints imposed on dynamic trading strategies, unless a fund's positions are frequently monitored. The benchmarking restriction does not necessitate frequent monitoring: it is sufficient to just observe the horizon return.

Proposition 2 characterizes the solution to (3)–(4) in terms of the primitive economic state variable ξ .

Proposition 2. *The optimal risk exposure and terminal wealth of a fund manager facing implicit incentives and a benchmarking restriction are given by*

(a) for economies with $\theta^N > \theta^Y$:

$$\begin{aligned}
\theta_t^* &= \theta^N + \left[\mathcal{N}(d(\hat{\kappa}, \check{\xi})) - \mathcal{N}(d(\hat{\kappa}, \hat{\xi})) \right] \left(\frac{\gamma_M}{\hat{\kappa}} - 1 \right) A \theta^N Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} / W_t^* \mathbf{1}_{\{a_2, a_3, a_4\}} \\
&\quad + \mathcal{N}(-d(\check{\kappa}, \check{\xi})) (\gamma_M / \check{\kappa} - 1) B \theta^N Z(\check{\kappa}) \xi_t^{-1/\check{\kappa}} / W_t^* \\
&\quad + \left\{ \left[\phi(d(\hat{\kappa}, \check{\xi})) - \phi(d(\hat{\kappa}, \hat{\xi})) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} \mathbf{1}_{\{a_2, a_3, a_4\}} \right. \\
&\quad \left. + \left[\phi(d(\gamma_M, \tilde{\xi})) f_H^{(1/\gamma_M - 1)} + \left(\phi(d(\gamma_M, \check{\xi})) - \phi(d(\gamma_M, \xi_a)) \right) f_L^{(1/\gamma_M - 1)} \mathbf{1}_{\{a_4\}} \right] \frac{Z(\gamma_M)}{(y^* \xi_t)^{1/\gamma_M}} \right. \\
&\quad \left. - \phi(d(\check{\kappa}, \check{\xi})) B Z(\check{\kappa}) \xi_t^{-1/\check{\kappa}} \right\} \frac{\gamma_M \theta^N}{\hat{\kappa} \sqrt{T-t} W_t^*}, \\
W_T^* &= \frac{1}{f_H} J_M \left(\frac{y^*}{f_H} \xi_T \right) \mathbf{1}_{\{\xi_T < \tilde{\xi}\}} + e^\eta Y_T \mathbf{1}_{\{\tilde{\xi} \leq \xi_T < \check{\xi}; a_2, a_3, a_4\}} + \frac{1}{f_L} J_M \left(\frac{y^*}{f_L} \xi_T \right) \mathbf{1}_{\{\check{\xi} \leq \xi_T < \xi; a_4\}} \\
&\quad + e^\varepsilon X_T \mathbf{1}_{\{\check{\xi} \leq \xi_T\}}
\end{aligned}$$

(b) for economies with $\theta^N < \theta^Y$:

$$\begin{aligned}
\theta_t^* &= \theta^N + \left[\mathcal{N}(d(\hat{\kappa}, \check{\xi})) - \mathcal{N}(d(\hat{\kappa}, \xi_b)) \right] \left(\frac{\gamma_M}{\hat{\kappa}} - 1 \right) A \theta^N Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} / W_t^* \mathbf{1}_{\{b_2, b_3, b_4, b_5\}} \\
&\quad + \left[\left(\mathcal{N}(d(\check{\kappa}, \xi_b)) - \mathcal{N}(d(\check{\kappa}, \xi_1)) \right) \mathbf{1}_{\{b_2, b_3\}} + \mathcal{N}(-d(\check{\kappa}, \check{\xi})) \right] \left(\frac{\gamma_M}{\check{\kappa}} - 1 \right) B \theta^N Z(\check{\kappa}) \xi_t^{-1/\check{\kappa}} / W_t^* \\
&\quad + \left\{ \left[\phi(d(\hat{\kappa}, \check{\xi})) - \phi(d(\hat{\kappa}, \xi_b)) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} \mathbf{1}_{\{b_2, b_3, b_4, b_5\}} \right. \\
&\quad \left. + \left[\phi(d(\gamma_M, \tilde{\xi})) f_L^{(1/\gamma_M - 1)} + \left(\phi(d(\gamma_M, \check{\xi})) - \phi(d(\gamma_M, \xi)) \right) f_H^{(1/\gamma_M - 1)} \mathbf{1}_{\{b_3, b_5\}} \right] \frac{Z(\gamma_M)}{(y^* \xi_t)^{1/\gamma_M}} \right. \\
&\quad \left. + \left[\left(\phi(d(\check{\kappa}, \xi_b)) - \phi(d(\check{\kappa}, \xi_1)) \right) \mathbf{1}_{\{b_2, b_3\}} - \phi(d(\check{\kappa}, \check{\xi})) \right] B Z(\check{\kappa}) \xi_t^{-1/\check{\kappa}} \right\} \frac{\gamma_M \theta^N}{\hat{\kappa} \sqrt{T-t} W_t^*}, \\
W_T^* &= \frac{1}{f_L} J_M \left(\frac{y^*}{f_L} \xi_T \right) \mathbf{1}_{\{\xi_T < \tilde{\xi}\}} + e^\eta Y_T \mathbf{1}_{\{\xi_b \leq \xi_T < \check{\xi}; b_2, b_3, b_4, b_5\}} + \frac{1}{f_H} J_M \left(\frac{y^*}{f_H} \xi_T \right) \mathbf{1}_{\{\check{\xi} \leq \xi_T < \xi; b_3, b_5\}} \\
&\quad + e^\varepsilon X_T \mathbf{1}_{\{(\xi_1 \leq \xi_T < \xi_b; b_2, b_3) \text{ or } (\check{\xi} \leq \xi_T)\}}
\end{aligned}$$

where in all economies y^* solves $E[\xi_T W_T^*] = W_0$, with $J_M(\cdot)$, $\mathcal{N}(\cdot)$, $\phi(\cdot)$, $g(\cdot)$, $Z(\cdot)$, $d(\cdot)$, $\hat{\xi}$, ξ_a , ξ_b , A , $\hat{\kappa}$ as given in Proposition 1, and $\check{\kappa} = \kappa / (\delta \sigma)$, $\xi_1 = (y^* B^{\gamma_M} / f_L^{1-\gamma_M})^{1/(\gamma_M / \check{\kappa} - 1)}$, $\xi_2 = (y^* B^{\gamma_M} / f_H^{1-\gamma_M})^{1/(\gamma_M / \hat{\kappa} - 1)}$, $\xi_3 = (A/B)^{k/(\sigma(\beta-\delta))}$, $B = W_0 e^{[\varepsilon/T + (1-\delta)r + \delta(\mu - \sigma^2/2 - (r + \kappa^2/2)\sigma/\kappa)]T}$.

Economies (a) have four subcases: in a_1 $\xi_3 \leq \xi_2 \leq \hat{\xi}$, in a_2 $\hat{\xi} < \xi_2 < \xi_3$, in a_3 $\xi_1 \leq \xi_a \leq \hat{\xi}$, in a_4 $\xi_a < \xi_1 < \xi_3$, and then $\tilde{\xi} = \xi_2$ in a_1 and $\tilde{\xi} = \hat{\xi}$ otherwise; $\xi = \xi_3$ in a_2 and $\xi = \xi_a$ in a_3 , a_4 ; $\check{\xi} = \xi_2, \xi_3, \xi_a, \xi_1$, in a_1, a_2, a_3, a_4 respectively;

Economies (b) have five subcases: in b_1 $\xi_1 < \xi_3 \leq \xi_b$, in b_2 $\xi_1 < \xi_b < \xi_3 < \hat{\xi}$, in b_3 $\xi_1 < \xi_b < \hat{\xi} < \xi_3$, in b_4 $\xi_b \leq \xi_3 < \hat{\xi}$ and $\xi_b \leq \xi_1$, in b_5 $\xi_b < \hat{\xi} < \xi_3$ and $\xi_b \leq \xi_1$, and then $\tilde{\xi} = \xi_1$ in b_1, b_2, b_3 and $\tilde{\xi} = \xi_b$ otherwise; $\xi = \xi_3$ in b_2, b_4 and $\xi = \hat{\xi}$ in b_3, b_5 ; $\check{\xi} = \xi_1$ in b_1 , $\check{\xi} = \xi_3$ in b_2, b_4 , $\check{\xi} = \xi_2$ in b_3, b_5 .

The benchmarking restriction renders a much richer structure to the solution, with multiple subcases appearing for each economy. Figure 4 highlights the implications of the benchmarking restriction for the manager's optimal risk exposure by superimposing the optimal policies revealed by Proposition 2 on pertinent panels of Figure 1 from Section 2.

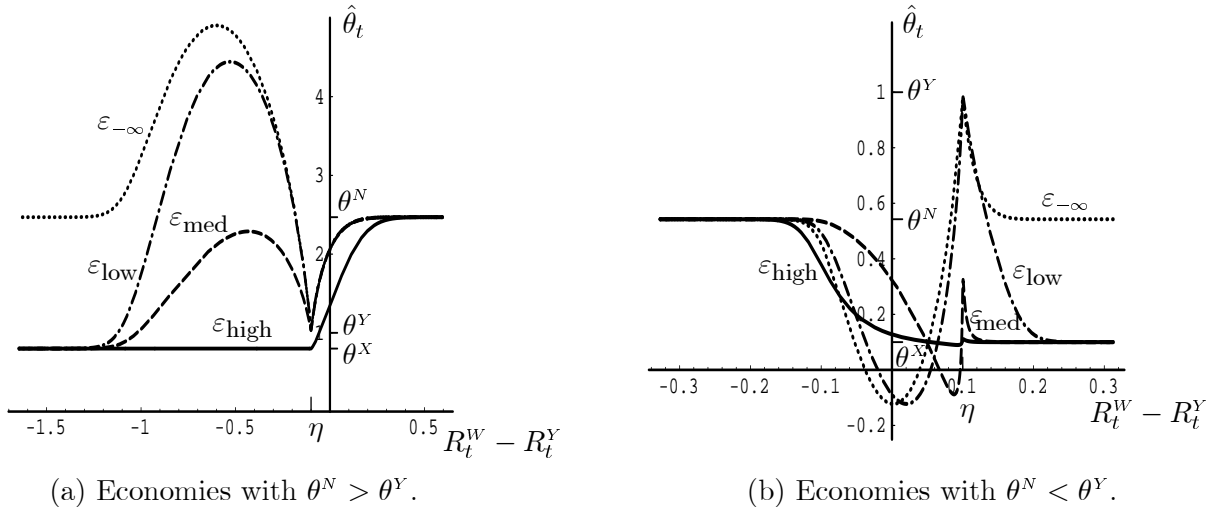


Figure 4. The effects of the benchmarking restriction. In economies (a) $\varepsilon_{\text{low}} = -1.0$, $\varepsilon_{\text{med}} = -0.5$, $\varepsilon_{\text{high}} = -0.05$, and $\delta = 0.8$; in (b) $\varepsilon_{\text{low}} = -0.2$, $\varepsilon_{\text{med}} = -0.04$, $\varepsilon_{\text{high}} = -0.01$, and $\delta = 0.1$. The remaining parameter values are the same as in Figure 1.

The figure underscores the importance of imposing a state-dependent restriction on the manager for the purposes of reducing her implicit incentive-induced tendencies to gamble. In the states in which the manager is outperforming the index, the benchmarking restriction does not drastically affect her behavior. In contrast, in the underperformance states, in both types of economies, the benchmark has a significant effect by forcing the manager to tilt her risk exposure closer towards the risk exposure of the benchmark X . Since by construction, the benchmark we propose is safer than both the manager's normal policy and the index, it will always act in the direction of reducing the manager's risk exposure. The lever controlling how much power the benchmarking restriction has in reducing the risk exposure is the allowed shortfall ε . An allowed shortfall of close to $-\infty$ essentially removes the benchmarking restriction; as ε increases, the manager's risk exposure is forced to approach that of the benchmark, converging to the latter when ε reaches its upper bound (the highest allowed shortfall for which satisfying the benchmarking restriction is feasible for the manager). Loosely speaking, it is this lever ε that gives rise to a range of subcases in Proposition 2. For the subcases corresponding to a very low ε (economies a_4 , b_4 , b_5), the manager is allowed to underperform the benchmark by a large amount, and so the benchmarking restriction has practically no effect in the range where the manager gambles (dotted plots in Figure 4). By increasing ε , we move to subcases a_3 , b_2 and b_3 , for which the benchmarking restriction is strong enough to target the risk-exposure humps induced by implicit incentives (dashed plots). Finally, for high enough ε (economies a_1 , a_2 , b_1), we reach the subcases where the gambling behavior is no longer present (solid plots).

Perhaps of no lesser importance to investors are also explicit incentives the manager faces. The benchmarking restriction can be very effective in aligning those as well. Absent implicit incentives,

the general rule is very simple: the manager’s risk exposure decreases if she is benchmarked to a portfolio X that is less risky than her normal policy, otherwise increases if benchmarked to X that is riskier than her normal policy. The overall effect of the benchmarking restriction on the manager’s incentives reflects the interaction of the two mechanisms described above. We assess it quantitatively in the following section, and discuss the cost-benefit implications for the investor.

The expressions for the optimal terminal portfolio value revealed by Proposition 2 make the distinction between the subcases we discussed very precise. The parameter space is subdivided into two (in a_1, b_1) to five (in b_3) regions of distinct behavior of the manager. Although the expressions for the subcases offer additional insights into the subtleties of the manager’s economic behavior, we do not present the details here in the interest of preserving space.

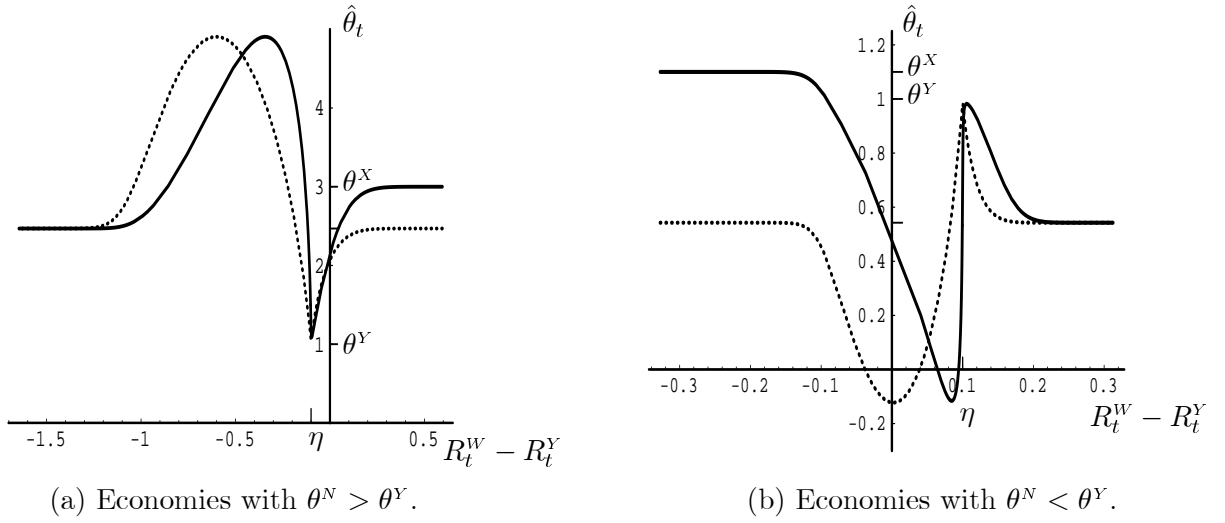


Figure 5. The effects of the benchmarking restriction with $\theta^X > \max\{\theta^N, \theta^Y\}$. The solid plots are for the risk exposure of the manager facing a benchmarking restriction, and the dotted plots are for the unconstrained manager. In economies (a) $\varepsilon = -0.25$, $\delta = 3$, and in economies (b) $\varepsilon = -0.125$, $\delta = 1.1$. The remaining parameter values are the same as in Figure 1.

Finally, we comment that our choice of a benchmark that is safer than both the manager’s normal policy and the index, $\theta^X \leq \min\{\theta^N, \theta^Y\}$, was for expositional purposes, and is also most likely to be a choice that will favorably resonate with regulators and investors. Indeed, Figure 5 examines the scenario in which the benchmark is riskier than both the normal policy and the index, $\theta^X > \max\{\theta^N, \theta^Y\}$. The contrast with Figure 4 is striking. The risk taking incentives are not reduced, on the contrary, the risk exposure is amplified as the manager tilts her portfolio towards the riskier benchmark X .

3.2 Cost-Benefit Implications of Benchmarking

To quantify the effects of imposing a benchmarking restriction, we need to define a measure of an incremental increase in the investor’s utility due to restraining the manager, λ^* :

$$V^I((1 + \lambda^*)(1 + \hat{\lambda})W_0) = V^*(W_0),$$

where $\hat{\lambda}$ is the utility loss to the investor absent the benchmarking restriction as defined in Section 2.4, and $V^*(\cdot)$ is the indirect utility of the investor under delegation with benchmarking. A positive λ^* means that the benchmarking restriction benefits the investor.

At the outset, one rarely thinks of investment restrictions as being beneficial. This would certainly be impairing if we proposed imposing a constraint on the investor himself. However, in the context of delegated money management, risk management restrictions can be economically justified. Consider, for example, the case of a highly risk averse investor (more precisely, consider the case of $\theta^I < \min\{\theta^N, \theta^Y\}$). Suppose now that we benchmark the fund manager to a low-risk portfolio X , along the lines of Section 3.1. As one can infer from Figure 4, by tightening the benchmarking restriction (increasing ε), the investor or a regulator can effectively reduce the risk exposure of the manager, bringing her policy closer to that optimal for the investor. Indeed, the corresponding gains reported in Table 2 for this scenario are all positive and can be very large in magnitude: for example, in the top left entry, an increase of 130.6% (most of the loss is recouped) in economies (a) and 11.84% in economies (b).

The surprising result is that even a risk tolerant investor may benefit from benchmarking a less risk tolerant manager to a safer portfolio. One could argue that such an investor would simply desire to increase the manager’s risk exposure, as the latter is normally below the investor’s optimal policy, by benchmarking the manager to a riskier portfolio. Instead, Table 2 illustrates that the reverse can be true. In Table 2, the benchmark portfolio X is safer than the optimal risk exposure of both the investor and the manager, but nevertheless all entries for the cost-benefit measure λ^* (including those in which the manager is less risk tolerant than the investor, $\gamma_M > \gamma_I$) are positive (except for the case of $\gamma_M = 3.5$ in Table 2a). These results show that the simple argument in favor of a riskier benchmark fails in the context of real-life mutual fund managers whose policies may be driven by implicit incentives to a larger degree than by their attitudes towards risk.

Once we have demonstrated that a benchmarking restriction reduces the cost of delegation, the natural next step is to ask how such a restriction needs to be designed for the highest benefit to the investor. The guideline can be inferred from Table 2. There are two parameters of the restriction that investors or regulators are free to choose: the risk exposure of the benchmark θ^X and the allowed shortfall ε . Table 2 shows an optimum for both. In economies (a), the optimal benchmarking restriction calls for selecting the risk exposure of around 0.4 (40% stock/ 60% money

market) and the allowed shortfall of about 0.20. In economies (b), these numbers are 0.15 and 0.05, respectively. In both economies, it is beneficial to the investor to benchmark the manager to a relatively safe portfolio. The benchmarking restriction is quite loose in economies (a) and very tight, close to the upper bound on ε , in economies (b).

4. Conclusion

In this paper we have attempted to isolate the two most important adverse incentives of a fund manager: an implicit incentive to perform well relative to an index, and an explicit incentive to manage the fund in accordance with her own appetite for risk. Implicit incentives introduce a nonconcavity in the manager's problem, akin to nonconcavities observed in many corporate finance applications (e.g., asset substitution problem, executive compensation, hedge fund managers compensation). We solve the manager's problem within a standard dynamically-complete Black and Scholes (1973) framework. The complete markets assumption offers considerable tractability, allowing us to derive the manager's optimal policy in closed-form, and also establishes a useful reference point for future research. In many real world applications, nonconcavities in the payoff structure go hand-in-hand with capital markets frictions, for example with restrictions against trading the underlying security designed to induce the "right" incentives to the manager. Our story of the optimal interaction of risk-shifting with risk aversion would then be further compounded by the effects of such frictions.

In our setup, the need for risk management restrictions arises as a natural consequence of aligning the manager's incentives with those of investors, who are significantly impaired by the manager's choice of risk exposure. The benchmarking restriction we advocate, clearly benefits the investor. However, our analysis leaves aside many possible constraints that may also be beneficial. We believe that endogenizing investment restrictions in the context of delegated money management is a fruitful area for future research. It would also be of interest to endogenize within our model the fund-flows to relative-performance relationship that we have taken as given.

There is some empirical work, such as Brown, Harlow, and Starks (1996) documenting that managers increase their risk exposure halfway during the year when underperforming. This is consistent with our manager's optimal behavior in economies (a), in which the index is less risky than the manager's normal policy. Subsequent work would be to investigate empirically whether in the economic environments where the index is riskier, the manager's behavior is consistent with that predicted by our analysis (economies (b)).

Appendix: Proofs

Proof of Proposition 1. Before proceeding with the proof, we present for completeness the results that for brevity were not included in the body of the proposition. First, note that for $\gamma_M = 1$, $g(\cdot)$ takes the form: $g(\xi) = -\left(\ln \frac{\hat{y}\xi}{f_L} + 1 - \ln \frac{\xi^{1/\hat{\kappa}}}{A f_H}\right) + y A \xi^{1-1/\hat{\kappa}}$. Second, since $\hat{W}_t \xi_t$ is a martingale (given the dynamics of \hat{W}_t and ξ_t), the time- t wealth is obtained by evaluating the conditional expectation of $\hat{W}_T \xi_T$. In the economies described in (a):

$$\begin{aligned} \hat{W}_t &= E_t \left[\hat{W}_T \xi_T / \xi_t \right] \\ &= \left[\mathcal{N}(d(\gamma_M, \hat{\xi})) f_H^{(1/\gamma_M - 1)} + \mathcal{N}(-d(\gamma_M, \xi_a)) f_L^{(1/\gamma_M - 1)} \right] Z(\gamma_M) (\hat{y} \xi_t)^{-1/\gamma_M} \\ &\quad + \left[\mathcal{N}(d(\hat{\kappa}, \xi_a) - \mathcal{N}(d(\hat{\kappa}, \hat{\xi})) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}}. \end{aligned} \quad (\text{A1})$$

Similarly, in the economies described in (b):

$$\begin{aligned} \hat{W}_t &= \left[\mathcal{N}(d(\gamma_M, \xi_b)) f_L^{(1/\gamma_M - 1)} + \mathcal{N}(-d(\gamma_M, \hat{\xi})) f_H^{(1/\gamma_M - 1)} \right] Z(\gamma_M) (\hat{y} \xi_t)^{-1/\gamma_M} \\ &\quad + \left[\mathcal{N}(d(\hat{\kappa}, \hat{\xi}) - \mathcal{N}(d(\hat{\kappa}, \xi_b)) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}}. \end{aligned} \quad (\text{A2})$$

Finally, when $\theta^N = \theta^Y$, if $\eta \leq \beta(1 - \beta)\sigma^2 T/2$ (so that $e^\eta Y_T$ and hence $R_T^Y + \eta$ are feasible) or $\eta \geq \bar{\eta}$ (so that $e^\eta Y_T$ and hence $R_T^Y + \eta$ are above a critical level of infeasibility), then $\hat{\theta}_t = \theta^N$ and $\hat{W}_T = J_M(\hat{y} \xi_T)$; otherwise $\hat{W}_T = \left\{ \frac{1}{f_L} J_M \left(\frac{\bar{y}}{f_L} \xi_T \right) \text{ or } e^\eta Y_T \right\}$, with the indifference solution alternating between the two values in any way that satisfies the budget constraint, where (using the steps outlined below) one can show that $\bar{\eta}$ solves $g\left(\xi = 1, y = f_L^{1-\hat{\kappa}} e^{(1-\hat{\kappa})(\mu+r-2(1-\beta)r)T/(2\beta)} / W_0^{\hat{\kappa}}, \eta\right) = 0$, and $\bar{y} > f_H^{1-\gamma_M} / A^{\gamma_M}$ solves $g(\xi = 1, y) = 0$.

We now proceed with the steps of the proof. To obtain the risk exposure expressions in the proposition, note that from (1), the diffusion term of the manager's optimal portfolio value process is $\hat{\theta}_t \sigma \hat{W}_t$. Equating the latter term with the diffusion term obtained by applying Itô's Lemma to (A1) and (A2) yields the expressions for $\hat{\theta}_t$ in economies (a) and (b), respectively. Therefore, to complete the proof, it is sufficient to establish optimality of the given terminal wealth \hat{W}_T . Methodologically, most related to this proof is the proof of Proposition 2 of the constrained model in Basak, Shapiro, and Tepla (2002), but the setting here is notably different and the optimization problem is unconstrained. The non-concavity of the problem, arising due to (3), has an extra dimension of complexity, as not only does the expression we employ for the convex conjugate has a discontinuous non-concavity at a stochastic location, but the magnitude of the discontinuity is stochastic as well. Therefore, to our knowledge, the way the proof below adapts the martingale representation and the convex-duality techniques (see, e.g., Karatzas and Shreve (1988)) to a non-concave problem, has not been previously used in the literature.

Appealing to the martingale representation approach, the dynamic budget constraint (1) of the manager's optimization problem can be restated using the terminal value of the state price density

process as $E[\hat{W}_T \xi_T] = W_0$. The manager thus effectively solves a static variational problem (in which, without loss of generality, $\xi_0 = 1$). For a given value of θ^N and θ^Y , let W_T be any candidate optimal solution, satisfying the static budget constraint $E[W_T \xi_T] \leq W_0$. Consider the following difference in the manager's expected utility:

$$\begin{aligned} & E[u_M(\hat{W}_T f_T)] - E[u_M(W_T f_T)] = E[u_M(\hat{W}_T f_T)] - \hat{y}W_0 - (E[u_M(W_T f_T)] - \hat{y}W_0) \\ & \geq E[u_M(\hat{W}_T f_T)] - E[\hat{y}\hat{W}_T \xi_T] + (E[u_M(W_T f_T)] - E[\hat{y}W_T \xi_T]) = E[v(\hat{W}_T, \xi_T) - v(W_T, \xi_T)], \end{aligned} \quad (\text{A3})$$

where the inequality is due to \hat{W}_T satisfying the budget constraint with equality, while W_T satisfying the budget constraint with inequality, and where

$$v(W, \xi) = u_M(W f_L 1_{\{R^W - R^Y < \eta\}} + W f_H 1_{\{R^W - R^Y \geq \eta\}}) - \hat{y}W\xi.$$

To show optimality of \hat{W}_T , it is left to show that the right-hand side of (A3) is non-negative. Given the geometric Brownian motion dynamics of Y_T and ξ_T , and using the normalization of Y_0 and ξ_0 , it is straightforward to verify that $Y_T = Ae^{-\eta}\xi_T^{-\beta\sigma/\kappa}$, and we get

$$v(W, \xi) = u_M(W f_L 1_{\{W < A\xi^{-\beta\sigma/\kappa}\}} + W f_H 1_{\{W \geq A\xi^{-\beta\sigma/\kappa}\}}) - \hat{y}W\xi.$$

Given the manager's CRRA preferences, to establish the non-negativity of (A3), one needs to account for the relation between the parameters γ_M , β , σ , and κ . To avoid repetition of technical details, we provide the proof for optimality of \hat{W}_T for the economies in (a) with $\gamma_M > 1$. The logic of the proof applies to the remaining subdivisions of the parameter space, as identified in the Proposition. Therefore, we now show that for the case in which $\kappa/(\beta\sigma) > \gamma_M > 1$,

$$\arg \max_W v(W, \xi) = f_H^{1/\gamma_M - 1} (\hat{y}\xi)^{-1/\gamma_M} 1_{\{\xi < \hat{\xi}\}} + A\xi^{-\beta\sigma/\kappa} 1_{\{\hat{\xi} \leq \xi < \xi_a\}} + f_L^{1/\gamma_M - 1} (\hat{y}\xi)^{-1/\gamma_M} 1_{\{\xi_a \leq \xi\}}.$$

Indeed, in the convex conjugate construction, there are three local maximizers of $v(W, \xi)$: $W_H \equiv \frac{1}{f_H} J_M \left(\frac{\hat{y}}{f_H} \xi \right) = f_H^{1/\gamma_M - 1} (\hat{y}\xi)^{-1/\gamma_M}$, $W_L \equiv \frac{1}{f_L} J_M \left(\frac{\hat{y}}{f_L} \xi \right) = f_L^{1/\gamma_M - 1} (\hat{y}\xi)^{-1/\gamma_M}$, and $W_A \equiv A\xi^{-\beta\sigma/\kappa}$, where each of the three can become the global maximizer of $v(W, \xi)$ for different values of ξ . When $\xi = \hat{\xi}$, then $W_H(\hat{\xi}) = W_A(\hat{\xi})$. When $\xi < \hat{\xi}$, then $W_L > W_H > W_A$ holds under the given subdivision of the parameter space, and so for $W \in \{W_L, W_H, W_A\}$, we get $v(W, \xi) = u_M(W f_H) - \hat{y}W\xi$, establishing W_H as the global maximizer. When $\xi > \hat{\xi}$, then $W_H < \min(W_A, W_L)$, and $v(W_H, \xi) = u_M(W_H f_L) - \hat{y}W_H \xi$, establishing that W_H cannot be the global maximizer, because for $W_L < W_A$ by the local optimality of W_L , we have $u_M(W_H f_L) - \hat{y}W_H \xi < u_M(W_L f_L) - \hat{y}W_L \xi = v(W_L, \xi)$, and for $W_L \geq W_A$ accounting for the local optimality of W_A due to the stochastic non-concavity, we have $u_M(W_H f_L) - \hat{y}W_H \xi < u_M(W_A f_L) - \hat{y}W_A \xi = v(W_A, \xi)$. Moreover, for $\xi > \xi$, where $\xi = (\hat{y}A^{\gamma_M}/f_L^{1-\gamma_M})^{1/(\gamma_M/\kappa-1)} > \hat{\xi}$, we have $W_L < W_A$; whereas for the range $\hat{\xi} \leq \xi < \xi$, we get $W_L > W_A$, and for this range W_A is the global maximizer. Finally, note that for $\xi > \xi$, we obtain $v(W_L, \xi) = v(W_A, \xi) + g(\xi)$. Then, using $\kappa/(\beta\sigma) > \gamma_M > 1$, and the fact that $g(\xi) < 0$,

$g(\infty) = \infty$, it is straightforward to verify that $g(\xi) > 0$ if and only if $\xi > \xi_a$, where $g(\xi_a) = 0$, and $\xi_a > \underline{\xi}$, thereby completing the proof for the case of interest in the parameter space. Note that since $W_L(\underline{\xi}) = W_A(\underline{\xi})$, having $\hat{W} = W_A$ for $\hat{\xi} < \xi < \xi_a$ gives rise to a discontinuity in \hat{W}_T as a function of ξ_T at ξ_a . The discontinuity arises in the other subcases in (a) as well, and analogously, under the parameter values in (b), the optimal policy is discontinuous at ξ_b . ■

Proof of Proposition 2. In states in which the benchmarking restriction in (4) is binding, the manager's terminal wealth is given by $W_T^* = e^\varepsilon X_T$, where similarly to the case with the index Y , the benchmark level X_T is given by $X_T = B e^{-\varepsilon} \xi_T^{-\delta\sigma/\kappa}$. In states in which the restriction is not binding, the Lagrange multiplier associated with (4) is zero, and hence $W_T^* = \hat{W}_T(y^*)$, where y^* is the Lagrange multiplier associated with the static budget constraint of the restricted manager. Therefore, the terminal wealth is given by $W_T^* = \max\{\hat{W}_T, e^\varepsilon X_T\}$. For $\varepsilon = -\infty$, we have $W_T^* = \hat{W}_T$, while as ε increases, the maximum operator generates the economies described in the proposition. The time- t wealth can then be obtained as a conditional expectation of the terminal wealth. In the economies described in (a):

$$\begin{aligned}
W_t^* &= \mathcal{N}(d(\gamma_M, \tilde{\xi})) f_H^{(1/\gamma_M-1)} Z(\gamma_M)(y^* \xi_t)^{-1/\gamma_M} \\
&\quad + \left[\mathcal{N}(d(\hat{\kappa}, \check{\xi})) - \mathcal{N}(d(\hat{\kappa}, \hat{\xi})) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} \mathbf{1}_{\{a_2, a_3, a_4\}} \\
&\quad + \left[\mathcal{N}(d(\gamma_M, \check{\xi})) - \mathcal{N}(d(\gamma_M, \xi_a)) \right] f_L^{(1/\gamma_M-1)} Z(\gamma_M)(y^* \xi_t)^{-1/\gamma_M} \mathbf{1}_{\{a_4\}} \\
&\quad + \mathcal{N}(-d(\tilde{\kappa}, \check{\xi})) B Z(\tilde{\kappa}) \xi_t^{-1/\tilde{\kappa}}. \tag{A4}
\end{aligned}$$

In the economies described in (b):

$$\begin{aligned}
W_t^* &= \mathcal{N}(d(\gamma_M, \tilde{\xi})) f_L^{(1/\gamma_M-1)} Z(\gamma_M)(y^* \xi_t)^{-1/\gamma_M} \\
&\quad + \left[\mathcal{N}(d(\hat{\kappa}, \check{\xi})) - \mathcal{N}(d(\hat{\kappa}, \xi_b)) \right] A Z(\hat{\kappa}) \xi_t^{-1/\hat{\kappa}} \mathbf{1}_{\{b_2, b_3, b_4, b_5\}} \\
&\quad + \left[\mathcal{N}(d(\gamma_M, \check{\xi})) - \mathcal{N}(d(\gamma_M, \check{\xi})) \right] f_H^{(1/\gamma_M-1)} Z(\gamma_M)(y^* \xi_t)^{-1/\gamma_M} \mathbf{1}_{\{b_3, b_5\}} \\
&\quad + \left[(\mathcal{N}(d(\tilde{\kappa}, \xi_b)) - \mathcal{N}(d(\tilde{\kappa}, \xi_1))) \mathbf{1}_{\{b_2, b_3\}} + \mathcal{N}(-d(\tilde{\kappa}, \check{\xi})) \right] B Z(\tilde{\kappa}) \xi_t^{-1/\tilde{\kappa}}. \tag{A5}
\end{aligned}$$

The optimal risk exposure is derived for each economy using (A4) and (A5), following the steps outlined in Proposition 1. ■

Table 1a
Costs and benefits of active management in economies (a)

The investor's gain/loss quantified in units of his initial wealth, $\hat{\lambda}$, solves $V^I((1 + \hat{\lambda})W_0) = \hat{V}(W_0)$, where $V^I(\cdot)$ denotes the investor's indirect utility under his optimal policy θ^I , and $\hat{V}(\cdot)$ his indirect utility under delegation. The gain due to explicit incentives, λ^N , solves $V^I((1 + \lambda^N)W_0) = \hat{V}(W_0; f_T = 1)$, where $\hat{V}(W_0; f_T=1)$ denotes the investor's indirect utility under delegation absent implicit incentives. The gain due to implicit incentives, λ^Y , solves $1 + \hat{\lambda} = (1 + \lambda^N)(1 + \lambda^Y)$. The fixed parameter values are (where applicable) $\gamma_M = 1.0$, $\gamma_I = 2.0$, $f_L = 0.7$, $f_H = 1.3$, $(f_L + f_H)/2 = 1$, $\beta = 0.5$, $\eta = 0.1$, $\mu = 0.1$, $r = 0.02$, $\sigma = 0.18$, $W_0 = 1$, $T = 1$.

Effects of		Cost-benefit measures				
		λ^Y, λ^N		$\hat{\lambda}$ (%)		
Managerial risk aversion	γ_M	<u>0.5</u>	<u>1.00</u>	<u>2.00</u>	<u>3.00</u>	<u>3.50</u>
		-33.87, -35.88	-4.20, -4.82	-2.60, 0.00	-0.70, -0.55	-0.04, -0.90
		-57.60	-8.81	-2.60	-1.25	-0.95
Implicit reward for outperformance	$f_H - f_L$	<u>0.2</u>	<u>0.4</u>	<u>0.6</u>	<u>0.8</u>	<u>1.0</u>
		-1.55, -4.82	-2.82, -4.82	-4.19, -4.82	-5.70, -4.82	-7.35, -4.82
		-6.29	-7.51	-8.81	-10.25	-11.81
Risk exposure of the index	θ^Y	<u>0.50</u>	<u>0.75</u>	<u>1.00</u>	<u>1.25</u>	<u>1.50</u>
		-4.20, -4.82	-5.18, -4.82	-7.00, -4.82	-9.65, -4.82	-12.92, -4.82
		-8.81	-9.75	-11.72	-14.00	-17.12
Flow threshold	η	<u>-0.10</u>	<u>-0.05</u>	<u>0.00</u>	<u>0.05</u>	<u>0.10</u>
		3.44, -4.82	3.06, -4.82	1.66, -4.82	-0.97, -4.82	-4.20, -4.82
		-1.54	-1.90	-3.23	-5.75	-8.81

Table 1b
Costs and benefits of active management in economies (b)

The investor's gain/loss quantified in units of his initial wealth, $\hat{\lambda}$, solves $V^I((1 + \hat{\lambda})W_0) = \hat{V}(W_0)$, where $V^I(\cdot)$ denotes the investor's indirect utility under his optimal policy θ^I , and $\hat{V}(\cdot)$ his indirect utility under delegation. The gain due to explicit incentives, λ^N , solves $V^I((1 + \lambda^N)W_0) = \hat{V}(W_0; f_T = 1)$, where $\hat{V}(W_0; f_T=1)$ denotes the investor's indirect utility under delegation absent implicit incentives. The gain due to implicit incentives, λ^Y , solves $1 + \hat{\lambda} = (1 + \lambda^N)(1 + \lambda^Y)$. The fixed parameter values are (where applicable) $\gamma_M = 1.0$, $\gamma_I = 2.0$, $f_L = 0.7$, $f_H = 1.3$, $(f_L + f_H)/2 = 1$, $\beta = 1.0$, $\eta = 0.1$, $\mu = 0.08$, $r = 0.04$, $\sigma = 0.32$, $W_0 = 1$, $T = 1$.

Effects of		Cost-benefit measures				
		λ^Y, λ^N $\hat{\lambda}$ (%)				
Managerial risk aversion	γ_M	<u>0.5</u>	<u>1.00</u>	<u>2.00</u>	<u>3.00</u>	<u>4.00</u>
		-10.20, -3.45	-6.10, -0.39	-3.86, 0.00	-3.00, -0.04	-2.52, -0.09
		-13.31	-6.47	-3.86	-3.01	-2.62
Implicit reward for outperformance	$f_H - f_L$	<u>0.2</u>	<u>0.4</u>	<u>0.6</u>	<u>0.8</u>	<u>1.0</u>
		-3.52, -0.39	-4.98, -0.39	-6.10, -0.39	-7.17, -0.39	-8.26, -0.39
		-3.90	-5.35	-6.47	-7.53	-8.62
Risk exposure of the index	θ^Y	<u>0.50</u>	<u>0.75</u>	<u>1.00</u>	<u>1.25</u>	<u>1.50</u>
		-6.16, -0.39	-5.35, -0.39	-6.10, -0.39	-7.81, -0.39	-9.16, -0.39
		-6.53	-5.72	-6.47	-8.17	-9.51
Flow threshold	η	<u>-0.10</u>	<u>-0.05</u>	<u>0.00</u>	<u>0.05</u>	<u>0.10</u>
		-1.60, -0.39	-2.81, -0.39	-5.63, -0.39	-5.55, -0.39	-6.10, -0.39
		-2.00	-3.19	-6.00	-5.88	-6.47

Table 2a
Costs and benefits of benchmarking to the investor in economies (a)

The investor's gain/loss quantified in units of his initial wealth, $\hat{\lambda}$, solves $V^I((1 + \hat{\lambda})W_0) = \hat{V}(W_0)$, where $V^I(\cdot)$ denotes the investor's indirect utility under his optimal policy θ^I , and $\hat{V}(\cdot)$ his indirect utility under delegation. The incremental increase in the investor's utility due to restraining the manager, λ^* , solves $V^I((1 + \lambda^*)(1 + \hat{\lambda})W_0) = V^*(W_0)$, where $V^*(\cdot)$ is the indirect utility of the investor under delegation with benchmarking. The fixed parameter values are (where applicable) $\gamma_M = 1.0$, $\gamma_I = 2.0$, $\delta = 0.05$, $\varepsilon = -0.2$, $f_L = 0.7$, $f_H = 1.3$, $(f_L + f_H)/2 = 1$, $\beta = 0.5$, $\eta = 0.1$, $\mu = 0.1$, $r = 0.02$, $\sigma = 0.18$, $W_0 = 1$, $T = 1$.

Effects of		Cost-benefit measures $\hat{\lambda}, \lambda^*$				
Managerial risk aversion	γ_M	<u>0.5</u>	<u>1.00</u>	<u>2.00</u>	<u>3.00</u>	<u>3.50</u>
		-57.60, 130.6	-8.81, 8.59	-2.60, 1.63	-1.25, 0.24	-0.95, -0.07
Implicit reward for outperformance	$f_H - f_L$	0.2	0.4	0.6	0.8	1.0
		-6.29, 5.73	-7.51, 7.11	-8.81, 8.59	-10.25, 10.30	-11.81, 12.26
Risk exposure of the index	θ^Y	<u>0.50</u>	<u>0.75</u>	<u>1.00</u>	<u>1.25</u>	<u>1.50</u>
		-8.81, 8.59	-9.75, 9.68	-11.72, 11.41	-14.00, 13.89	-17.12, 17.07
Flow threshold	η	<u>-0.10</u>	<u>-0.05</u>	<u>0.00</u>	<u>0.05</u>	<u>0.10</u>
		-1.54, 0.30	-1.90, 0.88	-3.23, 2.19	-5.75, 5.11	-8.81, 8.59
Risk exposure of the benchmark	θ^X	<u>0.1</u>	<u>0.2</u>	<u>0.3</u>	<u>0.4</u>	<u>0.5</u>
		-8.81, 8.65	-8.81, 8.73	-8.81, 8.78	-8.81, 8.79	-8.81, 8.78
Allowed shortfall	ε	<u>-0.25</u>	<u>-0.20</u>	<u>-0.15</u>	<u>-0.10</u>	<u>-0.05</u>
		-8.81, 8.58	-8.81, 8.59	-8.81, 8.47	-8.81, 8.11	-8.81, 7.29

Table 2b
Costs and benefits of benchmarking to the investor in economies (b)

The investor's gain/loss quantified in units of his initial wealth, $\hat{\lambda}$, solves $V^I((1 + \hat{\lambda})W_0) = \hat{V}(W_0)$, where $V^I(\cdot)$ denotes the investor's indirect utility under his optimal policy θ^I , and $\hat{V}(\cdot)$ his indirect utility under delegation. The incremental increase in the investor's utility due to restraining the manager, λ^* , solves $V^I((1 + \lambda^*)(1 + \hat{\lambda})W_0) = V^*(W_0)$, where $V^*(\cdot)$ is the indirect utility of the investor under delegation with benchmarking. The fixed parameter values are (where applicable) $\gamma_M = 1.0$, $\gamma_I = 2.0$, $\delta = 0.05$, $\varepsilon = -0.2$, $f_L = 0.7$, $f_H = 1.3$, $(f_L + f_H)/2 = 1$, $\beta = 1.0$, $\eta = 0.1$, $\mu = 0.08$, $r = 0.04$, $\sigma = 0.32$, $W_0 = 1$, $T = 1$.

Effects of		Cost-benefit measures $\hat{\lambda}, \lambda^*$				
Managerial risk aversion	γ_M	<u>0.5</u>	<u>1.00</u>	<u>2.00</u>	<u>3.00</u>	<u>4.00</u>
		-13.31, 11.84	-6.47, 3.66	-3.86, 1.47	-3.01, 1.44	-2.62, 1.39
Implicit reward for outperformance	$f_H - f_L$	<u>0.2</u>	<u>0.4</u>	<u>0.6</u>	<u>0.8</u>	<u>1.0</u>
		-3.90, 1.35	-5.35, 2.44	-6.47, 3.66	-7.53, 4.86	-8.62, 6.11
Risk exposure of the index	θ^Y	<u>0.50</u>	<u>0.75</u>	<u>1.00</u>	<u>1.25</u>	<u>1.50</u>
		-6.53, 4.86	-5.72, 3.51	-6.47, 3.67	-8.17, 4.91	-9.51, 5.83
Flow threshold	η	<u>-0.10</u>	<u>-0.05</u>	<u>0.00</u>	<u>0.05</u>	<u>0.10</u>
		-1.99, 0.06	-3.19, 0.30	-6.00, 3.46	-5.88, 3.24	-6.47, 3.66
Risk exposure of the benchmark	θ^X	<u>0.05</u>	<u>0.1</u>	<u>0.15</u>	<u>0.2</u>	<u>0.25</u>
		-6.47, 3.67	-6.47, 3.72	-6.47, 3.74	-6.47, 3.73	-6.47, 3.70
Allowed shortfall	ε	<u>-0.25</u>	<u>-0.20</u>	<u>-0.15</u>	<u>-0.10</u>	<u>-0.05</u>
		-6.47, 2.90	-6.47, 3.67	-6.47, 4.47	-6.47, 5.29	-6.47, 6.07

References

- ADMATI, A. R., AND P. PFLEIDERER (1997): “Does it All Add Up? Benchmarks and the Compensation of Active Portfolio Managers,” *Journal of Business*, 70(3), 323–350.
- ALMAZAN, A., K. C. BROWN, M. CARLSON, AND D. A. CHAPMAN (2001): “Why Constrain Your Mutual Fund Manager?,” working paper, University of Texas at Austin.
- ARORA, N., AND H. OU-YANG (2000): “A Continuous-Time Model of Explicit and Implicit Incentives,” working paper, University of North Carolina.
- BASAK, S., A. SHAPIRO, AND L. TEPLA (2002): “Risk Management with Benchmarking,” working paper, LBS, NYU, and INSEAD.
- BERK, J., AND R. GREEN (2002): “Mutual Fund Flows and Performance in Rational Markets,” working paper, University of California, Berkeley, and CMU.
- BHATCHARYA, S., AND P. PFLEIDERER (1985): “Delegated Portfolio Management,” *Journal of Economic Theory*, 36, 1–25.
- BLACK, F., AND M. SCHOLES (1973): “The Pricing of Options and Corporate Liabilities,” *Journal of Political Economy*, 81(3), 637–654.
- BRENNAN, M. J. (1993): “Agency and Asset Pricing,” working paper, UCLA.
- BROWN, K. C., W. V. HARLOW, AND L. T. STARKS (1996): “On Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry,” *Journal of Finance*, 51(1), 85–110.
- CARPENTER, J. N. (2000): “Does Option Compensation Increase Managerial Risk Appetite?,” *Journal of Finance*, 55(5), 2311–2331.
- CHEVALIER, J., AND G. ELLISON (1997): “Risk Taking by Mutual Funds as a Response to Incentives,” *Journal of Political Economy*, 105(6), 1167–1200.
- COLE, H. L., AND M. OBSTFELD (1991): “Commodity Trade and International Risk Sharing: How Much Do Financial Markets Matter?,” *Journal of Monetary Economics*, 28(1), 3–24.
- CUOCO, D., AND R. KANIEL (2000): “General Equilibrium Implications of Fund Managers’ Compensation Fees,” working paper, University of Pennsylvania and University of Texas at Austin.
- DAS, S., AND R. SUNDARAM (2002): “On the Regulation of Fee Structures in Mutual Funds,” *Mathematical Modelling in Finance*, forthcoming.
- DYBVIK, P. H., H. K. FARNSWORTH, AND J. N. CARPENTER (2001): “Portfolio Performance and Agency,” working paper, Washington University in Saint Louis.
- ELTON, E. J., M. J. GRUBER, AND C. R. BLAKE (2002): “Incentive Fees and Mutual Funds,” *Journal of Finance*, forthcoming.
- FAMA, E. F. (1980): “Agency Problems and the Theory of the Firm,” *Journal of Political Economy*, 88(2), 288–307.
- GOMEZ, J., AND F. ZAPATERO (2002): “Asset Pricing Implications of Benchmarking: A Two-Factor CAPM,” working paper, University of Southern California.
- GREEN, R. C., AND E. TALMOR (1986): “Asset Substitution and the Agency Costs of Debt Financing,” *Journal of Banking and Finance*, 10(3), 391–399.
- GRUBER, M. (1996): “Another Puzzle: The Growth in Actively Managed Mutual Funds,” *Journal of Finance*, 51(3), 783–810.

- HALL, B. J., AND K. J. MURPHY (2000): "Optimal Exercise Prices for Executive Stock Options," *American Economic Review*, 90(2), 209–214.
- (2002): "Stock Options for Undiversified Executives," *Journal of Accounting and Economics*, 33(1), 3–42.
- HIRSHLEIFER, D. (2001): "Investor Psychology and Asset Pricing," *Journal of Finance*, 56(4), 1533–1597.
- HOLMSTROM, B. (1999): "Managerial Incentive Problems: A Dynamic Perspective," *Review of Economic Studies*, 66(1), 169–182.
- HUDDART, S. (1999): "Reputation and Performance Fee Effects on Portfolio Choice by Investment Advisers," *Journal of Financial Markets*, 2(3), 227–271.
- HUGONNIER, J., AND R. KANIEL (2002): "Mutual Fund Portfolio Choice in the Presence of Dynamic Flows," working paper, HEC Montreal and University of Texas at Austin.
- HULL, J. C. (2002): *Options, Futures, and Other Derivatives (5th edition)*. Prentice Hall, Upper Saddle River, NJ.
- JENSEN, M. C., AND W. MECKLING (1976): "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, 3(4), 305–360.
- KARATZAS, I., AND S. E. SHREVE (1988): *Brownian Motion and Stochastic Calculus*. Springer-Verlag, New York.
- (1998): *Methods of Mathematical Finance*. Springer-Verlag, New York.
- LAMBERT, R. A., D. F. LARCKER, AND R. E. VERRECCHIA (1991): "Portfolio Considerations in Valuing Executive Compensation," *Journal of Accounting Research*, 29(1), 129–149.
- LEWELLEN, K. (2002): "Financing Decisions When Managers Are Risk Averse," working paper, University of Rochester.
- MEHRA, R., AND E. C. PRESCOTT (1985): "The Equity Premium: A Puzzle," *Journal of Monetary Economics*, 15(2), 145–161.
- MERTON, R. C. (1971): "Optimum Consumption and Portfolio Rules in a Continuous-Time Model," *Journal of Economic Theory*, 3, 373–413.
- (1987): "A Simple Model of Capital Market Equilibrium with Incomplete Information," *Journal of Finance*, 42(3), 483–510.
- ROLL, R. (1992): "A Mean-Variance Analysis of Tracking Error," *Journal of Portfolio Management*, 18(4), 13–22.
- ROSS, S. (1973): "The Economic Theory of Agency: The Principal's Problem," *American Economic Review*, 63(2), 134–139.
- (2002): "Compensation, Incentives, and the Duality of Risk Aversion and Riskiness," working paper, MIT.
- RUBINSTEIN, A. (1998): *Modeling Bounded Rationality*. MIT Press, Cambridge, MA.
- SIRRI, E. R., AND P. TUFANO (1998): "Costly Search and Mutual Fund Flows," *Journal of Finance*, 54(1), 359–375.
- TEPLA, L. (2001): "Optimal Investment with Minimum Performance Constraints," *Journal of Economic Dynamics & Control*, 25, 1629–1645.
- ZWIEBEL, J. (1995): "Corporate Conservatism and Relative Compensation," *Journal of Political Economy*, 103(1), 1–25.