AGEFI Luxembourg
Le Journal Financier de Luxembourg

PAYS :Luxembourg
PAGE(S) :28
SURFACE :61 %

► 1 mars 2020 - N°XX

Research in Finance

On efficiently inefficient markets

Till relatively recently, the standard story in Financial Economics went like this. Financial markets can be analyzed by assuming that rational individual investors construct portfolios. If those investors have standard risk profiles they will chose mean-variance portfolios. In a recent paper, Markowitz actually analyzes the necessary and sufficient conditions for the mean-variance approach to apply.

In that framework, markets are efficient and prices rapidly reflect information. Following Kahneman's Nobel Prize, this rational asset pricing framework became questioned leading to the field called Behavioral Finance and recently to a new Nobel Price by Thaler. Lately, a synthesis is emerging based with the idea of and the Adaptive Market Hypothesis (Lo (2017)). In a famous earlier paper, Grossman and Stiglitz (1980) highlight the impossibility of "informationally efficient markets".

The more recent literature not only emphasizes behavioral aspects but also institutional aspects that had been neglected in an earlier literature. Indeed, most investors delegate the management of their assets to asset managers, a phenomenon that creates an agency problem. There is a broad debate in the academic literature about the value added of the asset management industry. Some argue that the fees of asset managers are too high compared to their value added measured in terms of performance compared to a passive benchmark. This implies that investors would be better off investing in a passive index. Some have suggested that asset managers mainly guide investors and help them invest in risky projects, the so-called Money Doctor Hypothesis (Gennaioli *et al.* (2016)). From a social viewpoint, such guidance might well have value as the amount of risk investments plays a role in the price discovery process and hence the capital allocation process. As Easley *et al.* (2018) document, the so-called passive ETF market is not so passive in the end.

More recently, Gârleanu and Pederson (2018) develop an interesting approach taking into account different types of investors as well as asset managers. They elaborate the Grossman and Stiglitz (1980) model by adding an asset management layer. They consider different types of small investors that have to expend some search costs, namely Due Diligence costs, to select informed asset managers. Alternatively, those small investors can trade on their own, either by spending time and effort to get a signal (information) about potential investment possibilities or by trading in an uninformed way. The asset managers also can decide to do research to get information that might enable them to outperform. There is evidence that most funds do not outperform their benchmarks. The optimum strategies for investors as well as asset managers will thus depend on the fees of asset managers, the due diligence costs of investors to select the well-informed asset managers as well as the degree of inefficiency in the markets, the latter enabling some managers to have access to the signal (information) to outperform.

The efficiency of the asset markets will depend on how many investors and asset managers are informed. Price efficiency is typically measured by the amount of uncertainty about asset value of someone only knowing the prices as compared to someone knowing the signal. This inefficiency, however, conditions the value of information of the informed investors by providing them with outperformance. The degree of asset market inefficiency is thus directly linked to the fees, information acquisition costs by asset managers as well as Due Diligence costs by small investors. The authors draw interesting conclusions in terms of asset management industry equilibrium.

The equilibrium asset management fee would be zero with perfectly efficient markets and asset management fees can be viewed as the fact that some investors believe markets to be inefficient. Moreover, for informed investors, the Due Diligence costs to select asset managers should be less than half the costs of acquiring information to invest directly. In that environment, however, some investors and asset managers will be uninformed and their respective fractions will depend on fees, costs structures and efficiency of asset markets. The informed asset managers will outperform uninformed investors before and after fees. Searching investors also outperform non-informed investors net of fees, just compensating their search costs. The term efficiently inefficient refers to the equilibrium level of inefficiency that depends on the different frictions, measured by the different search costs, including markets and asset manager search costs.

What is the plausible level of inefficiency? Gârleanu and Pederson (2018) show that with a relative risk aversion index of 3 and an equilibrium asset management fee of 1%, the equilibrium degree of inefficiency is around 6%. Moreover, the inefficiency is higher in markets with higher fees, for Private Equity for instance, and during periods of higher risk aversion, when a crisis hits. More generally, what are the empirical implications of the model? The literature documents a net after-fee performance difference between best and worst performing funds. This fact is not only inconsistent with the standard Efficient Markets Hypothesis, but also with the famous Green and Berk (2004) model where fees should be equalized with abnormal performance across different funds. Net after-fee out-performance should thus be 0 across funds. as rational investors would invest as long as this after-fee out-performance is positive. The Gârleanu and Ped-

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erson (2018) model, however, can account for the extreme performance measures.

Concerning the factors that determine the activeness of investors, high wealth, low risk aversion and low search costs increase the probability for an investor to be actively searching for good asset managers. This implies that mainly sophisticated and institutional investors tend to be active. Indeed, the literature documents after-fee outperformance of institutional investors. The model also has implications for the industrial organization of the asset management industry. Even though the industry at the aggregate level faces decreasing returns to scale, individual managers do not face decreasing returns to scale at the fund level. This leads to more industry concentration with bigger asset managers having on average better performance, a fact documented by Ferreira *et al.* (2013)).

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