Innovation, Delegation, and Asset Price Swings

Yuki Sato*

Swiss Finance Institute and University of Lausanne

Abstract

We propose a dynamic asset-market equilibrium model in which (1) an "innovative" asset with as-yet-unknown average payoff is traded, and (2) investors delegate investment to experts. Experts secretly renege on investors' orders and take on leveraged positions in the asset to manipulate investors' beliefs, thereby attracting more orders and fees. Despite agents' full rationality, the combination of experts' moral hazard and investors' learning generates bubble-like price dynamics: gradual upswing, overshoot, and reversal. Consistent with empirical observations, hedge funds "ride" price swings, adjusting holdings counter-cyclically to other financial intermediaries. Capping fees may lower fund leverage, dampen price swings, and improve welfare.

JEL classification: D80, G10, G23

Key words: asset price swings, delegated investment, innovation, learning, moral hazard, signal jamming.

*University of Lausanne, UNIL-Dorigny, Extranef 235, CH-1015 Lausanne, Switzerland. E-mail: yuki.sato@unil.ch.