Innovation, Delegation, and Asset Price Swings

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Abstract

This paper studies 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. Innovative assets with highly uncertain payoff characteristics have high trading volumes.