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Decentralized Decision Making In Investment Management

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Decentralized Decision Making In Investment Management

Abstract

The article addresses the investment problem of a pension fund in which a centralized decision maker, the Chief Investment Officer (CIO), employs multiple asset managers to implement investment strategies in separate asset classes. The investment management division of pension funds is typically structured around traditional asset classes such as equities, fixed income, and alternative investments. The asset allocation decisions are made in at least two stages. Firstly, the CIO allocates capital to the different asset classes, each managed by a different asset manager. Secondly, each manager decides how to allocate the funds made available to him, that is, to the assets within his class. The CIO of the fund therefore faces a tradeoff between the benefits of decentralization, driven by the market timing and stock selection skills of the managers, and the costs of delegation and decentralization. The optimal portfolio of the asset managers can be decomposed into two components. The first component is the standard myopic demand that optimally exploits the risk-return trade-off. The second component minimizes the instantaneous return variance and is therefore labeled the minimum-variance portfolio. The minimum variance portfolio substitutes for the riskless asset in the optimal portfolio of the asset manager. The two components are then weighted by the risk attitude of the asset manager to arrive at the optimal portfolio.

Keywords

investment management, standard myopic demand, minimum variance portfolio, riskless asset, optimal portfolio, pension funds

Disciplines

Finance and Financial Management

Comments

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Decentralized Decision Making In Investment Management

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Abstract and Keywords

The article addresses the investment problem of a pension fund in which a centralized decision maker, the Chief Investment Officer (CIO), employs multiple asset managers to implement investment strategies in separate asset classes. The investment management division of pension funds is typically structured around traditional asset classes such as equities, fixed income, and alternative investments. The asset allocation decisions are made in at least two stages. Firstly, the CIO allocates capital to the different asset classes, each managed by a different asset manager. Secondly, each manager decides how to allocate the funds made available to him, that is, to the assets within his class. The CIO of the fund therefore faces a tradeoff between the benefits of decentralization, driven by the market timing and stock selection skills of the managers, and the costs of delegation and decentralization. The optimal portfolio of the asset managers can be decomposed into two components. The first component is the standard myopic demand that optimally exploits the risk-return trade-off. The second component minimizes the instantaneous return variance and is therefore labeled the minimum-variance portfolio. The minimum variance portfolio substitutes for the riskless asset in the optimal portfolio of the asset manager. The two components are then weighted by the risk attitude of the asset manager to arrive at the optimal portfolio.

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Jules H. Van Binsbergen is Assistant Professor of Finance at the Kellogg School of Management at Northwestern University and the Stanford Graduate School of Business. Professor Binsbergen conducts theoretical and empirical research in finance. His current work focuses on asset pricing, in particular consumption-based asset pricing, return predictability, and quantitative portfolio management. Some of his recent research focuses on the implications of good-specific habit formation for asset prices, the interaction between cash flow growth predictability and stock return predictability, and the maturity structure of risk and return in financial markets. His research has appeared in leading academic journals such as the *Journal of Finance*. He is also a Faculty Research Fellow of the National Bureau of Economic Research (NBER).

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