Efficiently Inefficient Markets for Assets and Asset Management

Nicolae Gârleanu and Lasse Heje Pedersen†

This version: January 13, 2016

Abstract

We consider a model where investors can invest directly or search for an asset manager, information about assets is costly, and managers charge an endogenous fee. The efficiency of asset prices is linked to the efficiency of the asset management market: if investors can find managers more easily, more money is allocated to active management, fees are lower, and asset prices are more efficient. Informed managers outperform after fees, uninformed managers underperform after fees, and the net performance of the average manager depends on the number of “noise allocators.” Small investors should be passive, but large and sophisticated investors benefit from searching for informed active managers since their search cost is low relative to capital. Hence, managers with larger and more sophisticated investors are expected to outperform.

Keywords: asset pricing, market efficiency, asset management, search, information
JEL Codes: D4, D53, D83, G02, G12, G14, G23, L10

*We are grateful for helpful comments from Jules van Binsbergen, Ronen Israel, Stephen Mellas, Jim Riccobono, Tâo Santos, Andrei Shleifer, Peter Norman Sørensen, and Morten Sørensen, as well as from seminar participants at Harvard University, New York University, UC Berkeley–Haas, CEMFI, IESE, Toulouse School of Economics, MIT Sloan, Copenhagen Business School, and the conferences at NBER Asset Pricing, Queen Mary University of London, the Cowles Foundation at Yale University, the European Financial Management Association Conference, the 7th Erasmus Liquidity Conference, the IF2015 Annual Conference in International Finance, the FRIC’15 Conference, and the Karl Borch Lecture. Pedersen gratefully acknowledges support from the European Research Council (ERC grant no. 312417) and the FRIC Center for Financial Frictions (grant no. DNRF102).

†Gârleanu is at the Haas School of Business, University of California, Berkeley, NBER, and CEPR; e-mail: garleanu@haas.berkeley.edu. Pedersen is at Copenhagen Business School, New York University, AQR Capital Management, and CEPR; www.lhpedersen.com.