

Research Highlight: The Effect of Illiquidity on Delegated Portfolio Choice

Work of Professor DAI Min

Professor Dai Min and his coauthors develop a continuous time utility maximization model to study the effect of illiquidity on delegated portfolio choice. In response to how they are compensated, mutual fund managers who are under-performing by mid-year are likely to increase the risk of their portfolios towards the year-end. The authors argue that an increase in the liquidity of the stocks that managers use to shift risk can lead to an increase in the size of their risky bets. This in turn hurts fund investors by increasing the costs of misaligned incentives associated with delegated portfolio management. The authors provide both theoretical and empirical results that are consistent with this argument. The authors use decimalization as an exogenous shock to liquidity to identify causal effects.

Reference:

M. Dai, L. Goncalves-Pinto and J. Xu, How does illiquidity affect delegated portfolio choice? *Journal of Financial and Quantitative Analysis* (2019) 54(2), 539-585