

Information Asymmetry and Incentives for Active Management

Min S. Kim

*Department of Finance and Business Economics
Marshall School of Business, University of Southern California*

October 5, 2008

Abstract

This paper examines the equilibrium consequences of strategic behavior of mutual fund managers who withhold information about their funds and their managerial ability. We show that under this information asymmetry, low skills in the industry can result in a growth of passive management. A separating equilibrium in which skilled managers actively manage funds arises only if their compensation depends on performance and their skills are sufficiently superior. A growth of passively-managed funds such as closet-index funds (Cremers and Petajisto (2007)), therefore, suggests that the mutual fund industry may lack performance-based compensation. In essence, the flow-performance relationship, which has been considered an implicit performance fee, may not actually reward skills. Alternatively, more closet-indexing could derive from a diminution in skills—for example, due to a brain drain as skilled mutual fund managers migrate to the hedge fund or private equity industry.

Key words: mutual fund, information asymmetry, mechanism design, performance compensation, closet-indexing

Email address: minskim@usc.edu (Min S. Kim).