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Decentralized Decision Making In Investment Management

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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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