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ENTRUSTING INVESTMENT DECISIONS TO MANAGERS WITH
SUPERIOR INFORMATION: THE DELEGATION PROBLEM

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by

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ABSTRACT

Owners of capital often delegate the management of assets to managers. A common impediment to such delegation is the possession of valuable private information by the manager. This induces the manager to misrepresent his information and make investment decisions that may not be in the owner's best interest. We analyze in this paper optimal contracting policies the owner could adopt that would eliminate the manager's inclination to misuse his information when the manager knows the asset's index of excess return but the owner does not. The properties of these optimal policies are compared with the solution to this problem proposed by Heckerman (1975), whose paper was the first to address this issue. The policies we develop are found to yield the owner higher expected utility than the policy derived by Heckerman. Two of our most important results are that the owner's lack of information depresses investment and that restrictions on the positions managers can take in their own firms' securities can improve the owner's welfare.