Discussion of:

Delegated Blocks

by

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Summary

Question: Delegation of voting & activism to asset managers and the tradeoff between risk diversification and monitoring

- Optimal delegation contracts under no commitment over portfolio and monitoring decisions => Maximization of joint surplus subject to a managerial incentive constraint
- How the bargaining power is allocated matters:
  - Maximization of client surplus ⇔ activist hedge funds
  - Maximization of managers' pay ⇔ mutual funds that provide risk sharing but no monitoring
- Complication: multiple asset managers → A special form of common agency problem (Bernheim and Whinston, 1986) and/or contracting with externalities problem (Segal, 1999)
- Coasian dynamics through trading → (Gul and Sonnenschein, 1986, Admati, Pfleiderer and Zechner, 1994, DeMarzo and Urosevic, 2006)

Model Structure

- One firm with risky free cash flows
- Risk-averse investors (CARA utility function)
- Two types: fund managers (**FM**s measure 1- λ) and retail investors (**FC**s measure λ endowed with a fraction $\omega < \lambda < ½$ of the firm's equity)
- *First key friction*: FCs can only hold equity through FMs
- *Second key friction*: FCs cannot monitor
- Equilibrium ownership structure (τ, ϕ, f), where τ is the fraction of FMs holding a fraction ϕ of the fund's assets, and f is the upfront management fee paid by FCs
- Contracting outcome when FCs have all the bargaining power: FMs hold an effective stake equal to ω and FCs hold $(\lambda/1+\lambda)(1+\omega)$
- Contracting outcome when FMs have all the bargaining power: no monitoring but access to higher ownership stakes for FCs

Model Structure

- *Third key friction*. **curse of capitalization** (Holmstrom): share value increase from extra monitoring on shares FCs purchase is capitalized into the price they pay for the extra shares

- FC optimum under full commitment: (with risk tolerance ϱ)

$$\max_{(m,\alpha)} \ \alpha\mu(m) - c(m) - \alpha^2\sigma^2/2\varrho\lambda - (\alpha - \omega)[\mu(m) - (1-\alpha)/\varrho(1-\lambda)\sigma^2]$$

price capitalization

- any monitoring beyond the level justified by the FCs' initial endowment ω is fully capitalized

Model Structure

- FMs equity stake: $\phi\alpha^{D}$
- Monitoring incentive constraint m^{D} is chosen to maximize FMs payoff

$$\phi\alpha^{D}\mu(m) - c(m) - (\phi\alpha^{D})^{2}\sigma^{2}/2\varrho\tau$$

- where, α^{D} must be ***globally stable!*** That is, the activist fund does not want to trade its stake in the firm up or down

$$\alpha^{D*} = \tau/\phi/(\tau/\phi + 1 - \lambda - \tau)$$

- ***Key point:*** contract with FMs offers a commitment device to overcome the curse of capitalization (i.e. Coasian dynamics through trading)
- *The optimal contract selects $\phi*$ and $\tau*$ so that the FMs' globally stable holdings equal the FCs' initial endowment ω*

My Comments

1. Optimal contracting problem for delegated portfolio management is a difficult contract theory problem

2. This paper makes an important contribution to this topic, specifying a very simple, elegant model, and making realistic simplifying assumptions

3. The delegated monitoring problem when FCs have all the bargaining power solves the curse of capitalization problem first identified by Admati, Pfleiderer, and Zechner (1994). The contract between FMs and FCs is a commitment device that achieves optimal skin-in-the-game incentives to monitor, while eliminating any temptation to trade the ownership position up or down.

Questions and Suggestions

1. Why do you need a whole mass of FMs? Why do you need to set both ϕ^* *and* τ^*? Why isn't delegation to a single general partner enough? Multiple FMs monitoring through a single large activist fund complicates the interpretation (Paul Singer @ Elliott, Carl Icahn, Nelson Petz @ Trian Partners)
2. Why not model delegation of monitoring in a dynamic model as in DeMarzo and Urosevic (2006) and Gryglewicz, Mayer and Morellec (2025), with full trading dynamics rather than using the global stability notion of APZ?

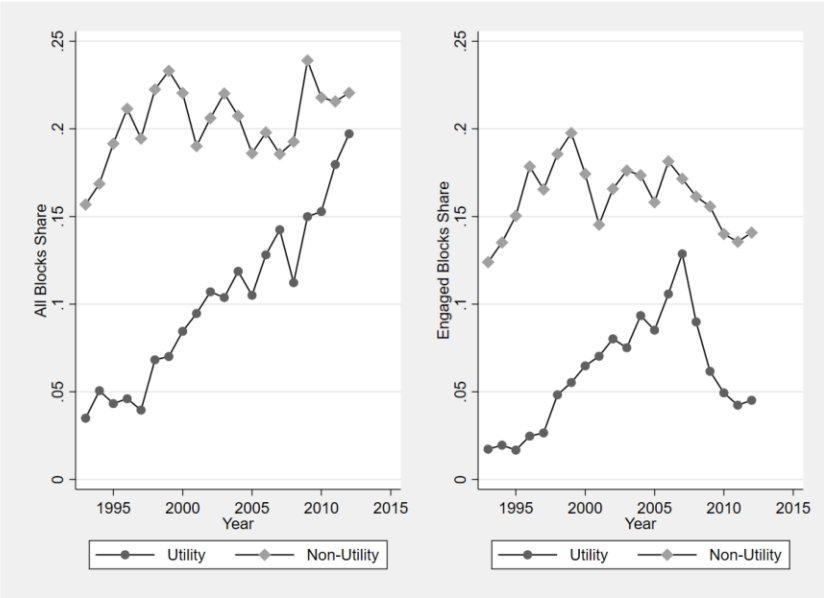
* Conceivably, in a fully dynamic trading model the contract must be continuously revised?

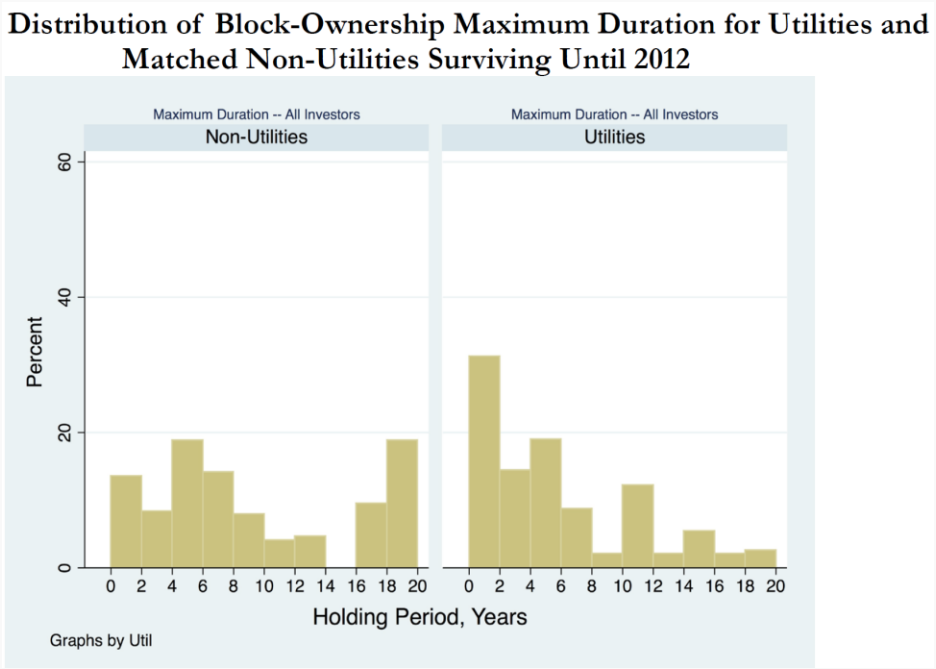
* Also, wouldn't gradual trading and capital gains on the toehold partially undo the curse of capitalization?

Questions and Suggestions

3. Activist HFs do not hold large positions forever; they are in-and-out block-holders. They identify opportunities and build a position to pressure for value-increasing changes and then sell. This also reduces the curse of capitalization problem...

The left panel plots the mean of the total of all ownership blocks in S&P utilities and non-utilities. The right panel, plots the mean excluding all disengaged blocks:





From Bolton and Rosenthal (2019)

To Conclude

- This paper makes an important contribution to the theory of optimal incentive contracts for delegated portfolio management

- This is a difficult problem, and this paper makes a significant advance to understanding key elements of this contracting problem (how to structure skin-in-the game, scaling the equity stake, the implications of the curse of capitalization)

- The model makes the right assumptions on the non-contractibility of trading and monitoring

Thank You