Discussion of The Industrial Organization of Money Management
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Main Idea

- Managers signal their skills via transparency
- The benefit of transparency: higher service fees
- Transparency is costly

Main Results

- High ability managers choose opaque to save this cost
- Medium ability managers choose transparency to separate
- Low ability managers pool with high ability ones
- Interpretation: Hedge funds v.s. Mutual Funds
- Equilibria refinement

Model

- Three types of managers: *h*, *m*, *l*.

$$\tilde{r}_n(\ell) = \begin{cases} r_{\mathrm{G}}, & \text{prob. } p_{\mathrm{G}} \\ r_{\mathrm{A}}, & \text{prob. } p_{\mathrm{A}} \\ r_{\mathrm{B}}, & \text{prob. } p_{\mathrm{B}}, \end{cases}$$

$$\tilde{r}_n(m) = \begin{cases} r_{\mathrm{G}}, & \text{prob. } \frac{p_{\mathrm{G}}}{p_{\mathrm{G}}+p_{\mathrm{A}}} \\ r_{\mathrm{A}}, & \text{prob. } \frac{p_{\mathrm{A}}}{p_{\mathrm{G}}+p_{\mathrm{A}}}, \end{cases}$$

$$\tilde{r}_n(h) = r_{\mathrm{G}}$$

Transparency

- At the outset, managers choose t, $0 \le t \le 1$.
- Managers go through a screening first
- A low type is caught with probability t
- Cost of the screening is $k_t A_n^2$ each period
  - Should be fine if managers get screened every period

Equilibrium

- The only **undefeated** equilibrium is $\{0,t,0\}$
  - h: don't care to get a certificate
  - m: need a certificate to prove he is not bad
  - l: too expensive to get a certificate

Comments

- Interesting idea
- Carefully executed
- Well explained

1. What is this cost of transparency?

- Obtain a certificate that the manager is not Madoff?
- Difficulty of credible communication?
- How costly is this? for mutual/hedge funds
  - Cost of compliance, expense ratio.
  - “Regulation is my single biggest fixed cost”---Peter Schiff
- Idea: Very costly to share a “secret recipe”
  - Hard to share ideas with clients
  - e.g., John Paulson and his **former** friend
- Cheaper to share if it is hard to copy the idea
  - e.g., key to success is to reduce transaction costs

2. Is transparency chosen, or given?

- "Given" view:
  - Hedge funds are more opaque because it is more costly to be transparent
  - h and l choose to work in hedge funds, m work in mutual funds
  - Hedge funds and mutual funds have ***different*** activities

- "Chosen" view:
  - The managers choose to be opaque or transparent
  - The business activities are the ***same***

3. Limited liability

- To achieve separation, h type can offer contract
  - Receives W_n if his return is r_G
  - Compensate investors x otherwise
- Something like "limited liability" assumption is needed
  - Zero initial wealth will do in a static environment
  - But not in a dynamic environment
- With "limited liability", the model implication is robust to more general contracts, including "claw-back"

4. Implication on Regulation

- Pressure to increase the transparency of hedge funds
- “if the opaqueness of hedge funds is a key ingredient in the efficient discovery of talent……the regulation of hedge funds may do more harm than good.”
- Interesting thought
- In the model, investors don’t care; it only affects managers
- The discovery idea is good. A bit more discussion is helpful

5. Empirical relevance

- A very nice set of implications
- Testable predictions
- A novel way to think about various phenomena
- I think the value of the model: It offers an interesting, coherent perspective, rather than fully explains them.

6. Equilibrium refinement

- {0, 0.6, 0} is ***defeated*** by {0, 0.5, 0}
  - In the equilibrium {0, 0.6, 0}, what off-equilibrium belief do you give to a deviator *t'*=0.5?
  - The off-eq. belief ***cannot*** be the same as the belief on *t'*=0.5 players in the equilibrium {0, 0.5, 0}, otherwise it breaks {0, 0.6, 0}

- {0, 0.5, 0} is not ***defeated*** by {0, 0.6, 0}
  - In the equilibrium {0, 0.5, 0}, what off-equilibrium belief do you give to a deviator *t'*=0.6?
  - The off-eq. belief ***can*** be the same as the belief on *t'*=0.6 players in the eq. {0, 0.6, 0}: the potential defector will not defect under this off-eq. belief.