"Fund managers' contracts and short-termism"
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This paper considers the problem faced by long-term investors who have to delegate the management of their money to professional fund managers. Investors can earn profits if fund managers collect long-term information. We investigate to what extent the delegation of fund management prevents long-term information acquisition, inducing short-termism. We also study the design of long-term fund managers' compensation contracts. Absent moral hazard, short-termism arises only because of the cost of information acquisition. Under moral hazard, fund managers' compensation endogenously depends on short-term price efficiency (because of the need to smooth fund managers' consumption), thereby on subsequent fund managers' information acquisition decisions. The latter are less likely to be present on the market if information has already been acquired initially, giving rise to a feedback effect. The consequences are twofold: First, this increases short-termism. Second, short-term compensation for fund managers depends in a non-monotonic way on long-term information precision. We derive predictions regarding fund managers' contracts and financial markets efficiency.