"Career Concerns and Dynamic Arbitrage"

Abstract:
This paper analyzes the effect of career concerns on risky arbitrage. It presents an analytically tractable model where some fund managers can locate arbitrage opportunities, i.e., fundamentally very similar assets with a temporary difference in their price. Fund managers need operating capital from investors to exploit these opportunities. Investors judge the abilities of fund managers and decide whether to keep or fire them based on their past performance. Career concerns of fund managers distort their strategies which effect prices. In equilibrium, investors keep those arbitrageurs with higher probability who speculate on fast convergence of prices, even if the expected profit of this strategy is lower. As an effect, fund managers over-invest in these strategies which increase the probability of liquidity crises: episodes with large price divergences and large aggregate losses of fund managers without any change in the fundamentals.