The Cross-section of Managerial Ability and Risk Preferences

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Abstract

I use structural portfolio management models to study the joint cross-sectional distribution of managerial ability and risk preferences using manager-level data. The economic restrictions following from theory imply that (i) fund alphas reflect the manager’s ability and risk preferences and that (ii) information in second moments of fund returns can be used to estimate both attributes. The estimation relies on a novel framework to empirically analyze dynamic portfolio-choice models. The findings are twofold. First, the restrictions implied by recently-proposed models of managerial preferences are strongly rejected in the data. Second, introducing relative-size concerns into the manager’s objective delivers plausible estimates and is formally favored over the standard models and reduced-form performance regressions. Based on this model, I document large and skewed heterogeneity in risk preferences, but less dispersion in ability. Risk aversion and managerial ability are highly positively correlated. Finally, ignoring heterogeneity can lead to large welfare losses for an individual investor who allocates capital to actively-managed mutual funds.