The Systemic Effects of Benchmarking

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Abstract

We show that the competitive pressure to beat a benchmark may induce institutional trading behavior that exposes retail investors to tail risk. In our model, institutional investors are different from a retail investor because they derive higher utility when their benchmark outperforms. This forces institutional investors to take on leverage to overinvest in the benchmark. Institutional investors execute fire sales when the benchmark experiences shock. This behavior increases market volatility, raising the tail risk exposure of the retail investor. Ex post, tail risk is only short lived. All investors survive in the long run under standard conditions, and the most patient investor dominates. Ex ante, however, benchmarking is welfare reducing for the retail investor, and beneficial only to the impatient institutional investor.

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