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ARTICLES

Agency and Entrepreneurship in Capital Markets: Return on Equity and Asset Manager Wages

Jonathan Yen, Economics BS, Finance BS[a]

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In Austrian theory, the entrepreneur is the bearer of uncertainty in pursuit of profit (Mises 1998, 255). In capital markets, where stocks and bonds are traded, entrepreneur-investors speculate, forecasting future prices (Rothbard 2009, 848). Klein (2010, 48) has highlighted the lack of Austrian literature on the provision of capital to small ventures. This article opens the door to more sophisticated analysis of capital and investment by providing clarification on two related issues that relate to the Austrian understanding of capital markets. (1) What is meant by "return on equity," and what is the relationship between equity ownership and the decision-making rent described by Salerno (2018)? (2) What is the role of so-called asset managers, who are hired to invest other people's capital? In resolving these questions, this article incorporates insights from Rothbard (2009) and Mises (1998), as well as more recent Austrian analysis by Braun (2024a, 2024b) and Salerno (2018).

Ludwig von Mises, the father of the modern Austrian School, formulated a theory of the entrepreneur as a category of action that bears uncertainty in pursuit of profit. To illustrate this function, Mises (1998, 245–57) imagines the evenly rotating economy, a recurring world without uncertainty, where there would be no entrepreneurial profits or losses. In the real world of uncertainty, the entrepreneur evaluates the correctness of choices made under uncertainty through the accounting of profit and loss (Taylor 1981; Mises 1944, 45–46). Thus, entrepreneurship is characterized by forward-looking speculation and retrospective reflection (accounting), which analyzes the success of action. One of the most important entrepreneurial functions in the market is that of the entrepreneur-investor, who, in pursuit of profit, invests his capital in various ventures in capital markets (Mises 1998, 514). Praxeological analysis of entrepreneurial investment in capital markets (debt and equity securities) is key to understanding the market economy, since it is in these markets that capital in the financial sense becomes allocated to ventures and is invested in concrete capital goods (Braun 2024a; 2024b).

Within capital markets, there is a group of actors which requires consideration in Austrian analysis: "asset managers," hired agent managers who make investment decisions with their clients' capital and invest no capital of their

a Jonathan Yen (joncyen@outlook.com) is an independent scholar in Cheyenne, Wyoming. The author would like to thank Dr. Joseph T. Salerno, Dr. Mark Thornton, Ryan Turnipseed, and Jared Friesen for their valuable input on drafts of this article. All errors are the author's responsibility alone.

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own. The existence of these hired managers raises several questions: From whence do the wages of these hired asset managers arise? Are the wages of asset managers necessarily a form of profit-sharing, or are they discounted marginal revenue product derived from the final consumer goods produced by the ventures in which they invest?

Literature Review

According to Rothbard (2009, 509), while the entrepreneurial function can be generalized to all uncertainty-bearing action, the relevant entrepreneur is the capitalist entrepreneur. The capitalist entrepreneur faces not only the ex ante subjective opportunity costs and ex post psychic profits and losses attending all actions but also the money profit or loss on his own capital. Henceforth, when we refer to entrepreneurs, we refer to them in the narrow sense of capitalist entrepreneurs. Financial capital as a numéraire of profit calculation is an indispensable tool of the capitalist entrepreneur, since it provides an objective measure of success and failure (Taylor 1981; Braun 2024a).[1]

Austrian Analysis of Capital Markets

Thus far, Austrian theory has gone down several avenues of inquiry on the subject of capital markets, mostly criticizing neoclassical finance theory (Marion Ceolin and Mazzoni 2024; Hering et al. 2021; Hülsmann 2018; Daher and Rapp 2023; Pasour 1987) or focusing on valuation and appraisal (Olbrich et al. 2015; Herbener and Rapp 2016).

The nature of returns in capital markets has also been discussed in Austrian theory. Rothbard (2009, 431), in his treatise *Man, Economy, and State,* writes, "While the share market of joint-stock companies provides a ready channel for accumulating savings, *the share market is strictly dependent on the price spreads.* The savings or dissavings of capitalists are determined by time preferences, and the latter establish the price spread in the economy. The value of capital invested in the enterprise, i.e., its productive assets, will be the sum of future earnings from the capital discounted by the rate of interest" (italics original).

Salerno (2018) highlights the unhired wage that entrepreneurs earn, separate from entrepreneurial profit. Owners of firms earn a certain rent for their decision-making, which includes the hiring and firing of the firm's employees. Salerno points to early twentieth-century economist M. M. Bober as key to the development of this concept. Within Bober's framework, several decisions must be made by equity owners to coordinate production, notably the selection of corporate officers and decisions regarding securities issuance.

1 Mises (1998, 250) says that money in the evenly rotating economy would remain a numéraire for accounting.

Whatever decisions are delegated, there still remains an ultimate decision maker in a firm: the owners. This presents an interesting distinction between voting securities (equity) and nonvoting securities (debt).[2]

The Investor's Return on Equity

Equity is nothing more than a legal structure surrounding the ownership of factors of production and, importantly for investors, a convenient pro rata distribution of a firm's earnings. As Rothbard (2009, 440) has correctly pointed out, it does not matter whether the net income of a joint-stock company is paid out in the form of dividends or kept as retained earnings; all corporate earnings accrue to the firm's owners. Rothbard (439) provides an invaluable insight into how we are to understand the debt and equity ownership of a firm:[3] "We must conclude that economically and even in basic law, there is no difference between shareholders and productive creditors; both are equally suppliers of capital, both receive interest return as determined on the general time market, both own their proportionate share of the company's assets. The differences between the two are only technical and semantic. It is true that our discussion has so far applied only to the evenly rotating economy, but we shall see that the real world of uncertainty and entrepreneurship, while complicating matters, does not change the essentials of our analysis."

Understanding what comprises the return on an equity investment in a firm requires first understanding the relationship between the capital concept and economic calculation. All returns from an equity investment in a firm arise from financial capital (money) invested by the entrepreneur-investor; this capital is then invested in physical factors of production: land and capital goods. The purchased factors, as well as the firm's cash balances, are the firm's capital and are, in toto, appraised by the market at some money value (Rothbard 2009, 428–30; Herbener and Rapp 2016). The money revenue obtained through production by the firm, whether in dividends or retained earnings, can be divided by the money capital invested to obtain a percentage rate of return. The first component is the natural rate of interest corresponding to the aggregate of individuals' rates of time preference (Rothbard 2009, 375–76, 797). Since the firm is an amalgamation of factors of production, including not only capital goods but also land (428), the desired return on an equity investment also includes the land rents accruing to land, the nonreproducible factor of production. The land-rent component is of particular importance for equity investment in mining companies and other firms that rely on depleting natural resources.

2 There is a vast array of so-called hybrid instruments which contain contractual elements of debt and equity. For the purposes of our analysis, all nonvoting securities will be considered debt, and all voting or decision-making securities will be considered equity. The importance of decision-making power as a line of distinction will become clear later in this article.

3 The best Austrian analysis to date is in chapter 6 of *Man, Economy, and State.*

Next, there is the often-overlooked wage component accruing to the owners of a firm. The wage component of return on equity is not the wages of the hired employees of the firm but rather the entrepreneur's "decision-making rent," as described by Salerno (2018) and Rothbard (2009, 602).

Within the context of a joint-stock corporation, the imputed discounted marginal revenue product may be relatively small for the average stockholder since all but the ultimate decisions are hired out to managers. However, voting stockholders still have ultimate decision-making power over the most crucial decisions, including selecting board members and making capital-structure and dividend decisions. In cases where an entrepreneur-investor buys a large controlling interest in a firm, this component may constitute a large proportion of the sought returns.

The unhired wage component may be used to distinguish between returns on equity and returns on debt and other nonvoting instruments. Even if an individual stock buyer is disinterested in firm decision-making, the fact that other capitalist entrepreneurs seek to exercise decision-making authority results in an observed spread between debt and equity instruments of the same firm. This is not to say that the observed return spread between equity and nonvoting instruments of the same firm is fully explained by decision-making rents. Part of this spread is determined by entrepreneurial forecasts regarding the possibility of dissolution and the accompanying priority of claims. This decision-making rent is also sharply distinct from owners' implicit wages, which are rents earned by owners when they perform duties which could be delegated to various managers (Rothbard 2009, 601).

Rothbard (2009, 439) claims that, in the evenly rotating economy, there would be no distinction between equity and debt ownership. However, this is not necessarily true. The ownership or decision-making rent component of return on equity depends on a contractual structure permitting the owner to make decisions. In the evenly rotating economy, differences in knowledge and talents remain. Despite the lack of uncertainty regarding the future state of the market, some people are more competent as firm directors than others. It is thus perfectly reasonable to imagine that there would still be decision-making or ownership rents in an equilibrium of even rotation and thus a conceptual distinction between debt and equity ownership.[4]

Finally, we have the entrepreneurial profit component, the result of revenues being greater than costs. Faced with uncertainty, the entrepreneur speculates on the market seeking profit (Mises 1998, 288). The capital market is no different: The entrepreneur-investor seeks profit by choosing which ventures to supply with capital.

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4 The evenly rotating economy construct was never intended to deal with complex firm capital structures, which would doubtlessly cease to exist without uncertainty. This should not be taken as a criticism of Rothbard per se but rather as a recognition of the limits of the construct.

The components of return on equity cannot be empirically disaggregated ex post from observed rates of return. While entrepreneurial profit and a natural rate of interest exist, one can never know at any given time what numerical proportion of the observed return on equity came from each.

Agent Managers in Financial Markets

Now that we have analyzed investors' sought return on equity, the function of the entrepreneurial investor becomes clear. But we must now deal with the question of asset managers, actors hired by entrepreneur-investors to speculate on capital markets on their behalf. In the modern economy, many people voluntarily hire professionals not only to give investment advice but also to make investment decisions for them. An asset manager who does not own any of the capital invested is nothing more than a hired manager as described by Mises (1998, 301–4). However, unlike managers who coordinate within a production structure, these asset managers are hired by entrepreneur-investors to speculate on their behalf.[5] What, then, is the wage paid to the asset manager? There seem to be two possible answers: (1) The payments to the asset manager are imputed from the value consumers assign to the products of the firms invested in, making the fees collected similar to those earned by managers who coordinate production within the firm; or (2) they are a profit residual shared by the entrepreneur-investor.

Mises discusses this question in relation to managers within a firm:

> It is to [the manager's] credit if the accounts show a profit, and it is to his disadvantage if they show a loss. His own interests impel him toward the utmost care and exertion in the conduct of his section's affairs. If he incurs losses, he will be replaced by a man whom the entrepreneur expects to be more successful, or the whole section will be discontinued. At any rate, the manager will lose his job. If he succeeds in making profits, his income will be increased, or at least he will not be in danger of losing it. Whether or not a manager is entitled to a share in the profit imputed to his section is not important with regard to the personal interest he takes in the results of his section's dealings. . . .
>
> It is possible to reward the manager by paying for his services in proportion to the contribution of his section to the profit earned by the entrepreneur. But this is of no avail. As has been pointed out, the manager is under any circumstances interested in the success of that part of the business which is entrusted to his care. But the manager cannot be made answerable for the losses

5 The word *speculation* is not meant pejoratively but echoes Mises's (1998, 303) use of the term.

> incurred. These losses are suffered by the owners of the capital employed. They cannot be shifted to the manager. (Mises 1998, 302–3)

This insight by Mises can be easily applied to the asset manager who speculates on behalf of others on financial markets. There is no imputed discounted marginal revenue product accruing to the managerial function; this is even clearer for asset managers than for ordinary managers, since asset managers—insofar as they do not vote for their investor employers—do not make any decisions regarding the management of the firms invested in. The job of the asset manager is to assist the entrepreneur-investor in the pursuit of profit. It is not correct to say that the asset manager is part of the production structure; rather, he is a means used by the entrepreneur as a profit-seeking heuristic, no different from the various analytical tools, statistical models, and other technes of entrepreneurial decision-making. There would be no asset managers in the evenly rotating economy, since there would be no need to decide which firms to invest in under conditions of certainty. The asset manager's wages are a residual of profits earned by the entrepreneur. If an asset manager's decisions incur losses for the entrepreneur-investor, the asset manager will be fired and replaced.[6]

Given what we have concluded here, it is reasonable to inquire whether the modern prevalence of asset managers is part of the phenomenon of forced savings and a consequence of the entry of previously submarginal capitalist savers into capital markets due to artificial credit expansion creating price inflation. In other words, savers who would otherwise have been content to maintain plain savings (i.e., cash balances for rainy-day funds) are now forced to invest in stocks and bonds because of decreases in the purchasing power of their cash balances.

Conclusion

In this article, we have sketched a clarification of the Austrian understanding of capital markets. To this end, we present the following theses:

1. An investor's sought return on an equity investment includes the following components: pure interest, rents to the land factors of the firm, ownership or decision-making rents, and entrepreneurial profit.
2. The way to distinguish between returns on equity and returns on debt and other nonvoting instruments is the accrual of ownership or decision-making rent.

6 Whether the entrepreneur-investor earns a profit or incurs a loss, and thus whether the asset manager remains employed, is ultimately determined by consumer preferences for final consumer goods. However, those preferences do not impute value to the asset manager's work per se.

3. Asset managers who invest capital on behalf of entrepreneur-investors are not investors but merely hired assistants of the entrepreneur. These asset managers earn only a profit residual and not wages imputed from the value of a consumer good.

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