Discussion of

Are Mutual Fund Managers Paid For Investment Skill?

(Markus Ibert, Ron Kaniel, Stijn Van Nieuwerburgh, Roine Vestman)

by

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Summary

- Mutual fund literature has focused on **flow-performance** sensitivity
- Need work on **compensation-performance** sensitivity
  - Akin to “delta” in the managerial compensation literature
  - We have a useful measure of performance in the mutual fund industry: **Fund returns**
  - No data on managerial compensation
- This paper: We have data on managerial compensation!

Results

- Low compensation-performance sensitivity
  - One std.-dev. increase in abnormal returns lead to 2.9% increase in managerial compensation
- Low compensation-revenue sensitivity
  - Elasticity of 0.15
  - A one-percent increase in fee revenue is correlated with 0.15 percent increase in managerial compensation
  - (Comparable to corporate managers' compensation?)
- Socialism
  - Bonus pool divided amongst managers in the same family, but only when the family makes profits
- Even lower sensitivity in large banks
  - Cheaper distribution channel?

- Interesting paper …
  - Contributes to the contentious literature on managerial skill and managerial compensation (in the mutual fund industry)

- Concerns, quibbles, and suggestions ….

Optimal contract

- Fund manager=agent
- Fund family=principal
- Two objectives:
  - Attract skilled agents (adverse selection)
  - Induce effort from agents (moral hazard)
- Fund return is a (noisy) combination of effort and skill
- To attract (risk-averse) fund managers, fund family may have to provide some risk-sharing

How much “risk-sharing”?

- Providing too much “insurance” may result in the employment of less-skilled agents
  - Pooling equilibrium
- It may also result in agents providing low effort

- How much insurance is optimal?
  1. The noisiness of the signal
  2. Are there other (more precise) signals of agents’ skill and effort that principals can observe?
  3. How crucial is managerial effort in generating “optimal” results?
  4. How competitive is the labor market, i.e., the provision of skilled managers vs. the size of the fund industry?

Signal is quite noisy

- Fund investors can make a better decision in allocating assets to mutual funds if they have more information
- E.g., the investment process and risk profile
  - These are **closely guarded secrets**
  - "I could tell you, but then I'd have to kill you"

- Fund returns are probably the best signal that mutual find investors can employ
- But they don't seem too useful …
  - The literature is divided(?) on whether fund returns (1) are persistent and (2) provide useful indication of long-lasting skill

“Random Walk Down Wall Street” (Malkiel)

How the Top 20 Equity Funds of the 1970s Performed during the 1980s

Fund Name	*Rank 1970–80*	*Rank 1980–90*
Twentieth Century Growth	1	176
Templeton Growth	2	126
Quasar Associates	3	186
44 Wall Street	4	309
Pioneer II	5	136
Twentieth Century Select	6	20
Security Ultra	7	296
Mutual Shares Corp.	8	35
Charter Fund	9	119
Magellan Fund	10	1
Over-the-Counter Securities	11	242
American Capital Growth	12	239
American Capital Venture	13	161
Putnam Voyager	14	78
Janus Fund	15	21
Weingarten Equity	16	36
Hartwell Leverage Fund	17	259
Pace Fund	18	60
Acorn Fund	19	172
Stein Roe Special Fund	20	57
Average annual return:		
Top 20 funds	+19.0%	+11.1%
All funds	+10.4%	+11.7%
Number of funds	177	309

Can principals do better?

Fund families observe the actual holdings, portfolio allocations, and trades of each fund

- Can evaluate the risk profile
- May actually have enough information to evaluate the investment process

- To what extent should they rely on fund returns in compensating fund managers?
- Should they even rely on fund returns?

Fund families' objectives

- **<u>Maximize AUM</u>**(*management fee)!
  - Management fee is relatively sticky
  - To the extent that investors care about fund return in directing their investment, fund families should care too
- Improving fund return
  - Managerial skill and effort
  - **Trading skills?**
- Marketing is another avenue to increase AUM
  - Advertising (Ron's work with Laura and Steven)
  - Distribution channel (the large bank evidence)
  - More effective than improving "performance" per se?
    - "As long as it's not embarrassing …"
  - Can large fund families do better (economies of scale)?

How rare are skilled managers?

- Are (potential) fund managers a relatively homogenous set?

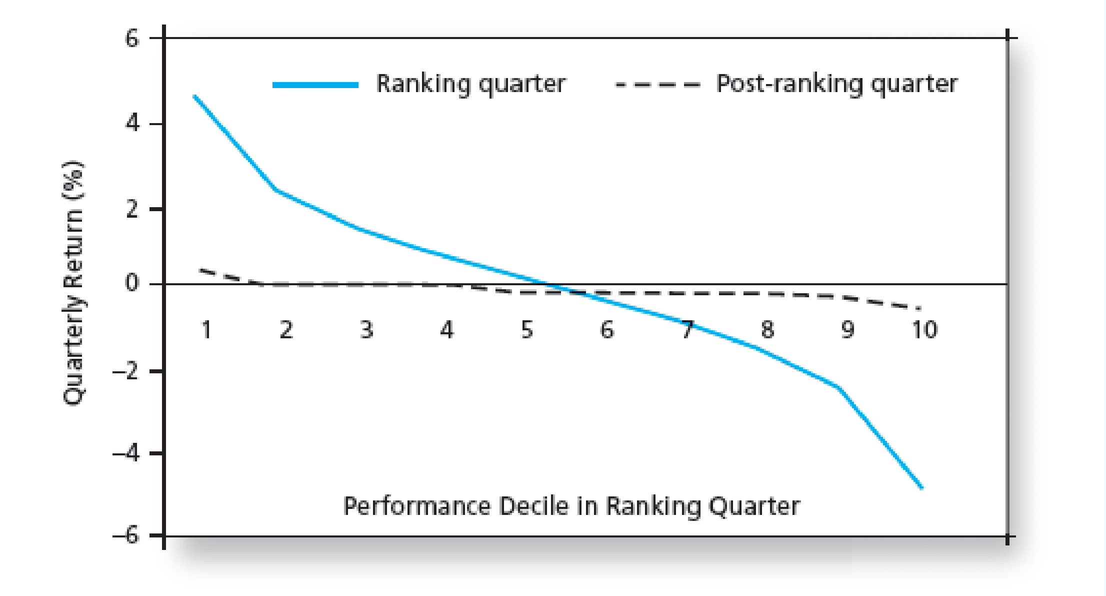

Figure 11.8 Risk-adjusted performance in ranking quarter and following quarter

(BKM textbook)

How rare are skilled managers?

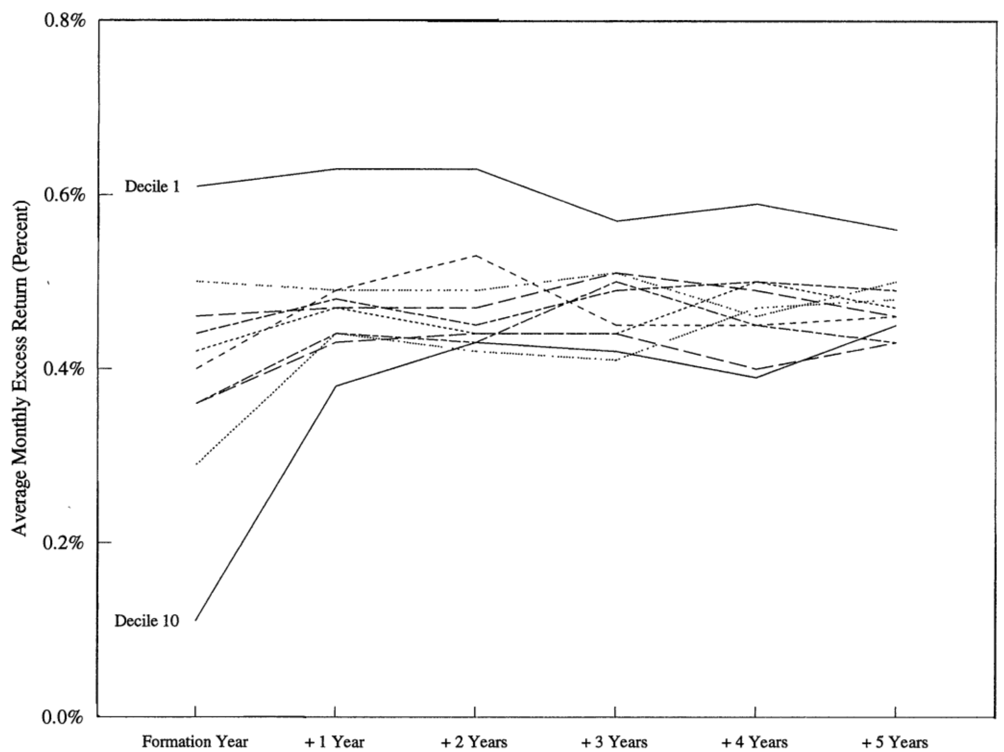

Figure 4. Post-formation returns on portfolios of mutual funds sorted on lagged three-year estimates of 4-factor alpha. In each calendar year from 1962 to 1987, funds are ranked into equal-weight decile portfolios based on three-year estimates of 4-factor alpha. The lines in the

(Carhart, 1997)

How rare are skilled managers?

- They are quite rare!
- Do they demand “insurance” in their contracts?

- How do these affect contracts for other (more homogenous) managers ?
- Do managers use compensation contract as a signalling mechanism?
- Market failure or just oversupply of capital?

Conclusion

- Very interesting paper with novel data
- Allow us to peek into the “blackbox” of mutual fund management
  - Low sensitivity of managerial compensation to fund returns and fee revenues
- Need to consider the implication of production function, agency issues, and labor market in the mutual fund industry more carefully