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ON INCENTIVES TO STAND OUT IN THE FAMILY: DEVIATION FROM A FAMILY PORTFOLIO & MUTUAL FUND PERFORMANCE

The mutual fund industry has grown tremendously over the past forty years. Mutual funds manage significant amounts of money on behalf of diverse groups of investors. According to the Investment Company Institute (U.S.) and the Investment Funds Institute of Canada, assets invested in mutual funds at the end of 2010 totaled $636 billion in Canada alone and $24.7 trillion worldwide. Given the amount of assets under management and the significant fees fund managers charge for their services, one of the important questions that both academics and practitioners have studied and debated is whether active management adds value. In one of my recent papers, I contribute to this literature by studying the behaviour of funds inside their fund family.

Family organization of the mutual fund industry is widely prevalent, with ninety percent of all actively managed equity funds belonging to a broader fund company (e.g., Fidelity, Vanguard). Family structure offers a number of advantages to family members including access to shared research and marketing resources. Yet, recent studies highlight that families often behave not as coordinated entities but as groups of competing funds that strive to dominate the family to enjoy benefits accruing to stand-out members. For example, researchers have documented evidence of favoritism in mutual fund families, highlighting that family members with the best recent performance benefit in the future at the expense of other family members. Among other things, they show that top funds receive higher inflows, enjoy better allocations of initial public offerings and get assigned more managers.

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The key insight of my paper is that preferential treatment of best-performing family funds provides strong incentives for managers to take into account holdings of other family members when making their investment decisions. Deviating from the family portfolio can be very costly for a manager with inferior investment ability. By deviating, such a manager may be foregoing the valuable research done at the family level that other managers rely on for their stock picking. Moreover, if the manager's portfolio decisions prove to be poor, he or she may be singled out and face the risk of being replaced and suffer low flows due to cuts in advertising exposure. By contrast, a skilled manager who can apply his abilities to obtain information superior to that gathered through centralized family research may prefer not to share this information with other family members but to act on it alone by deviating from the family portfolio. Thus, skilled managers have a strong incentive to deviate from the family portfolio, whereas unskilled ones can benefit from closely mimicking investment decisions of the rest of the family.

I studied the 1981-2010 performance of actively managed U.S. equity funds conditional on their deviation from the family portfolio. I find that managers who actively deviate from the family portfolio perform considerably better in the future than do those who passively mimic investment decisions of their family peers. After controlling for differences in risk, I show that high deviation funds outperform the low deviation ones by a statistically and economically important 2% per year. The empirical results suggest that the exceptional performance of managers who deviate strongly from the family portfolio is due primarily to their superior stock selection abilities. For example, the difference in risk-adjusted returns of stocks purchased by high and low deviation funds reaches 2.5% per year. Thus, skilled managers deviate from the family portfolio by investing in stocks in which they have informational advantages.

Overall, this paper emphasizes the importance of viewing mutual funds not as individual entities but as parts of a larger fund family and of studying interactions among family members. It suggests that managerial skills are more pronounced among managers who hold portfolios that deviate from those of other family members. The results support the value of active mutual fund management.

BIOGRAPHY

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TESTIMONIAL

I RECEIVED THE SCHOLARSHIP FROM THE **CSIRF** WHILE I WAS PURSUING MY Ph.D. DEGREE AT THE UNIVERSITY OF BRITISH COLUMBIA. The scholarship helped alleviate my financial concerns and allowed me to spend considerably more time on research topics. I am convinced that the scholarship played a big and important role in facilitating my research efforts. During the award tenure, I worked on a number of projects, which have proved fruitful, and the results of which have been published in leading finance journals. I am very grateful to CSIRF for the generous support.