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What Do We Know About the Mutual Fund Industry?

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2.1 Is there an engine in the car?

The Holy Grail in mutual funds literature has always been the analysis of performance. The literature has searched for answers to whether funds generate performance, whether they persist in doing so and whether it is enough to compensate for the fees that are charged. The answers have been mostly negative. Thus, a new question arises: if performance is not sizable and not persistent, what helps to justify the existence of the industry? The answer we will give in the following analysis is ‘marketing’. We will see how marketing strategies help to disguise poor performance and attract clients by focusing on non-performance-related features.

2.1.1 The myth of measurability of performance

We start as the standard analysis of the asset management industry has always done: by focusing on performance. Mutual funds have always been considered self-standing entities engaged in a competition with each other to deliver higher performance (‘alpha’). Performance has been defined as the ability to beat a ‘benchmark’ – i.e. deliver a return higher than the return of a portfolio which proxies for the investment in assets with similar risk as the fund. Various definitions of benchmarks have been provided. The first was the market portfolio – i.e. the return on a portfolio representing the main stocks in the market weighted according to their market capitalization. Next, a more sophisticated analysis has included other benchmarks: book to market and size portfolios. These represent the exposure to other classes of risk: the risk of investing in value stocks and the risk of investing in small stocks. Then, a third ‘factor’ has been considered: momentum. This proxies for the degree of autocorrelation of the returns of the assets in the relatively short period – momentum within a 6–12-month horizon and reversal beyond that period. Each new factor added to the benchmark was meant to proxy for new and different types of risk exposure.
of the fund (e.g., Carhart, 1997). However, as the ability to proxy for the degree of risk exposure improved, the quality of the detected performance deteriorated and quickly tipped to the negative side. More sophisticated models based on the observations of the actual stock holdings of the funds have not made the picture of the industry less bleak. The results in general have been dismal: mutual funds do not seem to outperform the market (e.g., Wermers, 2000). If we also include the fees charged by the fund, the picture gets gloomier: not only do funds not seem good at delivering superior performance, but after-fee they seem to underperform considerably.

Some trace of better performance could be found in some funds – extreme tail funds. However, this overperformance is very patchy and haphazard. Moreover, if we look at whether funds that overperform keep on doing it consistently over time, the answer seems to be negative. Mutual fund performance does not seem to persist, except in the case of negative performance. Some evidence of persistence of performance has been uncovered only recently. For example, funds with more incentive-loaded compensation structures for management seem to deliver better performance in a more consistent fashion (Massa and Patgiri, 2009).

Overall, skepticism remains. This is rooted in some of the characteristics of the process that generate performance: constraints on the ability to scale up the investment in profitable investment opportunities, negative size and organizational externalities. The existence of a directly observable link between fund-specific characteristics and performance would induce investors to flock to such funds, abnormally increasing their size and therefore, given these characteristics, limiting the ability of the funds to replicate such performance.

Given these considerations, it is instructive to look at how funds choose to present their performance and the benchmark they use. Funds characterize themselves in terms of investment styles. Performance is evaluated relative to the other competing funds operating in the same style. The idea is that, by using the other funds as a reference, investors can better identify fund managers’ skills. For example, fund managers investing in value stocks should be judged relative to other managers investing in value stocks. However, any comparison with funds investing in growth stocks would be misleading, as investors, by choosing a value fund, have already decided to pass on the higher returns of growth stocks to obtain the relatively greater safety of the value ones.

Unfortunately, the use of relative performance evaluation directly affects the behavior of fund managers, making evaluation of performance illusory. Indeed, benchmarks are conveniently selected by the managers themselves and, when imposed by outside assessors – e.g. Morningstar and Lipper – managers enact timing and window-dressing techniques meant to get around them.

Managers react to the setting of investment-style benchmarks in two ways. On the one hand, they may position themselves close to their peer-group