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A study of analyst-run mutual funds: The abilities and roles of buy-side analysts☆

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ABSTRACT

We assess the abilities and the role of buy-side analysts within mutual fund families by analyzing mutual funds managed by buy-side analysts from fourteen fund families. Buy-side analysts exhibit investment abilities by realizing positive style- and risk-adjusted returns and generating superior risk-return tradeoffs. Analysts' skills have a positive impact on the performance of funds from the same family. Although some managers benefit from closely following their buy-side analysts' ideas, research generated by these analysts is generally being underutilized by affiliated managers. The underutilization is consistent with longer-tenured managers choosing to forgo some of the analysts' ideas due to career considerations.

1. Introduction

Analysts employed by mutual fund families (i.e., buy-side analysts) play an important role in the fund management process. They provide investment recommendations and research support, which potentially have a direct impact on the portfolio decisions and performance of the mutual funds that they support. Assessing the abilities of buy-side analysts and their contribution to fund family performance is important because of the tremendous financial resources fund families invest in their research. If buy-side analysts are shown to not have abilities, then fund families and their investors are better served by eliminating their costly research programs. On the other hand, if buy-side analysts are shown to have abilities, then fund families and investors are better served by fund families leveraging these abilities to the fullest.

Despite the importance of buy-side analysts, existing research that covers the performance and the role of this class of analysts is at a relatively early stage in comparison to the extensive literature that studies sell-side analysts.[2] Three important recent studies each use data from a single large anonymous fund family (though not necessarily the same family) to assess the abilities

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[2] Unlike the extensive literature that studies sell-side analysts, we could identify only half a dozen articles that study buy-side analysts (see Cheng et al. (2006); Groysberg et al. (2008); Groysberg et al. (2013); Crawford et al. (2012); Frey and Herbst (2014); Rebello and Wei (2014)).

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of buy-side analysts based on the performance of their internal stock recommendations; results provide somewhat mixed conclusions. Groysberg et al. (2013) find that recommendations of buy-side analysts have no investment value and perform no differently than the recommendations of sell-side analysts. In contrast, Frey and Herbst (2014) and Rebello and Wei (2014)) conclude that buy-side analysts generate recommendations with investment value. One possible explanation for this discrepancy is that the underlying data is from different fund families, each with distinct analyst abilities, and because the fund families are anonymous, we cannot verify that this is the source of the disparity in findings.

In this paper, we revisit buy-side analysts but we take a different methodological direction. We introduce a novel approach to assess the abilities and role that buy-side analysts play within their families by analyzing 68 nontraditional mutual funds that are managed exclusively by buy-side analysts from 14 mutual fund families. Our approach utilizes the returns and holdings of analyst-run funds rather than the investment recommendations of analysts, which have been the focus of previous research. If buy-side analysts have investment abilities, then the performance of funds that they manage provides a more accurate indicator of their abilities because it reflects returns from analysts' actual investment decisions rather than returns from hypothetical portfolios that mimic their recommendations. Further, since analyst-run funds are likely to incorporate the best ideas of a family's analysts,[3] we can interpret their performance as an upper bound estimate on the profitability of proprietary strategies that exclusively rely on the ideas of in-house analysts. Thus, one of our contributions to this literature is to present more powerful tests of buy-side analysts' abilities based on a performance measure with a clear and realistic economic interpretation.

Besides providing an alternative assessment of the abilities of buy-side analysts, our second main contribution is addressing whether the investment skills of buy-side analysts have a positive impact on the performance of affiliated funds within their respective families. This analysis is possible because, unlike previous research that primarily utilizes data from only one fund family, our paper studies multiple fund families. This allows us to exploit cross-family variation in the quality of analysts, which we relate with fund performance across the 14 sample fund families. Combining this analysis with a bootstrap investigation, we establish that buy-side analysts have an impact on the performance of their affiliated funds.

To assess the abilities of buy-side analysts, we evaluate the performance of analyst-run funds using two benchmarking approaches. As it is common for mutual fund performance evaluation, our first approach adjusts returns for style and risk. But because fund performance could be driven by family and fund characteristics, we employ a second benchmarking approach. Specifically, we benchmark the performance of analyst-run funds against the performance of manager-run funds with similar characteristics, both from the same fund families (hereafter "affiliated funds") and from other families (hereafter "nonaffiliated funds"). We find strong support for the hypothesis that buy-side analysts have investment abilities, as analyst-run funds generate positive and significant benchmark-adjusted performance under both benchmarking approaches. This conclusion is further corroborated by additional findings suggesting that analyst-run funds exhibit superior risk-return tradeoffs, evidenced by greater Sharpe Ratios, and generate persistence in performance, which is lacking among manager-run funds.

However, running an analyst-run fund is secondary to the main responsibility of buy-side analysts to provide research support. Thus, to understand the overall contribution of buy-side analysts to their mutual fund families at a more general level, it is important to know whether analysts' skills have a positive impact on the performance of affiliated funds. We hypothesize that fund families housing analysts who are more skilled enjoy better performance for their member funds, which results from these analysts providing higher-quality support for their portfolio managers. We find strong support for this hypothesis in that the performance of manager-run funds is positively and significantly related to the level of skill of a given family's analysts. In addition, this relation is stronger than the relation between randomly paired fund managers within the same family, suggesting that analysts' skills positively affect the performance of the member funds.

Providing further evidence that buy-side analysts play an important role in the generation of mutual fund performance within their respective fund families, we find that funds that rely on their analysts' ideas the most (i.e., funds in the top reliance quintile) outperform all other funds that rely on their analysts' ideas to a lesser extent. This is sensible given our findings that analysts have good ideas that result in the outperformance of their funds and that their skills have an overall positive impact on the performance of all funds within their respective families. Moreover, these results are consistent with Cheng et al. (2006) and Rebello and Wei (2014). However, surprisingly, about half of the funds do not seem to follow their analysts' ideas at all. Thus, a natural question arises: why are all portfolio managers not fully utilizing their analysts' ideas to generate better performance? We consider two possible explanations.

First, analysts could choose to withhold good ideas from affiliated portfolio managers in the hope of outperforming portfolio managers and improving their own standing in the organization. We explore this possibility by comparing the performance of stocks that were uniquely-held by analysts with stocks that reflect ideas that analysts shared with portfolio managers, i.e., stocks analysts held in common with affiliated portfolio managers.[4] If analysts are withholding valuable ideas from the portfolio managers, we would expect the stocks uniquely held by analysts to outperform the shared ideas. We find no difference in the performance of these two sets of stocks, ruling out the possibility that analysts are withholding valuable ideas from affiliated portfolio managers.

Second, some portfolio managers may be biased against analyst recommendations. Chevalier and Ellison (1999b) show that longer-tenured portfolio managers are less likely to be fired in response to poor past performance. The rationale is that longer-tenured managers have a longer history of performance and investors are less likely to update their beliefs substantially after one period's performance. Thus, a longer-tenured manager can afford to ignore analyst ideas and undertake manager-specific investments, even if this causes her to forgo performance gains.[5] In doing so, as argued by Shleifer and Vishny (1989), a manager

[3] Levitz (2009) refers to analyst-run funds as "repositories for the best ideas from internal analysts." Along the same line, Dolan (2011) writes that analyst-run funds are viewed by fund families that offer them as "… a place [for analysts] to park their best ideas …"

[4] Commonly-held stocks are held concurrently in at least one analyst-run portfolio and at least one manager-run portfolio within the same fund family.

[5] Kinnel (2012) writes that "… a fund manager can undo an analyst's good stock selection … by ignoring the analyst's advice."