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New mutual fund managers: Why do they alter portfolios?☆

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ABSTRACT

This study examines why a new fund manager changes the mutual fund holding portfolio of his or her predecessor immediately after management turnover. The study considers three possible explanations: private information, reputation concerns, and grace periods for new managers to sell underperforming stocks. Monthly data for the study come from a unique database of the Securities Investment Trust and Consulting Association in Taiwan over the period from 2004 to 2012. Both the regression models and the fuzzy-set qualitative comparative analysis (fsQCA) confirm that for the one-year period following a change of manager, portfolio turnover contributes to new managers' outperformance of their predecessors, thus supporting the private information hypothesis. However, for the three-month period following a change of manager, causal asymmetry occurs: portfolio turnover can lead to outperformance or underperformance outcomes, supporting the hypotheses of private information and successors' grace period.

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1. Introduction

When fund managers depart, investors need to decide whether to stay with the fund. Financial advisors suggest that an important factor in this decision is the fund's actual investment process. Establishing whether the new manager will maintain the existing investment process will provide information about the likely future return performance (Money Marketing, 2015). A key measure of a fund's actual investment process changes after manager replacement is the turnover of the mutual fund holding portfolio.

Although business practice suggests that portfolio turnover is an important factor to look at in deciding whether or not to redeem shares after managerial replacement (Wall Street Journal, 9/14/2012), few studies address this issue. The current study attempts to bridge the gap between research and practice by investigating why a succeeding fund manager changes the mutual fund holding portfolio immediately after management turnover and how the portfolio turnover activities influence fund returns in the post-replacement period.

Few studies address the issue of portfolio turnover activities after management turnover. Jin and Scherbina (2011) examine the effects of replacing fund managers on the composition of fund holding portfolios. They find that new managers sell off inherited momentum loser stocks at higher rates than stocks in any other momentum decile, a result consistent with behavioral bias of sunk cost fallacy that predecessor fund managers are reluctant to sell losing stocks while new fund managers are in the best position to eliminate poorly performing investments. This study extends the work of Jin and Scherbina (2011) and examines why a new fund manager changes the mutual fund holding portfolio of his or her predecessor immediately after management turnover by considering three possible explanations: private information, reputation concerns, and grace periods for successors. In particular, the change in portfolio holdings immediately after management turnover may relate to the new fund manager's private information on stock selections, leading to outperformance of the fund after a change of manager (private information, Jensen, 1968; Chang & Lewellen, 1984; Henriksson, 1984). Succeeding fund managers may also have an incentive to change portfolio holdings immediately after turnover to decrease their performance and reputations' association to those of previous fund managers, even though they may not have superior stock selection abilities (reputation concerns, Chevalier & Ellison, 1999). This behavior suggests that portfolio turnover following managerial replacement has no effect on the outperformance of new managers. Further, fund families usually grant a short grace period for new managers to sell all underperforming stocks immediately after a management turnover, suggesting a negative effect of portfolio turnover on the performance of new managers following replacement over a short period of time.

Data to address this research question come from the available monthly portfolio holdings of mutual fund managers from the Securities Investment Trust and Consulting Association (SITCA) in Taiwan, a

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unique data set that mutual fund companies directly file with SITCA. One advantage of using Taiwan data is that reports are on a monthly basis whereas US mutual fund holding data reports are quarterly. By using monthly holding data, the study can investigate portfolio turnover activities and focus on a relatively short measurement period of three months. Considering superior performance's short life, a brief measurement horizon provides a more precise method of identifying a fund manager's private information and corresponding portfolio turnover activities.

The study compares the portfolio holdings of the new fund manager immediately after management turnover, when the holdings are different from those of the previous fund managers prior to replacement. The study uses this *Active Share* measure to proxy for portfolio turnover activities, and uses the characteristic selectivity (CS) measure in Daniel, Grinblatt, Titman, and Wermers (1997) to measure fund managers' performance. According to the private information hypothesis, if *Active Share* positively contributes to subsequent outperformance of the fund after management turnover, the turnover correlates with the new manager's superior private information on stock selections. However, a lack of a systematic association between *Active Share* and subsequent outperformance may signal new fund managers' concern about their reputation, not wanting the company to blame them for the decision-making of their predecessors. Finally, the grace period hypothesis suggests that *Active Share* will result in subsequent underperformance of the fund following manager turnover because new managers sell underperforming stocks.

The study employs regression models and the fuzzy set Qualitative Comparative Analysis (fsQCA) approach (Ragin, 1987, 2006, 2008). The findings from regression analysis indicate that *Active Share* positively contributes to the return difference as does the characteristic selectivity (CS) difference of the fund in the pre- and post-replacement periods. The results are generally robust for three-month and one-year periods.

Regression analysis can only estimate the average effect of portfolio turnover on the relative return performance of new managers compared to their predecessors. This symmetric approach cannot analyze asymmetric causality. The effect of an increase in portfolio turnover on outperformance outcome is not the opposite of the effect of a reduction of the same magnitude. Portfolio turnover prompted by private information will contribute to the outperformance of new managers, whereas portfolio turnover resulting from the grace period motive will also contribute to underperformance. To address such issues of cause asymmetry, this study partitions the sample into four sub-samples: (1) funds that outperform for three months following management turnover, (2) funds that underperform for three months following management turnover, (3) funds that outperform for one year following management turnover, and (4) funds that underperform for one year following management turnover, and applies fsQCA.

This study finds that, for the outperformance sample, over a three-month period, a high score in simple *Active Share* configuration contributes to a high score in outperformance outcome. However, the study also finds that, for an underperformance sample, a high score in simple *Active Share* configuration contributes to a high score in underperformance outcome. Both outperformance and negation of outperformance outcomes include simple *Active Share* configuration as the cause recipe; therefore, these results confirm that portfolio turnover in a short period following managerial turnover is consistent with the hypotheses of private information and successors' grace period.

The findings for a one-year period are different. The study finds that a simple *Active Share* configuration indicates high outcome scores in outperformance cases. *Active Share* is sufficient for outperformance of new managers. In the underperformance cases, simple *Active Share* does not comply with the consistency threshold of 0.80. The results indicate that portfolio turnover one year following managerial replacement contributes to the outperformance of new managers, a finding consistent with the private information hypothesis.

The study makes three contributions. First, apparently, this is the first study to examine the rationale behind the turnover in the holdings of a fund immediately after managerial replacement, linking portfolio turnovers to fund returns in the post-replacement period. Second, consistent with the practitioners' views (Wall Street Journal, 9/14/2012), the study formally measures the portfolio turnover activities by calculating the differential between portfolio holdings of the succeeding fund manager immediately after management turnover and the portfolio holdings of the predecessor based on monthly holding data. This measure, along with the data frequency, provides a more precise method of comparing the portfolio turnover activities of a new manager to a predecessor, and is new in the literature. Furthermore, this study uses both regression and fsQCA approaches and confirms that for the one-year period following a change of manager, portfolio turnover helps to predict new managers to outperform their predecessors.

Third, fsQCA leads to a full understanding that portfolio turnover can lead to outperformance or underperformance for the three-month period following a change of manager. Therefore, investors should consider the measure of portfolio turnover if the objective is to identify which new managers are likely to outperform or underperform after managerial replacement.

This study proceeds as follows. Section 2 reviews the literature and hypothesis development. Section 3 describes the data, variables, regression and fsQCA methods. Section 4 presents the empirical results from the regression and fsQCA approaches, and presents the predictive validity of fsQCA. Section 5 provides the implications and conclusions. Section 6 presents the limitation and future research direction.

2. Literature review and hypothesis development

Woodside, Schpektor, and Xia (2013) investigate the complementary benefits of fuzzy set qualitative comparative analysis and regression analysis in the context of unobtrusive marketing field experiments. The current study builds its theory on the domain of managerial replacement in the mutual fund industry and forms hypotheses/tenets from a net-effect perspective and a causal recipe perspective.

2.1. Theory-building from a net-effect perspective

2.1.1. The literature on managerial replacement

Payne, Prather, and Bertin (1999) find that managerial tenure can enhance risk-adjusted return. An extensive literature on finance analyzes CEO turnover in firms (Coles, Daniel, & Naveen, 2008; Huson, Malatesta, & Parrino, 2004; Huson, Parrino, & Starks, 2001; Jensen & Meckling, 1976; Jensen & Murphy, 1990; Mobbs, 2013; Weisbach, 1988). Several studies examine managerial replacement in the mutual fund industry. Khorana (1996) investigates the relation between managerial replacement and prior fund performance, finding an inverse relationship between the latter and the probability of manager replacement. Khorana (2001) further finds that the replacement of underperforming managers results in a significant improvement in fund performance.

In the event of managerial turnover, new managers take over the projects of their predecessors. Weisbach (1995) finds that management turnover increases the probability of divesting an unprofitable acquisition. Staw, Koput, and Barsade (1997) examine whether the turnover of senior bank managers leads to a de-escalation of commitment to problem loans, finding that the turnover of bank managers increases the likelihood of future bad loan write-offs. Jin and Scherbina (2011) examine the effects of replacing fund managers on the composition and performance of fund holding portfolios and find that new managers sell off inherited momentum loser stocks at higher rates than stocks in any other momentum decile. Unlike new managers, continuing fund managers tend to hold the momentum losers even though loser stocks, on average, continue to underperform for as long as one year (Jegadeesh & Titman, 1993, 2001).

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