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# Comparing performance sensitivity of retail and institutional mutual funds' investment flows

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## ABSTRACT

In this paper, we examine and compare the form of the flow-performance relationship for U.S. retail and institutional mutual funds. We provide evidence that the convex form of the flow-performance function documented by previous research characterizes mostly the relationship in the upper region of the performance scale. In contrast, the flow-performance relationship for the low-performance region appears to be concave. Furthermore, we document that the observed convexity is more pronounced for retail funds, while the concavity can be mainly attributed to institutional funds.

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## 1. Introduction

In this study, we examine and compare the form of the flow-performance relationship for U.S. retail and institutional mutual funds.

The paper draws on three strands of literature. First, the majority of studies examining the link between past returns and fund flows conclude that the flow-performance relationship has a convex form. [Sirri and Tufano \(1998\)](#) show that mutual-fund investors allocate disproportionately more capital to funds with the highest recent returns, but fail to react aptly to poor performance by divesting from underperforming funds. [Del Guercio and Tkac \(2002\)](#) find further support for this observation, reporting that mutual-fund investors allocate disproportionately more capital to recent winners. In a related paper, [Chevalier and Ellison \(1997\)](#) argue that, given the prevalence of asset-based compensation mechanisms in the mutual fund industry, inefficiencies in investors' response to past performance, consistent with a convex flow-performance function, give managers an implicit incentive to alter the risk of their portfolios to increase a chance of being among the winners. [Ferreira et al. \(2012\)](#) study variation in the flow-performance relationship across countries. They find that the relationship tends to be less convex in countries with better economies and with more developed mutual-fund industries. The authors

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explain their findings by the higher level of financial sophistication of investors and the lower costs of participation in mutual funds typically observed in developed countries. In addition, the authors show that the level of portfolio risk is higher in countries with a more convex flow-performance relationship. Using a sample of UK-based funds, [Keswani and Stolin \(2012\)](#) examine the form of the flow-performance relationship separately for flows of retail and institutional investors. The authors document that the convex form of the flow-performance relationship reported in the previous literature is more pronounced for the retail investors.

The second strand of research examines mutual-fund performance persistence (see, for example, [Grinblatt and Titman, 1989](#); [Brown et al., 1992](#); [Gruber, 1996](#); [Elton et al., 1996](#); [Carhart, 1997](#); [Wermers, 2003](#); [Kosowski et al., 2006](#)). Studies on performance persistence report persistence only when risk-adjusted return measures are considered. Performance estimated as an absolute return is found to be uninformative for prediction of future performance. Further, this literature suggests that the return persistence is mostly observable among the best- and worst-performing funds. The worst-performing funds continue to perform poorly, while the best performers continue to generate superior returns. [Hendricks et al. \(1993\)](#) introduce the concept of “hot hands” to characterize the tendency of the best-performing funds to continue to outperform in the subsequent periods. [Grinblatt and Titman \(1992\)](#), [Goetzmann and Ibbotson \(1994\)](#), and [Bollen and Busse \(2004\)](#) also provide evidence of return persistence among the best-performing funds. At the same time, [Brown and Goetzmann \(1995\)](#) and [Berk and Tonks \(2007\)](#) document return persistence among the worst-performing funds. According to the authors of the latter study, the observed persistence for poorly performing funds is a result of investors' reluctance to withdraw assets from these funds. [Fama and French \(2010\)](#) find persistence, albeit temporary, in three-factor alpha among both winning and losing funds.

The third strand of literature explores differences between retail and institutional funds (see, for example, [James and Karceski, 2006](#); [Haslem et al., 2008](#); [Baker et al., 2009](#); [Glode et al., 2012](#); [Salganik-Shoshan, 2016](#)). Consistent with the differences in investors' profiles, the studies in this area highlight significant variation in the flow patterns between the two types of funds. For example, [James and Karceski \(2006\)](#) report that compared to the flows of retail funds, flows of institutional funds are more sensitive to risk-adjusted return, while less sensitive to fund absolute returns. [Salganik-Shoshan \(2016\)](#) confirms this observation.

Our study builds on the intersection of these three strands of literature. We argue that if investors were to take into account the well-documented persistence of best- and worst-performing funds, they would likely invest more in recent winners and divest from the worst-performing funds, due to the high probability that the latter would continue to underperform. In this case, the flow-performance relationship would be both concave, in the lower region of the performance scale, and convex, when considering funds with the highest recent returns. Moreover, we expect the flow-performance relationship for more sophisticated, institutional funds' investors to follow a concave-convex form, while the convex form documented by previous studies should describe better the relationship for retail funds' investors, often seen as less informed.

Consistent with the previous empirical literature, we find that the form of the flow-performance relationship is non-linear.<sup>1</sup> We observe that the convex relationship documented by existing research mostly characterizes the part of the flow-performance function in the upper region of the performance scale. The flow-performance relationship in the region of the lower performance scale appears to be concave. More importantly, we find that the observed convexity is more pronounced for retail funds, while the concavity mostly characterizes institutional funds. These findings imply that the previously documented tendency to allocate disproportionately more capital to the best performers is much stronger for investors of retail funds. Investors of institutional funds, however, demonstrate a significantly stronger tendency to divest from poorly performing funds, punishing the worst performers the hardest.

Our study contributes to the mutual-fund literature in a number of ways. First, we contribute to the flow-performance literature by providing empirical evidence of heterogeneity in the form of the flow-performance relationship for the U.S. mutual funds catering for different categories of investors. Second, we contribute to the growing literature on investor behavior by examining the extent to which investors with different levels of financial sophistication exploit mutual funds' performance persistence patterns documented by the empirical research. Third, we extend the recent research on retail and institutional funds, shedding additional light on the differences in flow patterns between the two types of funds. Finally, our findings contribute to the extensive literature on the incentives driving fund managers' behavior. The convexity of the flow-performance relationship, more pronounced for the retail funds in our sample, reflects investors herding in the best past performers. Thus, fund managers are incentivized to tilt their portfolios, often towards riskier assets, in attempt to get better chances of being among the winners. Such risk-shifting behavior is further exacerbated by the fact that fund managers' compensation is typically linked to the amount of assets under management.<sup>2</sup> At the same time, the convex-concave form of the relationship with relatively low convexity yet prominent concavity, as observed for the institutional funds in our sample, should considerably weaken the fund manager's incentives to follow the aforementioned risk-shifting behavior.

The remainder of this paper is organized as follows. [Section 2](#) describes the data. [Section 3](#) outlines the methodology and reports the results of our analyses. [Section 4](#) concludes the paper.

<sup>1</sup> See, for example, [Ippolito \(1992\)](#) and [Sirri and Tufano \(1998\)](#).

<sup>2</sup> See, for example, [Brown et al. \(1996\)](#) and [Chevalier and Ellison \(1997\)](#).

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