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What impact does a change of fund manager have on mutual fund performance?

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ABSTRACT

Using a unique database of UK fund manager changes over the period from 1997 to 2011, we examine the impact of such changes on fund performance. We find clear evidence to suggest that a manager change does affect the benchmark-adjusted performance of UK mutual funds. In particular we find a significant deterioration in the benchmark-adjusted returns of funds that were top performers before the manager exit and, conversely, a significant improvement in the average benchmark-adjusted returns of funds that were poor performers before the manager exit. Our use of the Carhart's (1997) four-factor model reveals that the improvement in average post manager exit performance is accompanied by a reduction in market risk, a slight reduction in exposure to small cap stocks, and an increase in exposure to value and momentum stocks. Overall, our results suggest that UK fund management companies have been relatively successful in replacing bad managers with better managers, but relatively unsuccessful at finding equivalent replacements for their top performing managers. We believe that regulators should therefore try to ensure that all efforts are made by fund management companies to inform all of their investors about a change in management.

1. Introduction

There is a great deal of empirical evidence that suggests that active fund managers cannot produce alpha.[1] However, these results are generally based upon fund data, rather than on the performance of an individual fund manager. In other words, calculating an alpha using 10 years of monthly return data associated with, for example, the *ABC North American Equities Mutual* fund, often leads one to the conclusion that the alpha is both economically and statistically indistinguishable from zero, and often that it is negative. So any investor that had invested in this fund would probably have been better off investing in a passive North American equities mutual fund. The related conclusion with regard to this result is that the manager responsible for managing the fund did not demonstrate any investment skill. But over 10 years the fund may have had more than one manager. Any one of these managers might have had investment skill, but when averaged over time with one or more managers that did not have skill, the impression is that *all* fund managers do not have any active investment skill worth paying for. However, it is possible that there are managers with skill, but that these managers may move frequently as they are poached by other fund management groups, taking their skill with them; skill that is lost when viewed at the fund level.

In this paper we investigate the impact of manager turnover on the performance of UK mutual funds using event study methodology. We construct a unique sample of 921 UK fund manager changes over the period January 1997 to December 2011. Fund performance is examined up to 36 months before and after the fund manager exit. This paper attempts to fill the gap in the literature by offering the first comprehensive study of the effect of fund manager changes on the performance of equity and fixed income UK mutual funds.

To understand more fully the role that fund managers play in generating returns, there has been an increasing focus in the academic literature on the fund manager rather than on the fund. A number of researchers have identified the negative impact that manager turnover has on a mutual fund's subsequent performance. Khorana (1996) examines a sample of 339 US mutual funds that experienced manager turnover in the period 1976–1992 and finds that the replacement of an incumbent manager on average leads to two years of significant underperformance. The study also finds that performance nearer the replacement date has a significant impact on the probability of a manager replacement. Chevalier and Ellison (1999) corroborate the negative manager change/performance relationship and find it particularly pronounced among poorly performing younger managers. More recently, Dangl, Wu, and Zechner (2008), develop a theoretical model of the fund management industry and use it to focus

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[1] For a recent survey of the vast literature on fund performance see Cuthbertson, Nitzsche, and O'Sullivan (2008).

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on the reasons for the replacement of portfolio managers. The model implies that the probability of a manager replacement increases with the inferiority of past performance (in line with empirical evidence in Khorana, 1996; Chevalier & Ellison, 1999) and decreases with manager tenure in the fund. In addition, if the tenure of the fired manager is short, the model predicts a change in fund flows and risk profile before (outflows and high risk) and after (inflows and lower risk) the replacement. These predictions are weaker (even inverse) if the replaced manager has a longer management tenure.

Khorana (2001) finds that the replacement of US fund managers with superior pre-turnover performance causes a drop in median objective adjusted fund returns from 1.9% one year before the turnover to only 0.4% three years post-change. Conversely, managers replacing the worst performers improve the median objective adjusted fund returns by 2.9% in the same period. Gallagher and Nadarajah (2004) focus on the change in the performance, risk and flow activity of Australian equity, fixed income and balanced funds pre- and post-top management[2] replacement in the period 1991–2001. They find that following the replacement of a top performing manager that there is a reversal in performance for both outperformers and underperformers; the idiosyncratic risk increases prior to the turnover; and that funds exhibiting poor pre-turnover performance are penalised by lower flows. More recently Bessler, Blake, Lückoff, and Tonks (2010) show that both fund flows and manager turnover (in combination and independently) explain the mean reverting nature of mutual fund performance. In the sample of 3946 active US equity mutual funds spanning the period from 1992 to 2007, they find that for winners, high inflows have a stronger negative impact on long-term performance than the manager change, while jointly these two mechanisms reduce Carhart's (1997) four factor alphas by 3.6% per year compared to winner funds with neither of the two effects present. For loser funds, the impact of the joint manager turnover and fund flows mechanism is more pronounced. When both manager replacement and outflow occur in the loser funds, their risk-adjusted performance improves by 2.4% per year relative to a subgroup of loser funds where neither of the mechanisms operates.

The findings of the studies on changes in fund performance before and after manager replacement suggest that 'star' fund managers may often be replaced by less competent ones leading to deterioration in performance; conversely, those managers replacing poorly performing managers tend to improve the performance of the fund. These results support the hypothesis that manager turnover is one of the reasons for the absence of long-term mutual fund performance persistence. It has been found that performance does persist over horizons of up to three years, particularly for poor performing funds, as documented for US mutual funds by Brown and Goetzmann (1995) and Blake and Morey (2000). In the context of manager replacements, one possible explanation for short-term performance persistence is suggested by Dangl et al. (2008). Specifically, the studies on manager replacement do not, indeed cannot, separate the contribution of the manager and the contribution of the management company to a fund's performance. Therefore, even though a top performing manager may leave a fund, the performance may not 'leave' with them immediately because it may be partly driven by the company's know-how. The converse might be true when a poorly performing manager leaves.

Overall, the evidence from previous studies of mutual fund manager turnover tends to suggest that it has a detrimental impact on subsequent performance, at least a short-term term. However, to our knowledge all of the existing studies of this phenomenon have so far been conducted using US equity mutual fund data.

The main result in our paper is the finding of very strong evidence to suggest that a manager change does have a significant positive impact on benchmark-adjusted fund returns. Our use of the four-factor Carhart model reveals that the improvement in average post manager exit performance is accompanied by a reduction in market risk, a slight reduction in exposure to small cap stocks, and an increase in exposure to value and momentum stocks. We also find evidence of a significant deterioration in the benchmark-adjusted returns of funds that were top performers before the manager exit and, conversely a significant improvement in the average benchmark-adjusted returns of funds that were poor performers before the manager exit. These results suggest that UK fund management companies have been relatively successful in replacing bad managers with better managers, but relatively unsuccessful at finding equivalent replacements for their top-performing managers. The rest of this paper is organised as follows: in Section 2 we describe our data and methodology; in Sections 3 and 4 we present our results; and finally in Section 5 we summarise the results in the paper.

2. Data and methodology

To determine the impact of a manger change on the subsequent performance of a fund we use the event study methodology to examine the relationship between mutual fund performance in the pre- and post-managerial turnover.

2.1. Event definition

The definition of event in this paper is a change (replacement/resignation/retirement/other) of a fund manager. Although a standard event study would employ daily data, we believe that it is reasonable to assume that the effect of manager change would not be observed over days, but rather over a longer period. The performance of the fund is gauged three years before the event date and three years after the event date, which constitutes the event window of 36 months prior to the event and 36 months after the event. Such a pre-event time period is chosen following Khorana (2001), who advocates that funds which experience a management turnover have at least two years of performance history before the management replacement month. Furthermore, Hendricks, Patel, and Zeckhauser (1993), Goetzman and Ibbotson (1994) and Brown and Goetzmann (1995) all find evidence of performance persistence in mutual funds over a horizon of one to three years.

2.2. Selection criteria for managers and data sources

The sample of managers and funds they manage was identified using Morningstar, Citywire[3] and the Financial Express Database. These databases cover UK mutual funds and provide information on fund management structures, investment objectives, fund benchmarks, fund managers' characteristics and other fund characteristics. Furthermore, the Morningstar and Standard & Poor's data sources provide us with information of manager replacements from January 1997 to December 2011. Choosing 2011 as the end year in our sample allows us to analyse the manager change impact over a three-year period following any change. A breakdown of the manager exit sample is presented in Table 1.

The full sample includes both surviving and non-surviving funds and consists of 941 fund manager changes in total. 755 of the managers that leave their funds manage equity funds. Of this total 328 managed UK equity funds, 325 managed developed economy (ex UK) equity funds and 102 managed emerging market equity funds. Of the total 941 manager changes in our database 186 managed fixed income funds.

The price data for the funds and for their respective benchmarks was obtained from Morningstar and covers the period from January 1994 (36 months prior to the first manager change in our sample) to June 2014 (36 months after the last manager change in our sample). All of the funds in which the change occurred were managed by a single manager, rather than by a team.[4] The Morningstar database identifies

[2] Head of Australian equities, Head of Australian fixed interest, or Chief Investment Officer.

[3] Citywire is a UK data source providing information on UK mutual fund managers.

[4] We excluded team managed funds as we would expect the effect of a change of the composition of a team to be less than that for a fund managed by an individual manager.