



## When active fund managers deviate from their peers: Implications for fund performance

Swasti Gupta-Mukherjee\*

Quinlan School of Business, Loyola University Chicago, Chicago, IL 60611, USA

### ARTICLE INFO

#### Article history:

Received 4 November 2011

Accepted 5 December 2012

Available online 25 December 2012

#### JEL classification:

G11

G14

G23

D83

#### Keywords:

Mutual funds

Performance evaluation

Heterogeneous beliefs

Networks

### ABSTRACT

This paper proposes that the extent to which mutual fund managers' beliefs deviate from the ex ante unobservable representative beliefs of their peers contains information about their skill. A new measure based on portfolio allocations, *peer deviation*, is used to capture a fund manager's divergence from the contemporaneously unobservable beliefs of her peers. The portfolio based on representative beliefs of a group of managers investing in similar assets outperforms passive benchmarks, indicating that they reflect informed beliefs. Fund managers who simultaneously arrive at portfolio selections which, in hindsight, are close to those implied by representative beliefs possess ex ante more skill and exhibit future outperformance. Copycat strategies replicating lagged portfolio holdings implied by representative beliefs outperform the actual portfolio holdings of funds that deviate most, but the outperformance dissipates after two quarters.

© 2012 Elsevier B.V. All rights reserved.

### 1. Introduction

This study empirically examines the implications of divergence in beliefs and choices of mutual fund managers as reflected in their portfolio selection decisions. In this paper, a fund manager makes portfolio allocation decisions based on her beliefs and cannot observe the contemporaneous allocation decisions or beliefs of her peers, i.e. beliefs of managers who have similar objectives and investment opportunity sets. The framework assumes the presence of heterogeneous beliefs among fund managers who are peers. In line with recent empirical studies that support the idea of portfolio holdings of actively managed funds revealing fund managers' expectations about future asset prices, this study employs portfolio allocations to elicit beliefs.<sup>1</sup> This setting forms the basis for introducing the main innovation in this study, which is the premise that a fund manager's deviation from the representative beliefs of her peers in a time period, while only observable ex post, contains information about her skill and fund performance in later periods.

\* Tel.: +1 312 915 6071.

E-mail address: [sguptamukherjee@luc.edu](mailto:sguptamukherjee@luc.edu)

<sup>1</sup> The setting of employing active portfolio allocations to elicit beliefs of fund managers is shared with several other recent papers like Shumway et al. (2011), Yuan (2007), Jiang and Sun (2012), and Jiang et al. (2011). The general focus of these studies is on how fund managers' revealed beliefs about expected stock returns elicited from their portfolio holdings relate to future stock returns.

To make the notion of divergence in beliefs empirically tractable, this paper first defines a hypothetical portfolio chosen by a fictional representative fund manager (RM) who is the representative agent of a group of competing individual fund managers. The hypothetical portfolio reflects RM's beliefs about future asset prices, which is the composite of the ex ante unobservable beliefs of individual fund managers, and behaves *as if* the investments made by the individual managers in a peer group represent one fund's portfolio allocations.<sup>2</sup> The underlying notion is that when a group of individual fund managers act on their private information, some or all of the information becomes incorporated into their RM's hypothetical portfolio. In a decision period, individual fund managers select allocations which diverge from RM's selections based on the divergence of their beliefs relative to RM's contemporaneously unobservable beliefs. For instance, if a fund manager overweighted (underweighted) a stock relative to RM, the manager is more optimistic (pessimistic) about the future prospects of the stock than implied by the representative beliefs of the fund manager's peers. Based on this intuition, I examine the dynamics of divergence in beliefs from representative beliefs in the context of actively managed mutual funds. Specifically, this study aims to study the information contained in an individual manager's deviations from representative beliefs about her skill and future fund performance. A manager's

<sup>2</sup> Note that this setting does not impose any assumption about the rationality of the representative fund manager.

divergence in beliefs can arise because the signals received by the fund manager about future asset prices are either more accurate or less accurate than the information signals reflected in the ex ante unobservable representative beliefs of her peers. In the context of this study, the likelihood of a negative (positive) relation between divergence in beliefs and fund performance increases when the representative beliefs of the fund managers' peer group reflects informed (uninformed) beliefs.

Using portfolio holdings data for actively managed equity mutual funds in the United States over the period 1990–2010, I study the implications of mutual fund managers having diverging beliefs from the ex ante unobservable representative beliefs of their peers. Funds are categorized into a peer group if they share a common passive benchmark following the assignments used in [Cremers and Petajisto \(2009\)](#), since these funds invest in a similar style category, compete for information about similar assets, and typically benchmark versus the same index. Each fund in a quarter is linked to one fictional RM who holds a hypothetical portfolio representing the composite beliefs of the fund's peer group, constructed as the equal-weighted portfolio of all stocks held by at least two funds in the peer group in the most recent reported holdings. The weight of each stock in a RM's hypothetical portfolio is the mean weight allocated to the stock by funds in the peer group. For each stock in RM's portfolio, a fund's stock-specific deviation from RM is computed as the absolute difference between the weight allocated to the stock by the fund and the weight of the stock in RM's portfolio. Cumulating these stock-specific deviations generates a proxy for the divergence of the fund manager's beliefs from representative beliefs, called *peer deviation*. The peer deviation measure can be viewed as a 100% position in RM's portfolio plus a zero-net-investment long-short portfolio that captures a fund's deviations from RM. The empirical design in this study is similar to [Cremers and Petajisto \(2009\)](#) who construct "Active Share" to measure how a manager's allocations deviate from the allocations in a passive benchmark, with Active Share increasing when the fund manager increases her active positions relative to the passive index.<sup>3</sup> A critical difference between peer deviation in this study and Active Share is that a fund manager exhibits peer deviation if she has more passive or more active bets relative to RM, since it aims to measure the absolute divergence of her beliefs.

This paper finds that peer deviation is positively related to some measures of activeness like Active Share, indicating that more active funds are more likely to have diverging beliefs relative to their peers. Funds which exhibit herding in their trades tend to deviate less from their peers' portfolio allocations. Fund managers also tend to deviate less when market uncertainty is high and when the overall herding behavior in the fund's peer group is high. Funds located in geographical areas with a low density of fund managers deviate more, suggesting that distinctive beliefs are linked to a fund manager's lack of word-of-mouth communication with other managers.<sup>4</sup> Overall, while several fund attributes have a significant relation with peer deviation, a substantial part of the variation in the measure remains unexplained.

Based on the returns generated by the hypothetical portfolios held by RMs, the results are consistent with RMs representing *composite informed beliefs* of peer groups of active managers. In the portfolio formation quarter, the mean four-factor alpha from the gross holdings return of RMs' hypothetical portfolios is a significantly positive 2.30% per year. The most active peer groups (i.e. for which RMs have higher Active Shares) appear to have the most

informed RMs, with the portfolios' mean four-factor alpha being 3.21% per year for the RMs in the highest quintile based on their Active Share. Additionally, this study shows that peer deviation has a significantly negative relation with measures of fund managers' skill and fund performance. Funds ranked in the highest decile based on peer deviation (i.e. distance from RM) underperform those in the lowest decile by a four-alpha of 1.64% (2.06%) per year based on gross (net) return in the ranking quarter, and 2.05% (1.54%) in the post-ranking quarter. The performance differential persists for over 1 year following the quarter when peer deviation is measured. The negative relation between peer deviation and fund performance holds in multivariate regression analyses, within groups of funds with similar degrees of activeness, herding behavior, and network connections, and across periods of time with varying levels of market uncertainty. Overall, the evidence reported in this study indicates that fund managers who arrive at decisions which, in hindsight, are close to those implied by the informed representative beliefs of their peers possess ex ante more skill. Peer deviation also has a more detrimental effect on performance for more active funds and in regimes of low market uncertainty. Also, consistent with an information-based explanation of the empirical findings, the negative impact of peer deviation on performance is more pronounced for funds in which the manager has less access to networks with other fund managers. This result supports the view that fund managers may have distinctive but less accurate beliefs if they are disconnected from informal networks with other managers. Additionally, copycat strategies replicating lagged portfolio holdings of the RMs outperform the actual portfolio holdings of funds that deviate most, but the outperformance dissipates after two quarters.

This study contributes to the literature on informed trading and professional portfolio management. There is recent empirical evidence linking various aspects of mutual funds' portfolio allocations to skill, like deviations from passive indexes ([Cremers and Petajisto, 2009](#)), industry concentration ([Kacperczyk et al., 2005](#)), risk-shifting ([Huang et al., 2011](#)), and similarity of portfolio choices to the choices of star performers ([Cohen et al., 2005](#)). However, to my knowledge, this is the first empirical study to shed light on the implications of mutual fund managers acting on beliefs that differ substantially from the representative beliefs of their active peers. This study suggests that the proximity of fund managers' beliefs to the representative beliefs of their peers captures superior skill and valuable private information – attributes much sought after by mutual fund investors. In light of these results, and the findings on the diminishing value of activeness when it is coupled with managers' distinctive beliefs, the results in this paper could further refine the selection of skilled fund managers. Also, the result linking a presumably stable factor like informal networks to a fund manager's information endowment and divergence in beliefs provides fresh insights about the economic significance of word-of-mouth communication in financial markets. The link between market uncertainty, funds' herding behavior and peer deviation shown in this paper extends our understanding of how uncertainty in the information environment affects the divergence in beliefs of fund managers. Finally, the findings in this paper resonate with the proposition in recent studies that mutual funds function under relative transparency and are less likely to be able to protect the distinctiveness of valuable ideas, whereas the persistence and outperformance of distinctive strategies of hedge funds can be largely attributed to their ability to maintain secrecy (see [Glode and Green, 2011](#); [Agarwal et al., forthcoming](#)).

The remaining paper is organized as follows. Section 2 summarizes the background and motivation. Section 3 develops the setting to measure peer deviation used in the empirical investigation. Section 4 discusses the data and sample. Section 5 describes the empirical results. Section 6 concludes.

<sup>3</sup> Active Share of a fund is defined as:  $\text{Active Share} = \frac{1}{2} \sum_{i=1}^N |w_{fund,i} - w_{index,i}|$ , where  $w_{fund,i}$  and  $w_{index,i}$  are the portfolio weights of asset  $i$  in the fund and in the index, respectively, and the sum is taken over the universe of all equity assets.

<sup>4</sup> For evidence of the presence of word-of-mouth communication among mutual fund managers located in geographical proximity, see [Hong et al. \(2005\)](#).

Download English Version:

<https://daneshyari.com/en/article/5089685>

Download Persian Version:

<https://daneshyari.com/article/5089685>

[Daneshyari.com](https://daneshyari.com)