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Board governance, monetary interest, and closed-end fund performance

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ABSTRACT

Using a unique, large, and partially hand-collected panel database of U.S. closed-end funds (CEFs) during 1994–2013, we examine relations between board effectiveness and board structure. CEF boards with higher percentages of independent directors are associated with lower expense ratios and different CEF benchmark-adjusted returns, but not with CEF premiums. Thus, independent directors are more effective in monitoring and influencing fund performance measures that are less complex and more directly controllable (fees versus CEF returns). These results are consistent with theoretical and empirical findings in the literature that interested directors can better monitor and control firms with high degrees of information asymmetry, uncertainty, and require specialized knowledge to operate. Our results suggest that CEFs with higher board ownerships are better aligned with shareholders' interests. Ownerships of directors are positively and significantly associated with most variables that are expected to indicate greater value from the monitoring of directors. Using a dynamic panel two-step system generalized method of moments estimator, our results are robust in the presence of endogeneity concerns (reverse causality, unobserved heterogeneity, and simultaneity).

1. Introduction

Several monitoring mechanisms exist to alleviate agency problems between mutual fund managers and investors. Since the redemption right does not exist for closed-end funds (henceforth CEFs), their shareholders need to rely on other mechanisms, particularly the board of directors, to mitigate any agency problems. This appears to be the reason that regulators and legislators pay attention to board oversight, and especially to the role of board structure in dealing with agency issues. Under the Investment Company Act of 1940, the Security and Exchange Commission (SEC) initially required that 40% of directors must be "not interested" (i.e., independent). New rules added to this Act on March 2001 required 50% of the directors to be independent. On January 15, 2004, the SEC proposed and adopted a new rule requiring every mutual fund board to have an independent chairman and raising the proportion of independent directors from the previous 50% to at least 75%.[1] However, the rule was twice vacated by the D.C. Circuit in 2004 and 2005. In its second ruling, the court found fatal procedural irregularities in the adoption of the new rule, which included the SEC's failure to have a public comment period after a decision of an appellate court and the SEC's reliance on data outside the public rulemaking record (Roiter, 2015). Accordingly, these additional requirements are largely followed in practice but remain unimplemented in law.

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[1] http://www.sec.gov/rules/proposed/2006/ic-27395.pdf.

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Although it has been widely studied, the effect of boards of directors in controlling agency conflicts is still under debate. Some studies find boards are efficient in controlling agency issues, which leads to higher firm performances (Balsam et al., 2011; Baysinger and Butler, 1985; Dahya and McConnell, 2007; Paul, 2007). These studies find that higher percentages of independent directors are associated with higher firm performances. Other studies find no relation or even a negative relation between a board's characteristics and its firm's performance (Cheng, 2008; Hermalin and Weisbach, 1991).

Board effectiveness is also debated in the popular financial press. To illustrate, we now summarize the positions attributed to two knowledgeable commentators included in a *Wall Street Journal* article by Sterngold (2014). John Morley, a Yale Law school professor, believes that, unlike their mutual fund counterparts, industrial boards fire CEOs or change the directions of their companies. He argues that even independent mutual fund directors are often chosen by the fund advisors. However, Laura Lutton, a research director at Morningstar Inc., believes that, given their responsibilities, fund boards properly exercise their roles in representing investors. She argues that fund directors usually are retired senior corporate executives who devote sufficient time to fulfill their duties. She blames the lack of transparency in mutual fund boards as the main reason preventing a proper measurement of their performance. In an article in Forbes (Maiello, 2009), Daniel P. Wiener, editor of Independent Adviser for Vanguard Investors and CEO of Adviser Investments, argues that mutual fund boards can be more effective with equity based compensation and with the greater disclosure of compensation details.

Unlike most of the literature on board effectiveness, this study focuses on boards of directors of CEFs. Del Guercio et al. (2003) argue that mutual funds provide a better environment to measure whether boards act in the interests of shareholders. Unlike industrial corporations that represent a heterogeneous collection of industrial classifications, mutual funds are a somewhat more homogeneous industrial grouping. CEF boards are responsible for negotiating the fees charged shareholders annually by fund sponsors[2] and for monitoring the performance of the funds they oversee. The results of negotiating the fees and monitoring the performance of CEFs can be measured by examining fund expense ratios, fund returns, and fund premiums (i.e., the market price of a fund share minus its net asset value per share or NAVPS).

Using a large and unique database of U.S. CEFs, this study examines the relation between their board characteristics (e.g., independence, ownership, gender diversity, and compensation) and fund expenses, return performances, and premiums. We also study the determinants of director compensation in the CEF industry, which helps us better understand the incentives of directors to monitor CEFs. Since our sample includes all CEFs in existence at any point in time during the period 1994–2013, it is free of survivorship bias. To the extent of our knowledge, our database has the longest time series of board information among the studies which examine the effect of board characteristics on both open-ended fund (OEF) and CEF performances.

Our study contributes to the literature in different ways. First, our sample includes board information for virtually all stock and bond CEFs. Most of the studies on mutual fund governance focus on random samples or samples of equity mutual funds or the funds associated with large fund families (e.g., Cremers et al., 2009, Ding and Wermers, 2012, Meschke, 2007, Tufano and Sevick, 1997). If their sample sizes are relatively large, these studies examine one or only a few years of observations. As such, they suffer to varying degrees from various biases (e.g., sampling error, over- or under-representation of various types of funds or time periods), which could meaningfully affect their generalizability.

Second, taking advantage of the large number of time periods captured in our unique panel data, this study overcomes issues related to cross-sectional data like lack of power and endogeneity.[3] To examine the relation between board governance and firm characteristics, researchers should deal with endogeneity concerns as emphasized by many studies in the literature (e.g., Del Guercio et al., 2003, Hermalin and Weisbach, 1991, Tufano and Sevick, 1997, Wintoki et al., 2012). Unobserved heterogeneity and simultaneity are two potential sources of endogeneity that most empirical researchers recognize. However, there is another neglected source of endogeneity in which current governance variables are related to past fund characteristics like performance. Wintoki et al. (2012) show that ignoring this source of endogeneity can seriously affect inferences by changing the magnitudes or signs of the estimated coefficients. We show that in our sample past values of the dependent variables, like CEF benchmark-adjusted returns and expense ratios, are related with current values and changes in the values of board characteristics (such as board independence and size). Thus, in addition to the use of common statistical methods to study panel data (like OLS, fixed-effects models, and Fama–MacBeth), we use a two-step system generalized method of moments estimation, "system-GMM," which accounts for endogeneity issues (simultaneity, reverse causality, and unobserved heterogeneity). Flannery and Hankins (2013) evaluate the performance of different dynamic panel estimators (e.g., Arellano and Bond's (1991) difference GMM, Blundell and Bond's (1998) system-GMM, Huang and Ritter's (2009) Four Period Long Differencing, and Hahn et al.'s (2007) Longest Differencing) using corporate finance data and recommend that system-GMM should be used in the presence of endogenous regressors and unbalanced panels. Arellano and Bover (1995) and Blundell and Bond (1998) argue that this methodology is suitable for estimating a dynamic model, particularly when it is difficult if not impossible to find exogenous instruments to reduce endogeneity concerns (e.g., in governance variables). To the extent of our knowledge, this study is the first to apply the dynamic panel system-GMM estimator in the mutual fund governance literature.

Third, while many studies examine the relationships between some board characteristics and CEF premiums (Bradley et al., 2010; Del Guercio et al., 2003; Gemmill and Thomas, 2006), most use a more limited choice of board characteristics. Fourth, our long time-series data allows us to study better the effects of boards of directors on some funds characteristics like

[2] Sponsors are advisory firms such as Fidelity or Putnam, which manage and offer a set of funds.

[3] To the extent of our knowledge, only Meschke (2007) and Adams and Ferreira (2009) use a panel data set of board characteristics. Meschke (2007) uses 400 investment companies which are chosen randomly in each year for the 1995–2004 period. Adams and Ferreira (2009) use data for U.S. equity index OEM funds from 1998 to 2007.

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