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Flows impact on pension funds. Evidence from UK conventional and social responsible pension funds

Mercedes Alda

University of Zaragoza, C/Gran Vía, 2, C.P. 50005, Zaragoza, Spain

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ABSTRACT

We study the determinants of flows and their impact on managers' abilities in UK conventional and socially responsible (SR) pension funds. We examine three aspects barely documented in pension funds. First, flows may be affected by the fact that pension fund investors are restricted because they cannot disinvest until retirement, although they can switch the investment to another fund. Second, as both pension funds and SR funds are concerned with social welfare, SR pension funds present a special social interest and possibly different behavior. Third, the influence of flows on style timing abilities, as far as we are aware, has not been studied before. Our results indicate that both pension funds experience greater flows when they are younger and smaller, and have received flows in the past. Managers present negative stock-picking and poor timing abilities, independently of flows.

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1. Introduction

The pension fund industry is a market segment of first-order economic importance and significant for society as a whole. The worldwide pension fund investment has experienced significant expansion over the past two decades. With an average annual growth rate of 8.1% over the period 2008–2014, the total pension assets amounted to more than \$25.2 trillion in 2014 (OECD, 2015).

Pension funds are investment products with a specific purpose: to save for retirement. Nonetheless, the pension fund investment is subject to some constraints. Specifically, members cannot disinvest until retirement or under certain circumstances (illness, death...), and are able to move the investments from one fund to another, although supporting some charges and being able to lose additional benefits, like life insurance coverage. These constraints affect pension investor behavior, especially with regard to money flows, which impact on management and, ultimately, on retirement incomes. While extensive research has been conducted on mutual fund flows, finding a convex relationship between performance and subsequent net flows (Ippolito, 1992; Sirri and Tufano, 1998; Del Guercio and Tkac, 2002, among others), relatively little research has been conducted on the determinants of pension fund flows. The relative lack of research provides us with an opportunity for a richer understanding of the pension fund investor behavior.

Both mutual and pension funds are investment vehicles, professionally managed, and formed by the resources invested by a set of different investors; however, while mutual funds are a channel for retail investors to participate in capital markets (their sole purpose is to profit), pension funds are designed to cover the retirement needs of individual investors. As a consequence, pension funds are long-term investments that are expected to generate stable growth over time, and provide pension incomes when investors retire. Furthermore, mutual funds and pension funds usually present different tax treatments and different disinvestment restrictions.

The existing differences between both products originate different management strategies and manager behavior. Del Guercio and Tkac (2002) find lack of convexity in the flow-performance relation in pension funds because pension fund managers have little incentive to engage in the same risk-shifting behavior as mutual funds. On the other hand, Sialm et al. (2015) point out that retirement plan participants rarely adjust their portfolio allocations. Subsequently, whether pension fund investors cannot disinvest, and are reluctant to move the investments (the selecting process of a new fund needs time and resources), the relation between pension flows and performance may not be convex. Additionally, although managers usually change investment strategies in order to attract inflows and minimize outflows, the long-term nature of pension funds may produce that pension fund managers are less affected by flow movements.

On the other hand, pension fund flows can also be influenced by fund characteristics (size, age, past flows...) because most

E-mail address: malda@unizar.es

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of the pension investors are not professional investors and their investment decisions are guided by available public information (Renneboog et al., 2011), which is commonly related to fund characteristics.

In this paper we first examine the determinants of pension fund flows in UK conventional and social responsible (SR) domestic equity pension funds. The limited studies outside the US market, lend support for our analysis of the UK pension fund industry. The UK pension fund market deserves academic and professional attention because is the second worldwide pension fund industry with an investment of \$2.68 trillion in 2014 (OECD, 2015), and represents more than 10.8% of the OECD pension fund market. This remarkably size has been primarily motivated by the low public pensions, which has enhanced private initiative. In particular, pension funds are the main savings vehicle, and 49.8% of the household savings were invested in pension funds and insurances in 2014 (INVERCO, 2015). This apparent active participation of the private investors is an important factor in our study because UK pension fund investors can be more prone to move their investments whether pension funds do not produce the desired results.

We also differentiate between conventional and social responsible (SR) pension funds because while conventional pension funds are focus on the traditional risk-return portfolio management, SR funds invest in companies that are social responsible with the environment, the human rights or the labor relations, and avoid investing in companies that may cause health hazards (alcohol, tobacco, gambling. . .) and exploit employees. As a consequence, SR management does not only focus on financial aspects. The UK is one of the most advanced countries in social responsible investment, but SR pension funds are still developing, and only represent 0.89% of the assets. The analysis of the SR pension funds is especially interesting because SR pension managers may be overly concentrated on non-financial matters (SR aspects and retirement social welfare), and flows may not influence management. Prior evidence on SR mutual funds already shows that SR funds focus on non-financial attributes and are less concern with results, affecting the flow-return relationship (Renneboog et al., 2011).

Finally, we analyze the flows influence on timing abilities; the latter aspect, as far as we are aware, has not been examined previously on pension funds. Specifically, we study whether managers develop or improve their abilities to attract more flows and minimize outflows, which will depend on the investor behavior to past results.

Our results confirm a distinct pension investor behavior. First, past return does not influence pension flows, and fund characteristics do. This evidence shows that pension investors (conventional and SR) are influenced by the long-term nature of pension funds and the disinvestment boundaries. On the contrary, investors choose funds that receive more flows, suggesting that they invest in funds that they already own, and that they just invest in the chosen fund for retirement. Furthermore, we find negative timing abilities, and managers do not consider money flows to improve their abilities. Therefore, the lack of investor reaction to past results produces that pension fund managers do not take into account flows either.

The rest of the paper proceeds as follows. In Section 2, we undertake a literature review. Section 3 presents our methodology. In Section 4, we give a brief description of the UK pension fund market, and we describe the data. Section 5 contains our empirical results, and Section 6 presents our main conclusions.

2. Literature review

The financial literature focuses primarily on the study of mutual fund flows, and the evidence shows that investors tend to move their money according to past results (Capon et al., 1996; Johnson,

2010). Specifically, funds with good performance received additional flows, increasing manager compensation (Chevalier and Ellison, 1997; Sirri and Tufano, 1998; Busse, 2001; Del Guercio and Tkac, 2002), but funds with poor results do not experience the equivalent outflows, existing, in general, an asymmetric relationship (Ippolito, 1992; Sirri and Tufano, 1998; Del Guercio and Tkac, 2002). In contrast, Del Guercio and Tkac (2002) do not find evidence of this asymmetric relation in pension funds. These authors observe that pension fund managers do not depend on the performance relative to their peers, as mutual fund managers, and they do not have strong incentives to engage in risk-shifting strategies over time. James and Karceski (2006) point out that the asymmetric relation depends on the kind of fund; specifically, they find that institutional investors do not chase past performance in the same way as retail investors do. Sialm et al. (2015) find that US defined contribution pension plan investors rarely adjust their portfolio allocations, suggesting that flows are sticky and not discerning. Consequently, whether the long-term nature of pension funds provokes that investors do not monitor the investments closely, we will then expect less sensitive of flows to past return.

On the other hand, SR mutual fund evidence shows that these funds are more sensitive to past positive returns, but less sensitive to past negative returns, compared to their conventional counterparts (Bollen, 2007). Benson and Humphrey (2008) find that US SR fund flows are less sensitive to returns than conventional funds, and the impact of lagged flows on current flows is significantly greater for SR funds, suggesting that SR investors are more likely to invest in a fund that they already own. Renneboog et al. (2011) examine conventional and SR mutual funds from several countries, concluding that investors follow past returns. The absence of SR pension fund studies does not allow us to contrast our results with prior evidence, but we hypothesize that whether the non-financial targets are the most relevant aspects in investment decisions, and SR pension fund investors do not monitor their portfolios, as conventional pension investors, we then expect even lower link between flows and return.

Flows are a consequence of investor reactions and can impact on management behavior (Benson and Humphrey, 2008). Management behavior has been traditionally assessed by the stock-picking and timing abilities. The stock-picking ability is the manager's skill to pick stocks that outperform others at the same level of non-diversifiable risk. The timing ability is the skill to obtain results by changing exposure to the market (market timing) or to a management style (style timing) at the right moment. The most widely-used models to capture these abilities are those proposed by Treynor and Mazuy (1966) and Merton and Henriksson (1981). Empirical evidence shows mixed evidence of these abilities. Coggin et al. (1993) find positive stock-picking and negative market timing abilities in US pension funds, respectively. Blake et al. (1999) find negative evidence of both abilities in UK pension funds. Thomas and Tonks (2001) find positive stock-picking and size-timing abilities, but negative market timing in UK pension funds from 1983 to 1997. Other authors find a general absence of these abilities, as Koh et al. (2010) on Singapore pension funds, and Woodward and Brooks (2010) on Australian pension funds. The study of timing abilities in SR pension funds barely exists. Ferruz et al. (2010) find little positive stock-picking ability in SR pension funds, but negative market timing in conventional and SR funds.

Nonetheless, these traditional models do not take into account the influence of flows, so the spurious timing found in many studies (Lee, 1999; Fung et al., 2002; Abdel-Kader and Qing, 2007; Woodward and Brooks, 2010; Elton et al., 2012; Christensen, 2013) could be solved by including the influence of cash-flows in timing models, according to Warther (1995), Ferson and Warther (1996), and Edelen (1999). Edelen (1999) and Alda et al. (2015) control the effect of flows on market timing in US mutual funds, and

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