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Learning about individual managers' performance in UK pension funds: The importance of specialization

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ABSTRACT

This study examines the performance of managers over time, as well as its persistence, taking into account both manager characteristics and market conditions. Applying parametric and non-parametric methodologies, we examine a sample of UK equity pension fund managers. Our results help to understand the importance of manager assignments in the industry and reveal the importance and benefits of management specialization. We find certain manager performance persistence, revealing that some managers are better than others and possess superior investment skills. Additionally, we find that managers achieve better results when they run a single fund or one investment-objective funds, which allows managers to focus on specific tasks. Nonetheless, manager performance varies with market conditions and highlights managers' different skills. Specialist managers perform better in bullish markets, and generalists perform better in bearish periods.

1. Introduction

Much financial literature addresses the role and importance of pension fund management; however, few studies analyze the performance of individual managers. Pension funds have become the main financial vehicle to cover the retirement contingency; therefore, a proper management of these financial vehicles is crucial and may affect the future retirement incomes of many savers. If management companies are able to identify the best performing managers throughout their professional career and understand their behavior over time, they may re-allocate managers in different positions to improve fund performance and, consequently, attract investment flows to this industry.

The empirical evidence suggests that, in general, mutual and pension fund managers do not exhibit superior performance and usually underperform. This evidence is mainly found in US mutual and pension funds (Lakonishok, Shleifer, & Vishny, 1992; Grinblatt, Titman, & Wemers, 1995; Daniel, Grinblatt, Titman, & Wermers, 1997; Carhart, 1997; Chevalier & Ellison, 1999; Wermers, 2000; Pastor & Stambaugh, 2002). Some UK mutual and pension fund studies also support these results (Blake & Timmermann, 1998; Blake, Lehmann, & Timmermann, 1999; Thomas & Tonks, 2001; Blake & Timmermann, 2005). Nonetheless, these results are generally based on fund data rather than on mutual fund managers. Among the few studies focusing on managers, Baks, Metrick, and Wachter (2001) analyze manager performance in US mutual funds; however, these authors do not provide a complete picture about the manager performance as in our paper, because they only analyze the last manager in charge of the fund.

An analysis based on fund data over several years may have several drawbacks. First, funds can experience manager replacement; hence, fund performance cannot be attributed to a specific manager (Clare, Motsona, Sapuric, & Todorovic, 2014). Whether managers move frequently, manager performance is lost when the analysis is performed at the fund level. A performance analysis at the

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manager level can answer the common questions raised in financial literature, such as whether the ability resides in the management company or in the portfolio manager, and whether some managers are indeed better than others.

Whether some managers are better than others, they should present performance persistence over time. The pension fund literature shows mixed evidence about fund performance persistence and primarily reveals persistence in the short-term. Christopherson, Ferson, and Glassman (1998) find persistent performance in poor prior-period performance in US pension funds. Tonks (2005) find strong persistence in UK pension funds from 1983 to 1997, over one-year time horizons. Clare, Nitzsche, and Cuthbertson (2010) find little evidence of positive performance persistence in UK defined benefit pension funds investing in Pacific Basin equities.

According to Berk and Green (2004), the lack of performance persistence in the long term seems to imply that superior performance is derived from luck rather than skill. However, this finding may also be explained because most of the existing works analyze this topic using fund data instead of manager data. Among this scarce evidence is the study carried out by Pojarliev and Levich (2010), who analyze the performance of 15 currency fund managers over three years and find absence of alpha persistence but evidence of currency style persistence. This work is the first study, as far as we are aware, that analyzes performance and persistence in regard to managers.

The lack of long-term persistence may also be because managers are not able to outperform both in crises and expansions periods. Therefore, we study manager performance and its persistence over time. Prior studies find different fund performance with business cycles (Ferson & Schadt, 1996; Christopherson et al., 1998; Moskowitz, 2000; Glode, 2011). Moskowitz (2000) finds that active mutual fund managers obtain higher performance in recessions because investors are willing to pay more for assets negatively correlated with consumption when they have more needs of profitability; that is, in recessions (Cochrane, 2001). Kosowski (2011) argues that managers vary their portfolio decisions according to their forecasts of market movements. Specifically, Kosowski (2011) finds that US mutual funds present superior skills in crises because the higher information dispersion during recessions produces that some managers are better informed and, thus, outperform. Furthermore, this author points out that time-varying performance is asymmetric for funds with different characteristics, which might also be expected at a manager level. Kacperczyk, Van Nieuwerburgh, and Veldkamp (2011) find higher performance in recessions because skilled managers have a larger informational advantage over unskilled managers during a recession, which generates higher return for informed managers in these periods. Later, Kacperczyk, Van Nieuwerburgh, and Veldkamp (2014) explain that cyclical outperformance results are due to time-varying strategies because managers focus on different tasks at different time periods to adapt the portfolios to market movements and economic conditions.

In view of these results, we would expect different managerial performance with market conditions, as previously documented in US mutual funds (Ferson & Schadt, 1996; Christopherson et al., 1998; Moskowitz, 2000; Glode, 2011; Kosowski, 2011; Kacperczyk et al., 2011, 2014; among others).

Additionally, we examine whether managers with specific characteristics (managerial attributes) outperform their competitors. Different works relate fund performance with managerial attributes, such as tenure and age (Korniotis & Kumar, 2011), gender (Dwyer, Gilkeson, & List, 2002; Watson & McNaughton, 2007; Babalos, Caporale, & Philippas, 2015), fund type under management (Custodio, Ferreira, & Matos, 2013; Zambrana & Zapatero, 2016), or a variety of these (Gottesman & Morey, 2006; Fang & Wang, 2015). These previous works find that performance is affected by managerial traits, but the relation between them is not clear. Possible explanations for these diverse results may lie on the fact that manager features change over time (managers learn with experience, start/stop simultaneously managing several funds…). However, these studies examine the relation between performance and manager characteristics from a fund perspective and do not follow the manager record over time.

In this work, we first study the performance of UK equity pension fund managers over time, taking into account that managers can simultaneously manage different funds and can move from one management company to another. Undertaking parametric and non-parametric methods, we analyze manager's performance persistence to examine whether the worst (best) managers in the past will be the worst (best) performers in the future. This is especially important because management companies may identify the worst and best managers, independently of the fund that they were/are/will be managing. Choosing the adequate manager has important implications for management companies. Better outcomes may translate into higher company size, larger income and better reputation, which may lead to attract more investors and increase company's market position. Therefore, management companies should possess mechanisms to retain talent, such as special retribution to best performers.

Our persistence analysis shows the existence of managers with superior skills; however, the best managers have problems adapting to bearish markets. In line with our prior argument, our results show that the scarce long-term persistence found in prior literature (Goetzman & Ibbotson, 1994; Brown & Goetzmann, 1995; Blake & Morey, 2000) can be due to time-varying market conditions. This result reveals that some managers are not able to adapt correctly their managerial strategies to market movements, especially in bear markets.

Afterwards we explore whether certain managerial characteristics are associated with better or worse manager performance. Our results show differential skills among managers and market conditions. The manager performance is more affected by the level of specialization than by personal characteristics, such as gender. In general, we find that specialized managers (those who run funds in one investment vocation) report better performance than those managers who run funds in different investment vocations. Nonetheless, generalist managers achieve better performance in bearish markets, whereas specialists outperform in bullish periods.

Although no prior works have analyzed the specialization behavior in the economic cycles, our results are line with some related works that study one of these aspects, i.e. performance in economic cycles or performance according to the level of specialization. Zambrana and Zapatero (2016) find differential skills between specialist and generalist managers; specifically, the fund performance is higher when market timers are allocated to generalist tasks and stock pickers are allocated to specialist tasks, hence market-timing (stock-picking) managers should be assigned to generalist (specialist) responsibilities. Similarly, Göricke (2016), from a family