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Price support by bank-affiliated mutual funds ☆

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ABSTRACT

Fund managers are double agents; they serve both fund investors and owners of management firms. This conflict of interest may result in trading to support securities prices. Tests of this hypothesis in the Spanish mutual fund industry indicate that bank-affiliated mutual funds systematically increase their holdings in the controlling bank stock around seasoned equity issues, at the time of bad news about the controlling bank, before anticipated price drops, and after non-anticipated price drops. The results seem mainly driven by bank managers' incentives. Ownership of asset management companies thus matters and can distort capital allocation and asset prices.

1. Introduction

Conflicts of interest within financial institutions have recently attracted a lot of attention and are widely analyzed in the academic literature. Mehran and Stulz (2007) contend, however, that these conflicts of interest may be overrated because of regulation, self-imposed institutional controls, and the incentives of agents to take such conflicts into account in their decision making process. In this paper we identify a new conflict of interest in the asset management industry that distorts fund investment decisions and impacts asset prices despite the self-imposed controls and regulation in place.

Most individuals invest in security markets through mutual funds, pension funds, and hedge funds. These funds are managed by asset management firms, which are legal entities different from the funds they manage. Fund managers are thus "double agents" serving two principals—the fund's investors and the management firm's owners. This leads to potential conflicts of interest between these two principals. Fiduciary duty requires that the interests of the fund investors prevail, but in practice fund managers may have incentives to act on behalf of the parent firm's management and shareholders. The ownership of asset management firms may therefore matter

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because it can distort the allocation of capital and impact asset prices and fund performance.

This conflict of interest takes a specific form when management firms are fully owned or controlled by publicly traded companies in which the fund can invest. In these cases, the controlling company's management and shareholders could influence managers of affiliated funds to invest in the controlling company in their interests rather than the interests of fund investors.

The extent to which controlling companies are able to influence investment decisions of affiliated funds depends on the regulation and institutional details of each country. We focus on the case of Spanish financial conglomerates or banks. Spain is a perfect candidate for our study because Spanish funds are free to hold and trade the stock of the owner (subject to some holding limits that apply to all stocks), and because Spanish banks have a prominent presence in asset management.[2,3] In addition, bank-affiliated management firms are located in the proximity of the controlling companies; and affiliated fund managers are often treated as employees of the controlling companies. At the same time, Spanish bank-affiliated funds tend to have loyal investors who do not chase performance (Moreno and Rubio, 2007). Finally, despite regulation on financial misconduct, the level of prosecution in Spain is relatively low.[4] All this implies that Spain provides an environment in which the interest of the banks' managers and shareholders may have an impact on the investment decisions of the affiliated fund managers.

There are at least two ways in which banks could influence trading of the affiliated funds in the parent bank stock. First, affiliated funds could be used to gain friendly voting at shareholders meetings. In this case we would expect affiliated funds to overweight the parent bank (overweighting hypothesis).[5] Second, affiliated funds could be used to temporarily alter the bank's share price (price support hypothesis). Because the market for corporate control in Spanish banks is historically very weak, and bank shareholders are very friendly to Board proposals, the incentives to gain voting rights through affiliated funds are small. Accordingly, we find very weak evidence for overweighting of the parent bank by affiliated funds. We find, however, strong evidence of trading by affiliated funds to support the stock price of the parent bank around important corporate events and crisis periods.

More formally, we define price support as any fund buying the shares of the parent bank in an attempt either to increase the bank's share price or to prevent it from dropping. Because trading only has a temporary effect on prices, we expect price support to take place only around events of special interest for the bank's managers or shareholders, i.e., corporate events and crisis periods.

Due to career concerns and relative performance evaluations, bank managers are especially interested in price support during times of idiosyncratic shocks in order to prevent the bank's share price from dropping and thereby avoid standing out as poor performers.[6] On the other hand, bank shareholders are interested in price support during times of systematic shocks, as these periods are characterized by high marginal utility, high volatility, and low liquidity.[7] Finally, both bank managers and existing shareholders are interested in price support around special corporate events such as seasoned equity offerings (SEOs).[8] In summary, price support is expected around specific corporate events and crisis periods (idiosyncratic and systematic shocks).

While corporate events are known in advance, crisis periods cannot always be anticipated (by management and large shareholders). In equilibrium, price support trading should therefore occur before anticipated shocks to prevent the price from falling, and after non-anticipated shocks to speed up price recovery. If price support is at least partially effective, it should be observed especially when negative shocks do not result in large price drops.

Trades to support prices, however, do not come without a cost. Because the aim of these trades is to increase the bank's share price, rather than the net asset value of the fund, they may deteriorate the performance of the price-supporting funds. This can reduce the revenue from performance fees as well as fixed fees, if fund flows depend on the past performance. There is also a legal risk involved in price support as such trades may result in violations of rules against market abuse and price manipulation.

We test the price support hypothesis by analyzing how Spanish bank-affiliated funds trade in banking stocks. As noted earlier, the potential costs of price support are lower in Spain than in other countries because of low flow-performance sensitivity and weak prosecution. All the tests are based on quarterly portfolio holdings data for the period from 1995Q1 through 2009Q3. Our main sample covers the eight biggest Spanish banks and 1,236 funds, of which 418 are affiliated with these banks. Consistent with our price support hypotheses, we first note that banking funds trade very differently when it comes to trading in the parent bank. While they appear to be momentum traders when trading in all the banks, and such trades are positively related to good news (analysts' recommendations and earnings forecasts), they are contrarian traders when it comes to the parent bank. They also tend to increase their holdings in the parent bank with the deterioration of public news. Finally, while trades in banking stocks overall appear informative about future returns,

[2] U.S. funds cannot hold the stock of the controlling company, according to the Investment Company Act of 1940.

[3] As of 2009, funds affiliated with Spanish banks and savings and loan institutions accounted for nearly 80% of assets under management of the industry.

[4] In Section 5.1, we show that the level of enforcement and prosecution is much lower in Spain than in the U.S. (see also Table 2).

[5] Similarly, Cohen and Schmidt (2009) document for the U.S. that 401 (k) trustees overweight the holdings of the sponsor firms' stock.

[6] See Holmstrom (1979, 1982) and Diamond and Verrecchia (1982) for theoretical contributions on benefits of evaluating managers based on relative performance, and Gibbons and Murphy (1990) for supporting empirical evidence.

[7] For instance, see Hong, Wang, and Yu (2008) for theory and evidence on firms' actions (repurchases) to reduce volatility and provide liquidity.

[8] Firms' actions to influence the stock price around important corporate events have been documented elsewhere. For example, Ahern and Sosyura (2014) show that firms manage media coverage around mergers and acquisitions.