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"Down but Not Out" mutual fund manager turnover within fund families

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ABSTRACT

This study is the first to link managerial turnover to mutual fund managerial structure in a manner that indicates the strong presence of a conflict of interests between investors and fund sponsors in an area of fund governance where we have been led to believe there are strong and well-functioning mechanisms to guard against the exploitation of investors. I utilize the unique characteristics of mutual funds where managers sometimes manage multiple "firms" simultaneously, something not generally observed in industrial firms. I test the governance mechanisms using the mutual fund complexes management structure; unitary and multiple fund management (UFM and MFM). This study shows that UFMs tend to have higher asset growth rates and higher fees than MFMs, suggesting that sponsors can benefit more from keeping them intact. I find that changing managers under the UFM is more costly to sponsors making them more reluctant to fire poor performers. I document that underperforming UFM are −2.77% less likely to be replaced than their underperforming MFM counterparts. In addition, the conflict of interests affect the replacement decision, as high expense ratio fund managers have a lower probability of replacement for a given level of underperformance.

1. Introduction

Ever since Berle and Means (1932) first established that there is a separation between ownership and control and Jensen and Meckling (1976) recognized that this disconnect between managers and shareholders causes agency issues, financial economists have discussed ways to eliminate or at least

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minimize these agency concerns. The financial literature has advanced two fundamental theories about how to address agency problems and influence manager behavior. First, financial economists suggest that the board of directors design compensation schemes to provide managers with effective incentives to maximize shareholder value (pay-performance). Secondly, the market for corporate control imposes some constraints on the managers' actions. These two approaches are designed to align the managers' behavior with shareholders wealth maximization. Despite the interest in this area, there has yet to be a study that examines the effects of both the pay-performance and the market for corporate control theories simultaneously. The uniqueness of the mutual fund industry and the mutual fund manager contracts allows us to reexamine these agency issues.

Within the mutual fund industry, this issue is significant given the importance of management in the implementation of the fund's investment strategy, the sizable assets under their control, and the potential impact it has on the overall success and profitability of the fund complex. The issue is also critical in terms of the different corporate governance mechanisms and principal-agent problems that exist between investors, shareholders, and management. This is because investors that entrust funds to managers cannot participate in exercising corporate control in the same manner in which shareholders can exercise their collective will on company boards. This study identifies the importance of the management structure within the mutual fund industry. Within some fund families, a portfolio manager works autonomously managing only one fund. I refer to this management structure as a unitary fund management (UFM) structure. At other fund families, an individual portfolio manager is responsible for two or more mutual funds within the same sector, related sectors or with complementary investment objectives. For the sample period, 22% of mutual funds accounting for 25% of the funds under management are now in the multiple fund management (MFM) structure. Fund sponsors make manager turnover decisions by comparing the cost of firing UFM versus MFM[1] and the benefits of having the MFM structure. The incremental cost of replacing a unitary fund manager includes the employee search cost and hiring of a new fund manager and the potential cost of losing loyal investment customers of the replaced manager. Under the MFM structure, these costs aren't necessarily a concern for fund sponsors since the replaced managers remain with the fund family. In addition, the MFM structure lowers the individual cost of operating each fund. If fund sponsors are less likely to end the services of a UFM manager, because it is more costly to the sponsor, then this is a clear indication of a conflict of interests because for the same level of underperformance investors would benefit more if the "pay for performance" relationship (proposed by Khorana (1996)) worked effectively for the costlier funds/fund management system. However, without considering the specific organizational form and, more specifically, the management structure of the fund family previous research might have significantly overstated the sensitivity of managerial replacement to past performance. I show that, in addition to prior performance and managerial experience, the number of individual funds managed by a fund manager increases the probability of manager replacement. UFM are -2.77% less likely to be replaced than a MFM, even though both managers are underperforming. This suggests that fund sponsors tend to replace underperformers only when it is "cheap" because replacing a UFM is more expensive than taking one fund from a manager that operates multiple funds. This presents an obvious conflict of interests between fund investors and fund management.

The second objective of this study, as in Khorana (2001), is to examine whether funds that experienced manager replacement underperform funds where the manager maintains responsibility and, if so, by how much and for how long prior to replacement. However, unlike Khorana (2001) this study takes into account the fund family management structure prior to replacement. Consistent with Khorana (2001), I find that new fund managers exhibit dramatic performance improvement in the post-replacement period. This finding suggests that the previous manages were replaced due to poor past performance. Potential explanations for poor past performance is that fund managers have too many funds or fund objectives to manage to be effective and/ or diminished fund management abilities. I also find that unitary fund managers significantly underperform their objective and risk adjusted peers (1.8%, 2.8% respectively), which is a greater underperformance than multiple fund

[1] In the case of an MFM, we regard a manager as having been replaced if he is relieved of his duties related to one or more funds of the two or more that he manages, even if he continues to be in charge of other funds.