Virtual Finance Workshop

Mutual Funds

Introductory Remarks

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Introduction

- Mutual funds
  - broad area
  - heavily researched
  - abundant data
- Today's topics
  - benchmarks and performance
  - fund flows and asset prices

Benchmarking performance

- Objective: control for effects not reflective of manager skill
- Potential controls:
  - risk
  - style
  - trading costs
  - mandates and constraints
    - liquidity
    - investment universe
    - short sales
    - borrowing/cash
    - turnover
- First paper today: Beber, Brandt, Cen, and Kavajecz (2019)
  - "Bespoke" benchmarks incorporate mandates/constraints
  - Generally improve benchmark-adjusted performance

The mushrooming mandate: sustainable investing

- Environmental, social, and governance (ESG) criteria
- In 2019, 400% higher flows into sustainable US mutual funds
- 34% two-year increase in global assets, to $30 trillion in 2018
- Benchmarking sustainable investing
  - both return and ESG performance
  - imprecise mandates (how strong; what E, S, and G weights?)
  - disagreement across ESG stock ratings
    (MSCI's KLD & IVA, Sustainalytics, Bloomberg, Refinitiv, RobecoSAM)

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- Potentially many and disparate bespoke benchmarks
  - choose mandate (benchmark) and fund simultaneously
  - benchmark-adjusted performance useful to investors?
  - trade-off mandate vs. performance?

Flows and pricing

- Second paper today: Dou, Kogan, and Wu (2020)
  - Active manager j's consumption is proportional to fund's AUM
  - $\Delta AUM^{(j)} = r^{(j)} + flow^{(j)}$
  - Manager is averse to $\text{Var}(\Delta AUM^{(j)})$
  - Under-weights asset i, the higher is $\text{Cov}(r_i, flow^{(j)})$
  - Flow commonality: $flow^{(j)}$ correlated with $flow^{agg}$
  - Equilibrium: high $\text{Cov}(r_i, flow^{agg}) \Rightarrow$ low $\text{E}(r_i)$
  - Supportive empirical evidence

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- Efficient provision of fee insurance?
  - depresses fund's return, most of which goes to investors
- Incidence of fee-revenue risk on portfolio managers
- Flow-hedging motive stronger for hedge funds?

Flows and mispricing

- Akbas, Armstrong, Sorescu, and Subrahmanyam (JFE, 2015)
- Composite mispricing measure (11 characteristics)
  - $R_{L,t}$: return on most underpriced stocks
  - $R_{S,t}$: return on most overpriced stocks
- Multiple regression (includes controls):

Dependent variable		
$R_{L,t} - R_{S,t}$	$R_{L,t}$	$R_{S,t}$
Indep. variable: $FLOW_t$		
-1.94	-0.25	1.69
(-3.62)	(-0.60)	(2.53)
Indep. variable: $FLOW_{t-1}$		
2.11	0.54	-1.57
(3.28)	(1.53)	(-2.50)