Brent Sheather's
RESEARCH

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FUND MANAGEMENT – MOVING THE PERFORMANCE GOAL POSTS – Part 1

At the risk of stating the obvious, performance is the name of the game in fund management: managers that consistently beat their benchmarks are rewarded with increased funds under management (FUM) and thus higher fees. The business has high operating leverage and because costs are relatively fixed, a moderate increase in FUM can translate to a large increase in profitability. Given the importance of relative performance, a lot of effort is expended by fund managers on research and information gathering to discover the best shares to buy. However, because most markets are efficient and finding bargains is difficult, some fund managers discretely acknowledge the problem and instead devote their energies to researching "easy to beat" benchmarks rather than the more challenging task of researching stock and bond markets.

That nefarious activity is the subject of an interesting research note recently published on the website of the Social Science Research Network (SSRN). The paper, "Moving the Goalposts? Mutual Fund Benchmark Changes and Performance Manipulation" was written by Dr Kevin Mullally of the University of Central Florida and Dr Andrea Rossi from the University of Arizona.

The authors begin by describing the criteria investors use for assessing managed funds and thereby establish the motive for the "goalpost shifting". "Research has documented that mutual fund investors base their capital allocation decisions on funds' past performance. Investors use readily available information and simple performance measures to make these decisions. These findings suggest that fund managers have the incentive to manipulate the performance information they present to investors. In this paper, we explore how mutual funds manipulate performance information and whether such actions work in attracting investor flows."

By way of background the professors note that the US regulator, the Securities and Exchange Commission (SEC) compels fund managers to disclose their performance relative to at least one "appropriate" broad-based market index and display their performance and that of the index over 1 year, 5 years and 10 years. The rationale for this is to help investors determine "how much value the management of funds added by showing whether the fund outperformed or underperformed the market". The authors express surprise that the SEC allows fund managers to add or remove benchmark indices with little justification and doesn't prevent funds from comparing their past returns to those of newly chosen indices rather than the returns of the indices they selected at the time the returns were generated. "In essence the rules allow funds to manipulate the benchmark adjusted performance".

The paper then looks at actual changes in fund's self-selected benchmarks to see whether management "systematically

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misrepresent the value they add for investors". Using raw data from SEC filings they found that 37% of funds made changes to their benchmarks at least once over the 13-year sample period and of those that made at least one change the average number of changes was 2.27 per fund. The authors note that benchmarks can be changed for many legitimate reasons but because investors chase performance they expected funds to drop benchmarks with higher historic returns to improve their own relative performance.

No surprises then that the study found "that benchmark changes lead to a systematic decrease in the benchmark returns used by funds. On average funds add indices with low past returns and drop indices with high past returns. Similarly many funds also add peer–based benchmarks with low returns and drop peer-based benchmarks with high returns." Specifically, indices that were added had five-year returns 2.39% lower than their existing benchmark and 5.6% lower than a more representative index.

The authors go on to say that "funds are more likely to add value indices after periods in which growth stocks have outperformed value and vice versa." Funds also add small-cap indices after periods within which large-cap stocks have outperformed. Presumably much of this duplicitous behaviour is perpetrated by individuals with the CFA qualification which this column has previously noted emphasises ethics as being a key component of the credential.

Lastly, the paper looks at the determinants and consequences of benchmark changes: funds with poor performance and who are losing FUM are more likely to change their benchmarks, as are those with higher expense ratios. "In sum, our study has implications for regulators, investors, and academics. For regulators, our results suggest that a significant number of funds attempt to mislead investors by taking advantage of SEC regulation that allows them to change their benchmarks. These actions are in direct conflict to the stated purpose of fund disclosure which is to increase transparency for investors. Moreover, our results suggest that recently proposed changes to the format funds use to disclose information, which intend to make certain information more salient for retail investors, may have unintended consequences such as distorting investors' capital allocation decisions".

What permitting fund managers to customise and change their benchmarks at will potentially allows them to do is to erase from the record the impact of any bad "active" decisions they have made. The extent of the deception outlined by Drs Mullally and Rossi described in the paper led Bloomberg writer Jason Zweig to wryly comment to the effect that the standard warning that past returns are not a good predictor of future returns could be extended to note that past returns probably aren't a good predictor of the past either.

Brent Sheather's A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.

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