Has Your Fund Become Too Large, Or Is Industry Size the Problem?

By John Rekenthaler | 02-28-14 | 01:00 PM | Email Article

Bigger Is Not Better

Yesterday’s column set forth the notion that many mutual fund managers have substantial skill, but investors rarely reap the benefits. The best managers are quickly identified by fund buyers and swamped with incoming assets, to the point where the harm caused by the difficulty of investing the new assets neutralizes the manager's skill, causing the fund to subside to average performance.

It's not my notion, it is that of business school professors Jonathan Berk and Richard Green. The theory is attractive because it offers a rational explanation for the observed behavior of the mutual fund marketplace. Under Berk and Green, investors don't buy actively managed funds because they are brain-dead stupid, thereby violating the basic economic principle of rational self-interest. Instead, investors buy actively managed funds for the sound reason that that professional managers are good.

As the authors point out, this concept is analogous to the hypothesis of the efficient stock market. Stock prices are not (nearly) random, so that it’s difficult to identify future winners, because stock investors are dummies. Quite the reverse. They are savvy and ruthlessly effective at finding underpriced stocks and then bidding them up, so that future outperformance is arbitragged away.

The comparison is imperfect, however. It’s easy to see how competition drives up the price of a cheap stock. The stock sells at $35, the smart buyers realize that it’s worth $40, they place their bids, the stock moves up due to the demand from the smart money, and eventually equilibrium is reached. With funds, not so much. It’s all very well to wave one’s hands and say, “It’s difficult for portfolio managers to run a bigger asset pool,” but the mechanism by which competition lowers performance is nowhere near as clear as with stocks.

Also, it varies hugely by fund type. There aren’t any Treasury funds, for example, that suffer much from running too much money.

That is the theory and those are the caveats. Which brings us, finally, to the new Scale and Skill in Active Management paper, by Pastor, Stambaugh, and Taylor (PST) -- the paper that finds that newer funds, presumably run by younger managers, are superior. This column won't get at the younger-manager argument, but it will cover a step in that path.

That step is PST’s refinement of the Berk and Green thesis. PST accepts that fund investors are rational and that they have an ability to identify skilled managers, but that their investment results disappoint because fund managers are hurt by asset inflows. However, PST differs substantially in arguing that the asset problem is related to the size of the fund industry, and is therefore not primarily a fund-by-fund effect.
I won’t delve into the math, because I can’t. Suffice it to say that when I showed the Berk and Green paper’s equations to a recent astrophysics graduate, she asked if she could bone up before tackling. Then, the PST paper adjusts the Berk and Green approach. Admittedly, PST’s adjustments consist of adding factors and changing the specifications of the regressions, not fixing a calculation error ... but still. I must take its result on faith.

Should I? Mostly, I think. Pushing the asset problem from the fund level to the industry level greatly improves the story. That is, it’s unlikely that a Treasury fund has become too big for its breeches, but it’s quite possible that the hundreds of billions of actively managed mutual fund dollars that are devoted to U.S. Treasures have squeezed the opportunity out of the sector. Similarly, the argument morphs from claiming that the $50 billion in a given large-company U.S. stock fund is too much, to the problems caused by $3 trillion in smart money chasing the same ideas.

That I like.

In addition, the argument echoes--and provides the formal support for--the strong suspicion of the institutional investment community that outperforming the stock market is becoming increasingly difficult due to a higher level of competition. The PST paper gives the intellectual backing to what previously has been a largely anecdotal argument.

However, as PST concedes, the matter is not quite so simple as fund level, yes, industry level, no. Although the authors don’t find a statistically significant relationship between fund asset size and performance, there surely are important exceptions.

Consider, for example, the well-documented case of Jeff Gundlach. Before leaving TCW to strike out on his own in early 2010, he had posted four consecutive years of strong-but-not-sensational performance, with TCW Total Return Bond (TGLMX) ranking in the 12th, 16th, 29th, and 15th percentiles for calendar-year total return. At his new fund, DoubleLine Total Return Bond (DBLTX), Gundlach improved to spectacular, posting the number-one performance in the category for the nine months that the fund existed in 2010. The fund then landed in the 2nd percentile the following year. The small size of the new fund afforded Gundlach the opportunity to load up on esoteric mortgage-backed securities—a tactic that he could not have used as well at his older, larger fund.

Similarly, the authors find that the asset effect is stronger for high-turnover funds that invest in small-company stocks—that is, such funds suffer more from asset growth in the industry than do most other types of funds. It's possible to read that evidence as being consistent with the industry-size thesis. However, it's also consistent with the simpler idea that funds that trade frequently in illiquid markets had better remain small.

Overall, though, I think that PST has it right: The performance challenge for fund investors lies less with the bloat of individual funds, and more with the increased competition among portfolio managers. Next column, we’ll discuss PST’s estimate of
how things have changed--that is, just how much more difficult the climate for fund managers has become.

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