Discussion of

"Matching Capital and Labor"

Berk, van Binsbergen, and Liu

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What does the paper do?

General Hypothesis:	Firms add value through efficient allocation of managerial talent
Empirical Setting:	Allocation of active fund *managers* across 5,542 funds and 523 firms, between JAN 1977 and MAR 2011
Specific Hypothesis:	Reallocation of AUM across managers *by firms* (i.e., promotions) adds value
Measure of Value:	AUM * $(R_{active,it} – R_{passive,it})$

Source: Berk & van Binsbergen (2013)

Intuition: We care more about NPV than IRR

Implementation: Passive returns calculated using after-fee returns of *available* Vanguard index funds

What does the paper find?

Main findings:

T3: Firm-level value creation is persistent

T5: Firm adds $715k per month when it promotes or demotes internally; $576k when it adds co-manager

F2: Even assuming extreme investor flows, “firm still contributes more than 30% of total value added.”

F4: “It would have taken 6 years for investors to achieve what firm achieved in a single month”

T8: External promotions do not create value

T9: Alphas predict flows but not promotions

Conclusions:

- Firms add value through (re)allocation of managers...
- ... because investor flows are smaller, slower, and less inefficiently directed than in Berk & Green (2004)

Outline

1. General observations on the analysis
2. Place paper into existing literature and use this literature to motivate possible extensions
3. Propose alternative interpretations and tests related to market segmentation and marketing:
   a. **Across families:** Direct-sold families face stronger incentives to generate abnormal returns
   b. **Within families:** Internal promotions and manager name disclosures are strategic decisions potentially related to degree of cross-subsidization

General observations

- **Nature of value creation is time varying**
  - Greater variety of Vanguard index funds ➔ richer set of counterfactual investments ➔ fewer sources of value added
    - International added in 1990 and 1994
    - Value added in 1992 and 1998
    - Momentum may never be added
  - *Begs question whether persistence of value add declines over sample period or across market states*
- **Analysis ignores cross-sectional and time-series variation in incentives to generate abnormal returns...** *variation that may rationalize some of the authors' findings*
- *Conclusions regarding investor flows may explain why Chevalier & Ellison (1999) find "smart" managers persistently outperform and why Reuter & Zitzewitz (2013) find no evidence of diseconomies*

Existing literature (1)

- What do we already know about managers versus families?
  - Baks (2003): Models performance as Cobb-Douglas production function with manager and fund inputs; *"manager's contribution ranges from approximately 10 to 50 percent."*
  - Guedj & Papastaikoudi (2003): Performance persistence within families; larger effects for larger families; *"the better performing funds in a family have a higher probability of getting more managers, which are one of the main resources available."*
    - ***Their findings anticipate the co-manager result***
    - ***They also raise the possibility that cross-subsidization increases the value added from promotions***
  - Nanda, Wang & Zheng (2004): Families have an incentive to create star funds, which generate higher flows into other family funds

Existing literature (2)

- I like the finding in Figure 5 that families reallocate AUM more actively for low-tenure managers.
- Can the authors say more about the nature of learning by families?
    - Do internal promotions generate more value in more volatile asset classes, where it should be harder for investors to discern differences in manager skill? Or is private information noisier too?
    - Are external promotions more likely in some asset classes than others? The fact that they do not generate value may reflect the need to hire managers for funds in new asset classes (i.e., that reallocating existing managers is not possible).

Existing literature (3)

- *Does manager specialization limit the ability to add value through promotions?*
  - Massa (2003) and Sigglekow (2003) provide evidence of diseconomies of scope at family level ➔ *Value managers are unlikely to add value to growth funds*
  - Kempf, Manconi & Spalt (2013) provide evidence that fund managers acquire industry-level expertise
  - Fang, Kempf & Trapp (2014) show families allocate “smarter” bond fund managers to high yield fund instead of investment grade funds because high yield is less efficient ➔ *Allocation helps high yield at expense of investment*
- Authors benchmark fund returns in a way that will (eventually) adjust for different investment strategies, but they do not provide any statistics on extent of promotions within versus across styles

Alternative #1

Market Segmentation?

- Bergstresser, Chalmers & Tufano (2009): direct-sold funds persistently outperform broker-sold funds
- Del Guercio & Reuter (2014): differences in flow-performance give direct-sold families a much stronger incentive to generate alpha
  - Comparing active and passive *within segment* reveals underperformance limited to broker-sold segment
  - Direct-sold hire better managers, outsource less, and are more actively managed; earn largest alphas in small cap
- *Market segmentation ➔ skilled managers will work together*
- *Predict value added is larger in direct-sold segment*
- *Predict external promotions more likely in broker-sold segment*
- *If new subadvisers are classified as external promotions, would help explain lack of value added by external promotions*

Alternative #2

Marketing and Cross-subsidization?

- Authors assume manager names provide researchers with data on how returns are produced
- But manager name disclosure is (partly) a marketing decision
    - Until 2005, some funds listed one manager name, some listed multiple manager names, and some listed “team management”
    - Massa, Reuter & Zitzewitz (2010) show that single named manager funds enjoy marketing benefit and cross-subsidization
    - Fact that named manager gets credit for returns he/she did not generate drove use of anonymous “team management”
    - Kumar, Spalt & Niessen-Ruenzi (2014) show that firms are unwilling to list “foreign sounding” manager names after 9/11
- To the extent that internal promotions reflect marketing decisions to associate successful managers with more/different funds, increases in value added will capture skill plus cross-subsidization

Conclusion

- Paper argues that investors benefit from a well functioning internal labor market
- This argument is both reasonable and interesting
  - Fidelity sector funds allow Fidelity to evaluate a large pool of managers and analysts
- But, the authors abstract from cross-sectional and time-series variation in incentives to generate abnormal returns
  - I have a similar critique of Pastor, Stambaugh & Taylor (2014)
- These sources of variation have the potential to explain *some* of the authors' findings, but also suggest interesting extensions