Discussion of

“Portfolio Manager Compensation in the U.S. Mutual Fund Industry”

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WFA 2015

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What Does the Paper Do?

- Uses hand-collected data on nature of fund manager compensation to predict fund returns, risk taking, and risk shifting
  - Sample covers 5,040 funds between 2006 and 2011
  - **40.6%** equity, **27.2%** bond, **14.6%** global, ..., **1.9%** others
- Empirical Findings:
  - Only **3.2%** of managers receive a fixed salary with no bonus
  - **77.0%** receive “performance pay” bonus, **51.5%** receive “advisor profits” bonus, **19.2%** receive “AUM” bonus
  - Performance pay bonus predicts higher annual returns
  - Among funds that offer performance pay bonuses, longer evaluation windows predict higher annual returns
  - Fixed salary predicts less risk taking and less risk shifting

What Does the Paper Conclude?

- **Most managers face explicit convex incentives**
  - "In unregulated setting, asymmetric, option-like, performance-based incentives are the dominant form of compensation for individual portfolio managers."
- **SEC did right by investors (and academics)**
  - "SEC mandated disclosure of the structure of mutual fund manager compensation reveals valuable information to investors."
- **Refrains from specific causal interpretation**
  - "We do not disentangle whether [performance differences are] driven by inducing greater managerial effort or attracting better managers."

My Reactions?

- **I very much like the hypothesis that manager-level incentives should matter for fund performance.**
- **I agree the paper contains valuable information for investors.**
  - Differences in benchmark-adjusted and 6-factor alphas are an economically significant **40-60** bp per year...
  - ... that show up in univariate regressions
  - Reasonable for investors to choose funds that offer managers performance pay bonus and longer evaluation windows
- **I also believe the paper provides valuable information for academics...**
- **... but have standard discussant-style questions about robustness, interpretation, and the decision to offer performance pay.**

Robustness (1)

- Authors focus on one-factor (benchmark) and six-factor alphas.
- Regressions include style and year fixed effects. My preference is for style-by-year fixed effects, which compare funds of the same type in the same year.
    - Particularly appropriate to include style-by-year given that majority of funds are non-equity funds.
- For comparability with other studies, authors should also estimate some specifications limited to equity funds.
- I'm curious whether inclusion of non-equity funds is responsible for the two non-standard findings that:
    - Alpha is persistent.
    - Larger funds earn higher returns than smaller funds.

Robustness (2)

- Authors use the idea of a single manager (**agent**) working directly on behalf of an advisor (**principal**) to motivate the potential benefits of performance pay.
- There are two significant deviations from this principal-agent setup:
  - 19% of the observations involve managers who are “owners” ➔ managers who are principals rather than agents.
  - 21% involve subadvisors ➔ third party asset management firms with their own compensation schemes for managers.
    - *Several studies document that subadvised funds underperform internally managed funds. Literature recently has begun to think seriously about counterfactual returns.*
- **What are the returns associated with performance pay within the sample of internally managed funds whose managers are not owners?**

Interpretation?

- Does "performance pay" identify the **top 77%** of actively managed funds or the **bottom 23%**?
    - Carhart (1997) showed us that some funds are consistently good at being bad.
    - How many of the top 77% earn **non-negative after-fee alphas** (as opposed to less negative after-fee alphas)?
- Is this an independent finding of incentives/skill or a reinterpretation of existing findings?
    - How much of the cross-sectional variation in **active share** and **return gap** can be explained with variation in performance pay and evaluation windows?

What Drives Compensation?

- The paper has little to say about the potential costs and benefits of performance pay from the managers' and advisors' perspectives.
  - Anecdotal evidence suggests bonus can be 3x base salary, but authors lack comprehensive data on—and exogenous variation in—the relative importance of performance pay.
- Interestingly, performance pay is largely an **advisor-level** decision.
  - I expected evaluation window length to vary with manager tenure and with volatility of asset class returns...
  - ... until I read that only **39** (4.7%) of **814** advisors exhibit any within-advisor variation in nature of compensation.
- Unless those 39 advisors manage lots of funds or the authors can exploit variation from advisor mergers, authors should focus more on time-invariant advisor characteristics than on time-varying fund characteristics when predicting the nature of compensation.

Complements or Substitutes?

- Does use of performance pay vary with fraction of advisors' assets that are direct-sold vs. broker-sold vs. 401(k) vs. institutional?
  - Del Guercio & Reuter (2014) document differences in implicit incentives due to differences in flow-performance. Clemens et al. (2015) document monitoring by 401(k) plan sponsors.
- Is performance pay a complement or substitute with respect to managerial holdings of fund shares?
  - Evans (2008) shows fund returns are increasing in managerial holdings of fund shares.
- Is cross-subsidization more common in families that rely more heavily on "advisor-profits pay"?
- Do across-advisor differences in evaluation window length correlate with across-advisor differences in return horizons that best predict manager turnover?

Conclusion

- I very much like the idea that heterogeneity in incentives can be used to explain heterogeneity in fund behavior and returns.
- This paper takes the very reasonable first step of linking nature of manager compensation to fund returns.
- Magnitudes are economically significant and plausible.
- The big next step is to say more about the mechanism (selection vs. treatment) and why, since variation is at the advisor level, different advisors take different approaches to manager compensation.