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Investing when the tide goes out

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James Saft on the challenges of investing in mutual funds.

James Saft, Reuters Columnist

Mutual fund investors, to paraphrase Warren Buffett, only learn which of their managers have been swimming naked when the tide goes out.

Mutual fund flows are about twice as sensitive to performance during a market downturn as in an upturn, according to a new study by Francesco Franzoni of the University of Lugano and Martin Schmalz of the University of Michigan.

In other words, investors are far more likely to bail out of an underperforming fund, or invest in an outperforming one, during down markets as opposed to bull markets, according to the authors' models, which assume a rational investor base.

The reasons behind this aren't just interesting, they also tell us a lot about the challenge of investing using mutual funds, and perhaps even something about how the industry is likely to evolve in coming years.

Lest we think this is a small issue, consider that US households hold 23% of their financial assets and more than half their retirement IRA and 401(k) assets in mutual funds. Those funds in turn are huge players in US finance: the money invested in equity mutual funds is about half the size of the US stock market as a whole. (To be sure, some of that money is in index mutual funds, which presumably must be less sensitive to relative performance)

And indeed, fund managers are paid in large part based on their ability to attract fund flows, so understanding why their performance during downturns is so much more crucial is important in being able to set their compensation.

While active mutual funds offer many advantages, they also come with critical blind spots. Some of those are simply a function of active management. Investors can't count on performance persisting and often have difficulty drawing a straight line between what managers espouse and what they actually do.

Some problems, however, have to do with how the industry is structured. You only get pricing information on a mutual fund once a day, and information about holdings far less often. Because investors can't see what assets funds hold in real time, they don't really have insight into how they are generating returns. Are they closet index trackers, simply riding the market higher? Or are they taking out-sized bets, loading on risk in hopes of sparking out-sized returns and fund flows?

Rising tide lifts all boats

The authors argue that investors get better information about fund manager skill during downturns, and thus are more likely to act on that information by channelling fund flows one way or the other. Because you can't see exactly

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how a fund manager is generating returns, the tendency is to give less weight to doing a bit better or worse than the market in a bull period.

But in a downturn, that simply isn't true. Without an impressive overall market gain to fall back on, relative performance becomes much more important.

"The reason is that, in downturns, the noise coming from the loading on aggregate risk is smaller, which increases the signal-to-noise ratio and thus simplifies the inference about skill. As a result, in downturns investors reallocate more wealth between funds and the flow-performance sensitivity is higher than in upturns," the authors write.

Translation: it is easier to bamboozle, or to get away with sub-par performance, when times are good rather than tough.

All of this begs questions which are outside the scope of the study. Is performance during downturns more predicative of returns across the cycle than bull market returns?

And while the study pre-supposes a rational investor in order to make measurement possible, much of this behaviour strikes me as having a psychological element. When you are fat and happy, as during a bull market, you don't tend to ask that many questions.

Of course it is also true that the fees charged by active management seem less important during bull markets, which of course is why it is so hard to find bearish analysis from the active investment management community.

It is also interesting to note that, due to demographics and the impact of debt levels, a number of analysts expect an extended period of low returns. Barclays, for example, predicted this year that returns for a typical mixed portfolio might only beat inflation by 1.5% to 2% a year over the next five years.

If that is true and this study is correct, two things seem likely. First, fund flows will be more volatile than they usually are, with dissatisfied investors switching horses more often. That's expensive for mutual fund companies. Second, this may hasten the already pronounced trend away from actively managed investments and into low-cost index funds. That's just flat-out bad for mutual fund companies.

Fund management may be a tough business in coming years.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund. You can email him at jamessaft@jamessaft.com)

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