

Asset Management Industry: Recommendations for Lowering Rents

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Outline

- Asset management industry
 - Competitive
 - But appears to earn rents
 - Fees without performance
 - High compensation
 - Conjectures about the sources of super-normal profitability
- What should be the target to reduce rents?
 - Compensation?
 - Revenues
- Recommendations
 - Require enhanced disclosure on fees/expenses
 - Advertise desirable attributes of a mutual fund
- Effect on price discovery and market efficiency₂

Asset Management Industry

- Most of the elements of a competitive industry
 - Demand: Large number of buyers with a range of sophistication
 - Institutional – most sophisticated
 - Individual – sophisticated and not-so-sophisticated
 - Many intermediaries/advisors
 - Many brokers, working on commissions, recommend funds to individual investors
 - Investment consultants advise institutional investors

Asset Management Industry

- Most of the elements of a competitive industry
 - Supply
 - Large number of independently-owned mutual fund companies
 - More than one thousand hedge funds, with none too large
 - Large number of mutual funds offer each type of a fund – value, growth, income, small, large, international, domestic,
 - Multiple hedge funds offer similar products

Asset Management Industry

- Most of the elements of a competitive industry
 - (Expected) Performance – Homogeneous
 - Relatively little evidence of skill on a predictive basis among mutual funds and hedge funds
 - Evidence of superior performance persistence is weak
 - Past performance exhibits variation, which is subtly and not-so-subtly advertized as skill
 - Information available quite easily and cheaply
 - Information about performance available easily
 - Also about expenses
 - Which attribute to focus on is not known to not-so-sophisticated clients
 - Web-based tools offer investment/portfolio advice quite cheaply
 - Low barriers to entry
 - Start-up costs for a mutual fund and for a hedge fund are not staggering
 - Low compared to many other industries that are considered fairly competitive

Appearance of Rents

- Expense ratios indicative of the revenues to mutual funds and hedge funds
- But evidence shows
 - Expense ratios are unrelated to future performance – a long-standing literature in finance
 - Performance persistence evidence is weak, and often challenged to be non-existent
 - Distribution of abnormal mutual fund returns cannot reject the null hypothesis of lack of skill (Fama and French)
- Trading costs are flows representing costs incurred by investors (mutual funds, hedge funds, and individual investors) in the hope of generating superior performance
 - These costs are beyond the expense ratios

Magnitude of Revenues

- French reports aggregate incremental costs of active investing over passive investing
 - Active costs comprise expenses and fees plus trading costs
 - 67 basis points or about 10% of the aggregate market value of equities – has not changed much in more than two decades
 - 67 basis points includes expenses for institutional clients (much lower expenses), mutual funds, and hedge funds, plus trading costs
 - Trading costs average about 21 basis points in 2006, so even without trading costs, the aggregate costs are about 45 basis points
 - Mutual fund expenses and fees are about 85 basis points in 2006
 - Passive strategies cost only a few basis points
 - Fees generated by funds by securities lending are ignored – also a cost to investors

Appearance of Rents

- Revenues and compensation without demonstrable superior performance in the asset management sector, especially the hedge fund industry
- High compensation suggests employees corner considerable amount of the rents
- Large fraction of revenues paid out as compensation to employees
 - Not unique to the asset-management industry
 - Investment-bankers and traders also are paid a large fraction of their revenues

Conjectures: Reasons for Rents

- Inadequate disclosure
 - Expenses not disclosed prominently
 - Expenses in percent seem small
- Investment advisors and brokers as intermediaries receive commission, but commissions are not disclosed prominently
- Consultants to pension plans have little incentive to promote passive investing
- Lack of guidance from independent bodies/government agencies
 - They do not advertize desirable attributes of mutual funds/hedge funds
 - But in other areas they do, e.g., health and nutrition, see below

Example: Nutrition Guidance



One size doesn't fit all.
MyPyramid offers personalized eating plans and interactive tools to help you plan/ assess your food choices based on the [Dietary Guidelines for Americans](#).
<http://www.mypyramid.gov/>

Recommendations

- Recommendations
 - Target revenues, not compensation
 - Require enhanced disclosure – fees/expenses, in dollars and in percent
 - Require disclosure of commissions to brokers/advisors
 - WSJ, February 26, 2010
 - Last summer, Indian regulators changed the way investors pay for the mutual funds they buy, forcing sellers of the funds to better disclose these sales charges. The result: Sales of Indian stock funds have nearly stopped, in a dramatic slowdown in what was one of the world's fastest-growing fund markets.
 - Advertise
 - Desirable attributes of a mutual fund
 - Effects of expenses/commissions on performance and value of investment over time
 - Currently independent/government bodies do not advertise

Potential Effects

- Effect on price discovery and market efficiency
 - Less active investing might slow price discovery and thus adversely affect market efficiency
 - Concern is not entirely warranted because reduced rents will not discourage activity

Q & A
