“Unobserved Actions of Mutual Funds”

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Discussion by
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Basic Idea

- Mutual funds periodically disclose fees, returns, and holdings, but many things that impact net returns are unobservable
  - Commissions, price impact, negative investor externalities, agency costs $\Rightarrow$ *hidden costs*
  - Skilled (short-term) trading, access to underpriced IPOs $\Rightarrow$ *hidden benefits*

- **“Return Gap”** is intended to measure the net benefit (or cost) of these “unobserved actions”
  - Potentially better signal-to-noise ratio than net returns
Calculating Return Gap

\[ \text{Return Gap}_t^f = RF_t^f - \left( RH_t^f - EXP_t^f \right) \]

- **Positive** when fund outperforms a portfolio of prior reported holdings with same expenses
- Essentially, buy and hold version of measure from Grinblatt and Titman (‘93)
Key Findings

• Average return gap is zero (T2) but fund-level return gaps are persistent (T3)

• Return gap predicts abnormal fund returns
  – Extreme negative return gaps predict negative abnormal returns (T4); with back-testing, positive return gaps predict positive abnormal returns (T5)
  – Trading strategy based on return gap does at least as well as trading strategy based on expenses (T6)
  – Return gap helps predicts Carhart’s 4-factor alpha in multivariate regressions (T11)
Should You Read This Paper?

• Yes, I expect return gap will be widely used
  – *Full disclosure*: I’m using return gap as additional measure of fund performance in project on team-managed funds (with Massa and Zitzewitz)

• Morningstar’s Director of Fund Research said return gap “*sounds pretty flawed*” because of its focus on short-term performance
  – Return gap persistence ⇒ criticism is misplaced

• That said, I think return gap may tell us more about agency conflicts and less about skill
What’s Return Gap Good For?

• Authors take “consumer advocacy” view
  – Classic argument that investors should focus on low expense funds (Carhart ‘97)
  – Authors claim “return gap is more important in predicting abnormal returns [than] expenses” ⇒ investors should also focus on + return gap
  – Unfortunately, return gap is data intensive and restricted to funds that invest in domestic equity
  – Moreover, incremental power of return gap to identify future winners is unclear
Does Return Gap Identify Future Winners?

• Studies typically find persistence among losers but not among winners

• Is their study different? Yes and no
  – Without back-testing, return gap predicts future losers (based on net returns) but not future winners
  – With back-testing, return gap predicts both future losers and future winners…
  – … but with back-testing, Mamayksy, Spiegel & Zhang (‘05) find existing measures also predict future winners
  – When using back-testing, is return gap better than existing measures at predicting winners?
## Return Gap vs. 4-Factor Alpha

- Consider predicting Carhart’s alpha ($\alpha_4$) with deciles based on past return gap and past $\alpha_4$

<table>
<thead>
<tr>
<th>Deciles</th>
<th>Carhart's Alpha $t+1$</th>
<th>Source</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Decile 1</td>
<td>Decile 10</td>
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<tr>
<td>Return Gap w/ Back Testing</td>
<td>-0.33 ***</td>
<td>0.21 *</td>
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<tr>
<td>Carhart's Alpha w/ Back Testing</td>
<td>-0.31 ***</td>
<td>0.23 ***</td>
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- Comparison not quite apples to apples, but it suggests need to consider double sorts, etc.
Return Gap More Valuable to Academics than Investors?

• Several papers already help predict winners
  – *For example:* Bollen & Busse (‘05), Busse & Irvine (‘06), Cohen, Coval & Pastor (‘05), Kacperczyk, Sialm & Zheng (‘05), Kacperczyk and Seru (‘06), Mamayksy, Spiegel & Zhang (‘05)

• Return gap is interesting (to me) because it sheds new light behind the scenes
  – Allows us to ask **how** and **why** some funds create value for shareholders and others destroy it
  – Table 12 is a good start but I’d like to see more…
Possible Extensions

• How do return gaps vary within and between mutual fund families?
  – Negative average return gap is consistent with poor governance or poor trade execution at family level
  – Mix of positive and negative return gaps within family is (potentially) consistent with cross subsidization
  – Positive average return gap is consistent with high-quality research at family level or lots of skill

• How much do investors drive return gaps?
  – Monthly inflow volatility and redemption fees would allow study of negative investor externalities (Edelen ‘99, Johnson ‘04)

• Link between return gap and governance?