

# “Unobserved Actions of Mutual Funds”

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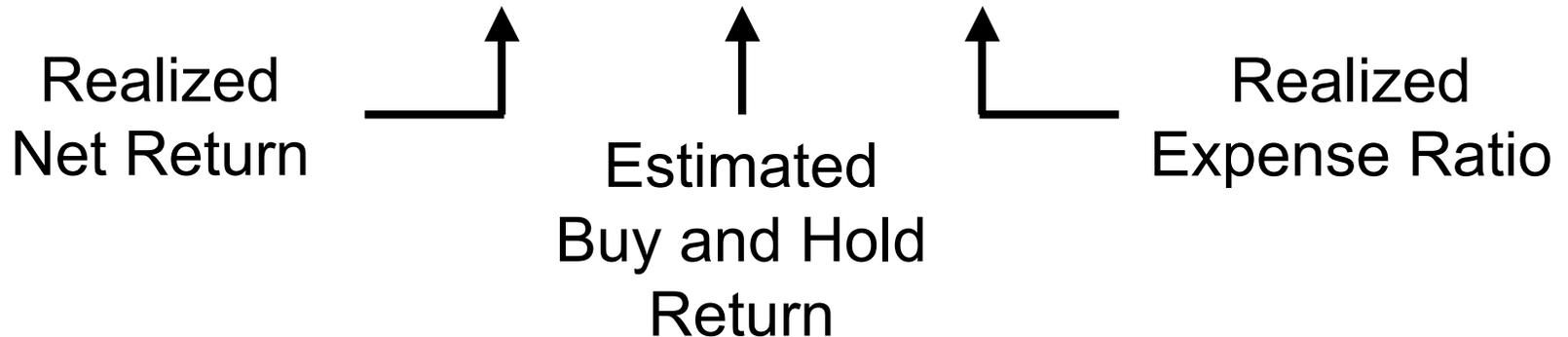
Discussion by  
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# Basic Idea

- 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

- $\text{Return Gap}_t^f = RF_t^f - (RH_t^f - EXP_t^f)$



- **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  $\Rightarrow$  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  $\alpha_4$

Deciles	<i>Carhart's Alpha t+1</i>		Source
	Decile 1	Decile 10	
Return Gap w/ Back Testing	-0.33 ***	0.21 *	<i>KSZ (2005) Table 5</i>
Carhart's Alpha w/ Back Testing	-0.31 ***	0.23 ***	<i>MSZ (2005) Table 5</i>

- 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?