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journal homepage: [www.elsevier.com/locate/jfec](http://www.elsevier.com/locate/jfec)Asset management and investment banking<sup>☆</sup>Janis Berzins<sup>a</sup>, Crocker H. Liu<sup>b</sup>, Charles Trzcinka<sup>c,\*</sup><sup>a</sup> BI Norwegian Business School, Norway<sup>b</sup> Cornell University, USA<sup>c</sup> Kelley School of Business, Indiana University, Bloomington 47405, Indiana

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## ABSTRACT

We find evidence that conflicts of interest are pervasive in the asset management business owned by investment banks. Using data from 1990 to 2008, we compare the alphas of mutual funds, hedge funds, and institutional funds operated by investment banks and non-bank conglomerates. We find that, while no difference exists in performance by fund type, being owned by an investment bank reduces alphas by 46 basis points per year in our baseline model. Making lead loans increases alphas, but the dispersion of fees across portfolios decreases alphas. The economic loss is \$4.9 billion per year.

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## 1. Introduction

The critical issue for financial economists studying conflicts of interest in financial institutions is the balance between the value added of an institution and the potential harm arising from conflicts of interest. A conflict of interest is defined as a situation in which a party to the transaction can gain at the expense of another party. Its occurrence does not necessarily mean that, in equilibrium, it results in an economic loss. As discussed in [Mehran and Stulz \(2007\)](#), the many potential conflicts of interest for investment banks are typically accompanied

by a variety of mechanisms that control the impact of conflicts of interest. [Bolton, Freixas, and Shapiro \(2007\)](#) develop a theory that models the interplay between conflicts of interest and their impact. The model predicts that, when profit margins are equal across products, conflicts will have less of an impact for the clients of an integrated financial institution than of a specialized institution. The question of whether the mechanisms control conflicts is ultimately an empirical one. We examine this question by testing whether diversification of activities within financial institutions adds value to assets under management due to information links or subtracts value due to conflicts of interest. The literature has ignored the large portfolios of publicly traded assets operated by investment banks with the exception of [Massa and Rehman \(2008\)](#) and [Ritter and Zhang \(2007\)](#), both of whom focus on bank operated mutual funds. This is surprising given that investment banking is highly regulated and, now, publicly supported. To fill the gap, we compare asset management services offered by

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investment banks with the same services offered by specialized firms, which do not engage in the range of activities of an investment bank.

Because investment banks operate many types of portfolios, any study of investment banking and portfolio management inevitably requires an examination of the economics of investment contracts. Investors who do not directly invest their money must choose not only the type of organization that manages their investments but also the type of contract that governs the relationship with the manager. The efficiency of the contract form is clearly important for researchers in evaluating whether investment banks add or subtract value compared with other organizations. Existing studies of contract form such as Ackerman, McEnally, and Ravenscraft (1999) and Cici, Gibson, and Moussawi (2010) compare mutual funds only with hedge funds and, with the exception of the side-by-side comparison in Cici, Gibson, and Moussawi (2010), they do not control for differences in the companies that offer these portfolios. Variation in assets under management, centralization of information gathering and trading, economies of scale, transactions costs levels, and risk control can create risk-return differences across portfolio type. A distinguishing feature of this study is the comparison of the investment performance of three types of delegated portfolios: mutual funds, hedge funds, and institutional funds. We compare portfolios owned by investment banks versus those owned by nonbank financial services groups, which we simply call financial conglomerates. Our sample consists of all financial groups, both investment banks and financial conglomerates that managed all three types of portfolios for at least one year during 1990–2008 and reported their performance data to widely available databases. There are 23 investment banks and 48 non-investment banks in our data. We examine the impact of investment banks (and the investor contract form) on the alphas of all portfolios that these financial groups operated during the time period. We compare investment banks only with other financial groups to control for the effect of omitted variables. Comparing investment bank-operated portfolios with portfolios not in a financial group is likely to increase the effect of omitted variables because comprehensive investment organizations centralize services that portfolio managers commonly demand.

To examine the risk-return differences, we estimate alphas on unsmoothed returns using the moving average process developed by Getmansky, Lo, and Makarov (2004) to account for differences in portfolio exposure to various risk factors. We use a seven-factor model with time-varying alphas similar to Agarwal and Naik (2004). We test the hypothesis that investment banks produce different alphas relative to nonbank conglomerates by examining the cross-sectional regression of fund alphas on control variables and type of organization. Our tests show that the form of the contract offered to investors does not matter once the control variables are included. While the contract form is occasionally significant in year-by-year regressions, competition equalizes the impact of the three contract forms across time. It is clear that the control variables are a critical part of explaining the

difference between types of contracts. However, when the data are confined to a single contract, these organizations appear to be optimized for institutional clients because the control variables do not matter for institutional funds. For hedge funds and mutual funds, the control variables are significant.

Our findings show that the organizational ownership structure matters. On average, investors experience a lower alpha of 46 basis points per year when an investment bank operates a fund. The harm is largely borne by mutual fund investors and depends on the fee dispersion across portfolios offered by the investment bank and the participation of the investment bank in lead loans during the year. It does not depend on equity or debt underwriting business. The greater the fee dispersion, the more the harm; the more the participation in lead loans, the lower the harm. The effect of investment bank ownership is material amounting to at least \$93 billion loss over the 19-year sample, but the dollar loss is time-varying. For 14 years of the 19-year sample, the costs of being owned by a bank were higher than the benefits. There were only five years, 1993–1994 and 2001–2003, when the benefits of being owned by an investment bank outweighed the costs.

The paper proceeds as follows. Section 2 reviews the relevant literature and develops the hypotheses. Section 3 presents the sample collection process and introduces descriptive statistics. Section 4 discusses our procedures for correcting selection biases in our sample and the methodology for testing our hypotheses. Section 5 discusses results and Section 6 concludes.

## 2. Hypotheses

We proceed by outlining theory papers that examine conflicts of interest for investment banks.

### 2.1. Conflicts of interests for investment banking

The Bolton, Freixas, and Shapiro (2007) model predicts that an integrated financial institution is more capable of offering an appropriate product for a customer simply because it has more products than a specialized financial firm. However, this also gives the integrated firm more opportunities to offer inappropriate products. In the model, the financial institution maximizes profits net of the reputation cost of lying to customers. If the reputation cost is sufficiently high, then there is no conflict of interest. However, Mehran and Stulz (2007) argue that reputation costs are likely not high enough to eliminate conflict of interest, and Bolton, Freixas, and Shapiro carefully examine the case in which reputation costs are lower than profits. They show (in Proposition 2) that all conflicts are eliminated if the gross margins are the same across products. Equal gross margins for products eliminates the incentive to misdirect the customer into inappropriate but profitable products. Mehran and Stulz (2007) observe that, in a perfectly competitive market for asset management services, products have the same profit margins. Cabral and Santos (2001) use a model with a different focus and develop the incomplete contracting between the client and the financial institution. Their financial institution is

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