Journal of Financial Economics 000 (2018) 1–21

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

Management sub-advising in the mutual fund industry[☆]

David Moreno[a], Rosa Rodríguez[a], Rafael Zambrana[b,*]

[a] Universidad Carlos III de Madrid- Department of Business Administration, C/ Madrid, 126–28903 Getafe (Madrid), Spain
[b] Nova School of Business and Economics, Campus de Campolide, 1099-032, Lisboa, Portugal.

ARTICLE INFO

Article history:
Received 28 September 2015
Revised 16 January 2017
Accepted 13 February 2017
Available online xxx

JEL classification:
G11
G20
L24
M55

Keywords:
Outsourcing
Sub-advisor
Mutual funds
Management company
Incentive contracts
Fund performance
Market share
Agency issue

ABSTRACT

This is a study of how contractual mechanisms can mitigate agency conflicts in sub-advised mutual funds. Sub-advising contracts allow fund families to expand their product offerings to include new investment styles and thereby gain market share. We show that costly contractual arrangements, such as co-branding, multi-advising, and performance-based compensation, can mitigate agency conflicts in outsourcing and protect investors from potential underperformance. Fund families will find it cost-effective to implement such incentive mechanisms only when investors are sophisticated in assessing manager skill. The findings help to explain why a large percentage of fund families outsource their funds to advisory firms.

1. Introduction

A highly competitive asset management industry and the drive to gain market share have made sub-advising portfolio management a valuable choice for asset managers. The number of outsourced mutual funds has grown considerably in the last decade. According to the Investment Company Institute, by 2009, nearly 40% of US mutual funds used at least one sub-advisor (affiliated or unaffiliated with the fund family) to manage portfolios, compared to 25% in 1999. By 2011, the value of sub-advised funds was about $1.7 trillion.[1]

One benefit of external advising (sub-advising) is access to talent that is not available in-house. Yet sub-

☆ We are grateful to Diane Del Guercio, Egemen Genc, and Hai Tran for providing us with the data on side-by-side management. We thank Carlos Bellon, Claudia Custodio, Miguel Ferreira, Jose-Miguel Gaspar, Javier Gil-Bazo, Alexander Kempf, Jose Maria Marin, Melissa Prado, Pablo Ruiz-Verdu, David Solomon, Helena Veiga, Fernando Zapatero and participants at the Finance Forum meetings, UC3M, University of Zaragoza, University CEU, Paris Dauphine University, ESSEC, ITAM, Nova Business School, MFA, FMA, and EFMA meetings for thoughtful comments. The authors are also grateful to Bill Schwert (the editor) and Roger M. Edelen (referee) for their help in improving the manuscript through a most constructive review process. Rafael Zambrana acknowledges financial support from the FCT Fundação para a Ciência e a Tecnologia under the project UID/ECO/00124/2013 and POR Lisboa (LISBOA-01-0145-FEDER-007722). David Moreno and Rosa Rodríguez thank financial support from Ministerio de Economía, Industria y Competitividad (through projects ECO2016-77807-P and ECO2015-67035-P), WRDS-UC3M (FEDER UNCC315-EE-3636), CAM grant S2015/HUM-3353 (EARLYFIN-CM) and Bank of Spain (grant PR71/15-20229).

* Corresponding author.
E-mail addresses: jdmoreno@emp.uc3m.es (D. Moreno), rosa.rodriguez@uc3m.es (R. Rodríguez), rafael.zambrana@novasbe.pt (R. Zambrana).

[1] See http://www.frcnet.com/documents/sub-advisory-mutual-fund-assets-to-reach-2%202-trillion-by-2016.pdf for detailed information.

https://doi.org/10.1016/j.jfineco.2018.01.004
0304-405X/

advisors generally manage funds for clients besides their own funds. This can present conflicts of interest, resulting in agency costs and lower returns. Research shows that management companies tend to favor their own mutual funds over sub-advised funds through preferential treatment in initial public offering (IPO) allocations and abnormal cross-trading activities (Chen et al., 2013; Chuprinin et al., 2015). Why then the significant growth of outsourcing contracts, and what is the principal benefit?

Our study of the growth of sub-advising shows that outsourcing helps fund families gain market share in an increasingly competitive industry. We explore different contractual mechanisms that might mitigate the agency conflicts inherent in outsourcing portfolio management. We find that mechanisms for co-branding, multi-advising, and performance-based compensation help to overcome the lower returns of sub-advised portfolios.

Interestingly, we observe that asset managers do not find it cost-effective to implement these mechanisms in funds whose clients are relatively uninformed or naïve in assessing a sub-advisor's contribution to returns. We argue that fund families use these costly contractual arrangements to protect their more sophisticated clients from the potential underperformance of funds whose management is outsourced. In this regard, outsourcing can lead to high-quality managed portfolios, allow asset management firms to offer new investment styles, and help firms gain added market share.

In this paper, we assess the primary benefits of delegating portfolio management responsibilities to unaffiliated managers and explain why the practice has become so popular in recent decades. Our main result shows that underperformance is not intrinsic in sub-advised funds. Sub-advisors can deliver performance that is as good as the performance of internally managed funds, if specific types of arrangements (co-branding, multi-advising, or performance fees) are used to protect against conflicts of interest in the sub-advisory firm.

The first contractual arrangement we examine is co-branding. Under a co-branding arrangement, the fund family partners with a sub-advisor to capitalize on the sub-advisor's reputation (by including the name of the sub-advisor in the fund name). The motivation is to attract new investors and align incentives.[2] This should mitigate conflicts of interest, as the sub-advisor cares about its reputation as well as management and compensation. The contract design literature indicates that firm reputation and brand name provide incentives to assure contract performance and protect against adverse selection (e.g., Marshall, 1949; Klein and Leffler, 1981). Co-branding relies upon the value of repeat sales to satisfied customers as a way to prevent underperformance.

The second mechanism is multi-advising. This is an agreement between the fund family and more than one sub-advisor.[3] We expect multi-advisory agreements to address management conflicts of interest for two reasons.

First, the Securities and Exchange Commission (SEC) exempts multi-advising funds from the requirement to gain shareholder approval to terminate sub-advisory contracts.[4] This exemption makes it easier to terminate contracts for poor performance and prompts greater competition among sub-advisors. Our evidence is consistent with Chevalier and Ellison (1997, 1999) and Kempf et al. (2009), who claim that the risk of job loss is an important determinant of managerial behavior.[5]

Second, we argue that because multi-advising contracts involve compensation that is shared by all sub-advisors subject to the contract, external managers will monitor each other. This is consistent with the literature on contractual theory that profit sharing generates mutual monitoring and peer pressure that positively affect firm productivity (Kandel and Lazear, 1992; Kruse et al., 2010).

The third contractual arrangement is performance-based fee compensation. There is an extensive literature analyzing performance-based contracts to solve problems of moral hazard or adverse selection (e.g., Holmstrom, 1979; Shavell, 1979). In the mutual fund industry, performance fee compensation has been proposed to eliminate conflicts of interest between the portfolio manager and mutual fund investors.[6]

Starks (1987) claims that symmetric contracts are better than bonus contracts in motivating manager performance, while Stoughton (1993) and Li and Tiwari (2009), among others, point out that symmetric could not be the optimal structure in some cases. Ou-Yang (2003) analyzes the relationship between an investor and a professional portfolio manager in a continuous-time principal-agent framework and finds that optimal contracts are of a symmetric form. Elton et al. (2003) find evidence that US mutual funds with explicit incentive fees outperform similar funds without explicit incentive fees. More recently, Kyle et al. (2011), in a model that endogenizes information acquisition, conclude that linear contracts could induce managers to apply more effort to information acquisition. We hypothesize that linking management compensation to performance will align managerial incentives, solving agency issues and positively affecting fund performance.

We first show that the various contractual arrangements reduce the underperformance of sub-advised funds by mitigating potential conflicts of interest and aligning

[2] For instance, the Metropolitan Series Fund (advisor) outsourced one of its funds to BlackRock (sub-advisor) under the name BlackRock Aggressive Growth. More recently, Metropolitan Series Fund approved a change of sub-advisor to Frontier Capital Management, and the name of the portfolio became Frontier Mid Cap Growth.

[3] For instance, JP Morgan Multi Manager Small Cap Growth Fund is externally co-managed by BlackRock Capital Management, ClariVest, UBS Global Asset Management, and Oberweis Asset Management.

[4] See SEC Release N.s. 33-8312, 34-48683, IC-26230, available at http://www.sec.gov/rules.shtml.

[5] This self-enforcement mechanism that assures performance by threatening termination of a relationship has also been examined by Klein and Leffler (1981), among others.

[6] Legally, if a mutual fund decides to charge an incentive fee, it must use a type of fee known as a "fulcrum fee," which constitutes a symmetric contract in which manager compensation relates investment performance to some benchmark. For example, the International Equity Fund of Accessor Capital Management compensates the sub-advisor Pictet Asset Management by a combination of a fixed rate and a floating rate based on its performance under a fulcrum fee arrangement.