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Allocation of decision rights and the investment strategy of mutual funds ☆

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ABSTRACT

The literature suggests that while decentralized decision making can allow for greater specialization in an organization, it heightens the cost of coordinating decisions. The mutual fund industry—in particular, sole- and team-managed balanced funds—provides an ideal setting to test the specialization versus coordination trade-off, as information on decision structures and fund actions is easily obtained. We show that sole-managed balanced funds, with centralized decision rights, exhibit significant market timing that requires reallocation across asset classes. However, consistent with coordination difficulties between managers specializing in particular asset classes, no market timing is evident in team-managed balanced funds. Team-managed funds exhibit greater returns from specialization, in the form of better security selection performance than sole-managed funds. These results hold cross-sectionally and for funds that switch management structures. The overall returns across different management structures are similar, indicating a market equilibrium. Investor flows reward market-timing performance for sole- but not team-managed funds.

1. Introduction

How should decision rights be located within organizations? What are the consequences of centralized versus decentralized decision making? In their analysis of organizational structure, Jensen and Meckling (1992) emphasize the cost and distortion associated with communicating information within organizations. They posit that decentralized structures benefit from lower information transmission costs by giving decision rights to those with specific information. Decentralized organizations, however, face a challenge in coordinating actions between agents that could differ in terms of their information and incentives (also see Hart and Moore, 2005; Hart and Holmström, 2010). These coordination problems can be alleviated in a centralized structure in which the decision-maker has a greater span of control, while having less specific information. Similar insights emerge from the literature on teams. It is suggested that while teams can add value when members have specialized and complementary skills (Lazear, 1988), substantial costs are associated with monitoring and coordinating actions within teams (Alchian and Demsetz, 1972; Becker and Murphy, 1992).[1]

Our objective in this paper is to propose and test predictions of the decision rights theory. We test whether centralized decision structures implement strategies

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[1] A large theoretical literature studies the implications of moral hazard problems in teams and the incentive schemes associated with the efficiency of teamwork (see, e.g., Holmström, 1982; Rasmusen, 1987; Prendergast, 1999).

consistent with lower coordination costs and a greater span of control and with less reliance on specific information. We identify a class of mutual funds—balanced funds—in which the investment strategies predicted under centralized decision making are different from those under decentralized decision making. The empirical predictions are developed within a simple framework that helps to clarify the trade-offs in centralized versus decentralized decision making in market equilibrium. Our empirical results are supportive of the decision rights theory: Investment strategies of sole-managed balanced funds are less reliant on specific information. They reflect the manager's greater span of control and lower coordination costs.

Studying decision making in organizations in the context of investment strategy and performance of balanced fund managers has several distinct advantages. First, US mutual funds are managed both by individual managers and by management teams. Management teams are typically composed of two or more managers who, depending on fund objectives, have expertise in different asset classes or industry sectors. The structure of fund management gives a straightforward way to categorize the decision-making structure: being more centralized under a sole manager or less centralized when team-managed. Second, many decisions of fund managers, such as their portfolio holdings and trading activities, are observable, which is not the case in most other settings. Furthermore, the performance of mutual funds can be reliably measured. The finance literature has developed a large set of performance evaluation methodologies that allows for evaluation of the performance of mutual funds and the characterization of their investment strategies.

Finally, our focus is specifically on balanced funds because, as we argue, they are particularly suited for testing decision-structure hypotheses. Balanced funds allocate investments across different asset classes, typically between stocks and bonds. They are usually required to maintain, with varying degrees of flexibility, a prespecified ratio of debt and equity investments.[2] In broad terms, two types of investment strategies are available to balanced funds. Balanced funds invest in both stocks and bonds and, hence, can deliver performance through allocation decisions across asset classes (generally referred to as market-timing skills) or by identifying investment opportunities within each asset class (referred to as security-selection skills) or both. While both types of strategies can contribute to fund performance, the structure of decision rights that facilitates one or the other strategy is different.

In team-managed balanced funds, individual managers are typically specialized in one of the asset classes.[3] We should, therefore, expect security selection strategies to contribute to the performance of team-managed funds. A market-timing strategy is less suited to a decentralized team structure because it places substantial coordination demands on the managers. Allocation decisions across asset classes have to rely on the agreement and coordination among the various managers specialized in particular asset classes. These coordination problems could be exacerbated by conflicting incentives and information, the potential adverse impact of asset allocation decisions on security selection performance, and an unwillingness to reduce the assets under their control. Hence, a fund in which the decisions are made by a sole manager faces fewer coordination problems. In such a centralized structure, the manager can unilaterally change allocations across asset classes and, therefore, has an inherent advantage in terms of implementing market-timing strategies. At the same time, a sole manager might not have the specialized skills or resources necessary for successful security selection within an asset class. Even if the manager has subordinates who specialize in particular asset classes, issues of agency and communication, highlighted in Jensen and Meckling (1992), tend to deliver weaker performance than if the subordinates had independent decision rights over the asset classes and were evaluated on that basis.

For the empirical analysis, our sample of balanced funds includes two types of asset allocation funds from the Center for Research in Security Prices (CRSP) Survivor-Bias-Free US Mutual Fund Database: those that strive to maintain a balanced portfolio of stocks and bonds within a prespecified range (Rigid funds) and those that are generally more free to allocate resources across the two asset classes (Flexible funds). We identify team- and sole-managed funds for the full sample of balanced funds based on the fund manager information provided in the same database.

We first study the asset allocation decisions, or market timing skills, in the sample of balanced funds based on fund returns and asset allocations. Results from the Treynor and Mazuy (1966) and the Henriksson and Merton (1981) market-timing models reveal significant market timing in the full sample of balanced funds. However, systematic differences exist in the market-timing performance between sole- and team-managed funds. In general, sole-managed balanced funds exhibit significant market-timing skills while little evidence exists of market timing in team-managed balanced funds. Further, sole-managed funds exhibit greater market-timing ability in Flexible funds, in which managers have greater discretion in their allocation decisions across asset classes, than in Rigid funds. The performance attribution methodology that employs information on both asset allocation and asset returns provides corroborating evidence.

To better understand the impact of management structure on fund investment strategy and performance, we decompose the overall performance of funds into two components: that due to market timing and that due to security selection. We again do this based on fund returns as well as asset allocation decisions. The results indicate

[2] The funds are often promoted as advantageous for investors seeking a simple way to achieve a broadly diversified holding of stocks and fixed-income investments. See, e.g., https://advisors.vanguard.com/VGApp/iip/site/advisor/investments/mutualfunds/.

[3] For instance, on October 27, 2011, the Eaton Vance Balanced Fund (A) website (http://funds.eatonvance.com/Balanced-Fund-EVIFX.php) listed its management team: Charles Gaffney is a portfolio manager on the "large-cap core/equity income" team, and Thomas Luster and Bernard Scozzafava are portfolio managers on the "investment-grade fixed-income" team.