Are Star Funds Really Shining? Cross-Trading and Performance Shifting in Mutual Fund Families

By Alexander Eisele, Tamara Nefedova, and Gianpaolo Parise

Discussant: Angelo Ranaldo

Fifth BIS Research Network meeting
Monday 26 September 2016, BIS, Basel

University of St.Gallen

This paper is about …

- Large asset managers with two options to trade securities of affiliated funds:
  1. Open market
  2. Off market
- Off-market should cost less because no transaction costs, commission, clearing fees, order handing costs, … but …

The main finding is …

- Off-market trades are apparently more expensive!
- Performing a transaction-based analysis, after controlling for stock, size, time, fund family … they also find that mispricing
  - Increases with uncertainty, illiquidity, and volatility
  - Is associated with a shift from «junk» to «star»

The main implications are …

- *For investors*: open- vs off-market can produce unfair wealth allocation
- *For regulators: need to regulate against possible mispricing*
  - *E.g. more* stringent SEC requirements on fund families in 2004
- *For academics*: (transaction-based) identification strategy is key

I think this paper …

- is very interesting
- addresses an important and timely issue, especially in a world of excess liquidity that flows everywhere including asset funds
- has potential for an original contribution to the literature
- However, the following issues can be improved
  - Measurement
  - Explanation and connection with theory

Comment 1: Measurement

Using ANcerno data, Execution Shortfall is computed as:

- $ES_{CT} = \frac{|P^{AM,CT} - P^{OM}|}{P^{OM}}; ES_{OM} = \frac{|P^{AM,OM} - P^{OM}|}{P^{OM}}$

Does this measure of mispricing incorporate NOISE?

- $P^{OM} = M + S$, where is M the fundamental value, and S is half bid-ask spread
- $P^{AM,OM} = M + S^{AM}$, where S^{AM} is half-spread for AM
- $P^{AM,CT} = \begin{cases} M \\ M + \pi \end{cases}$, depending if AM charges π

Comment 1: Measurement

Let us assume AM is a fair guy, i.e. $P^{AM,CT} = M$, then

- $P^{AM,CT} < P^{OM}$, if P^{OM} is a buy; opposite if a sell
- ES_{CT} increases with S and hence with illiquidity and volatility
- For any $S^{AM} > 0$, $ES_{CT} > ES_{OM}$ always !!!.

Comment 1: Measurement

Now let us assume that AM is opportunistic and charge π

- $ES_{CT} = \frac{|M+\pi-(M+S)|}{P^{OM}}$ giving $\frac{|\pi-S|}{P^{OM}}$ if P^{OM} is buy, $\frac{|\pi+S|}{P^{OM}}$ if a sell
- Downward (upward) bias of ES_{CT} for buys (sells) increasing with S
- In case of $\pi \geq S$, $E[ES_{CT}] = \pi$
- In case of $S^{AM} > 0$, $ES_{CT} > ES_{OM}$ always !!!.
- We reach the **same** conclusion no matter if the AM is fair or opportunistic

Comment 1: Measurement

What to do?

- Take M as a proxy of P^{OM} as the midquote price
- Should be snapped close to the time of the CT
- How? For instance TAQ data for U.S. stocks.
- Maybe midquote at opening or closing times, or midrange

- But opening price or VWP do not fix this issue!

Comment 2: Explanations, connection to theory

Research design at three levels …

- Trade-level: ES larger for CT
- Market-level: ES increases with volatility and illiquidity
- Fund-level: ES for weaker governance; winner-picking

But why?

Comment 2: Explanations, connection to theory

Why mispricing? Theories postulate …

- Risk (e.g. DeLong et al. 1990; Loewenstein and Willard 2006).
- Margin constraints (e.g. Gârleanu and Pedersen 2011; Ashcraft et al. 2011)
- Constraints on equity capital (e.g. Schleifer and Vishny 1997; Krishnamurthy and He 2008, 2009)
- Leverage constraints (e.g. Gromb and Vayanos 2002; Liu and Longstaff 2004; Brunnermeier and Pedersen 2009; Kondor 2009; Geanakoplos 1997, 2003)
- Short selling constraints (e.g. Duffie 1996; Krishnamurthy 2002)
- Search cost (e.g. Duffie et al. 2002; Vayanos & Weill 2008)
- Market power, segmentation, habitat (e.g. Vayanos Villa 2009)

Comment 2: Explanations, connection to theory

- For instance, Shleifer & Vishny (1997):
  - Capital constraints limit the ability to profit from mispricings;
  - Long position hit by a shock triggers outflows;
  - Higher leverage, stronger reduction and price effects

- Better connection to theory to set up HPs and interpret findings
- Many of these theories imply ASYMMETRIC effects between long and short positions. Why don't you look at asymmetries?