
Issues in fund management and some solutions

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Problems

Defining a core problem in fund management

- A participant recruits F_1 as a fund manager.
- How is the participant to know that F_1 is doing a good job?
- How can she ensure that F_1 is maximising her interest?

Symptoms of agency conflicts

- Managers adopt extremely high risks owing to skewed payoffs: F_1 gets rewarded if he is “the best fund manager”.

But F_1 only face a penalty if he delivers poor returns.

- Some of the problems in Indian fund management because of agency conflicts

1. Front running; Purchase of securities which benefit the fund manager in some ways; Purchase of services (e.g. brokerage) at a high price.
2. “Theft” by using non-transparent OTC markets: (e.g., the Seamen’s Pension Fund lost Rs.930 million to HomeTrade on trading GOI bonds.)

3. High fees, high expenses: Customers pay for high-pressure

Does competition solve these problems?

- The central insight of this field is: It is difficult to measure the performance of a fund manager.
 1. “Noise”: the fluctuations of overall market.
 2. “Signal” : the ability of the fund manager.
- It is difficult to discern when the fund manager is adding value (signal) to the fund returns.
- The problem is exacerbated because finance practitioners tend to emphasise short-term performance (say, 6 months, one year).

There is an inherent governance problem that may be better achieved by policy.

Two aspects of the governance problem

- ‘Corporate governance’: problems between shareholders and the management team.
- ‘Fund management governance’: problems between investors and fund managers.

Two case studies

Pension fund governance, case 1: Vanguard

- ~ USD 750 billion.
- Mixture of active and passive management.
- Mixture of internal and external fund managers – internal competition.
- Well-defined mandates for investment; well-defined benchmarks for investment returns.
- Focus on reducing costs.

Pension fund governance, case 2: BGI

- ~ USD 1.2 trillion.
- Almost all indexation.
- Purely internal fund managers.
- Well-defined benchmarks for investment returns.
- Primary focus on reducing trading costs.

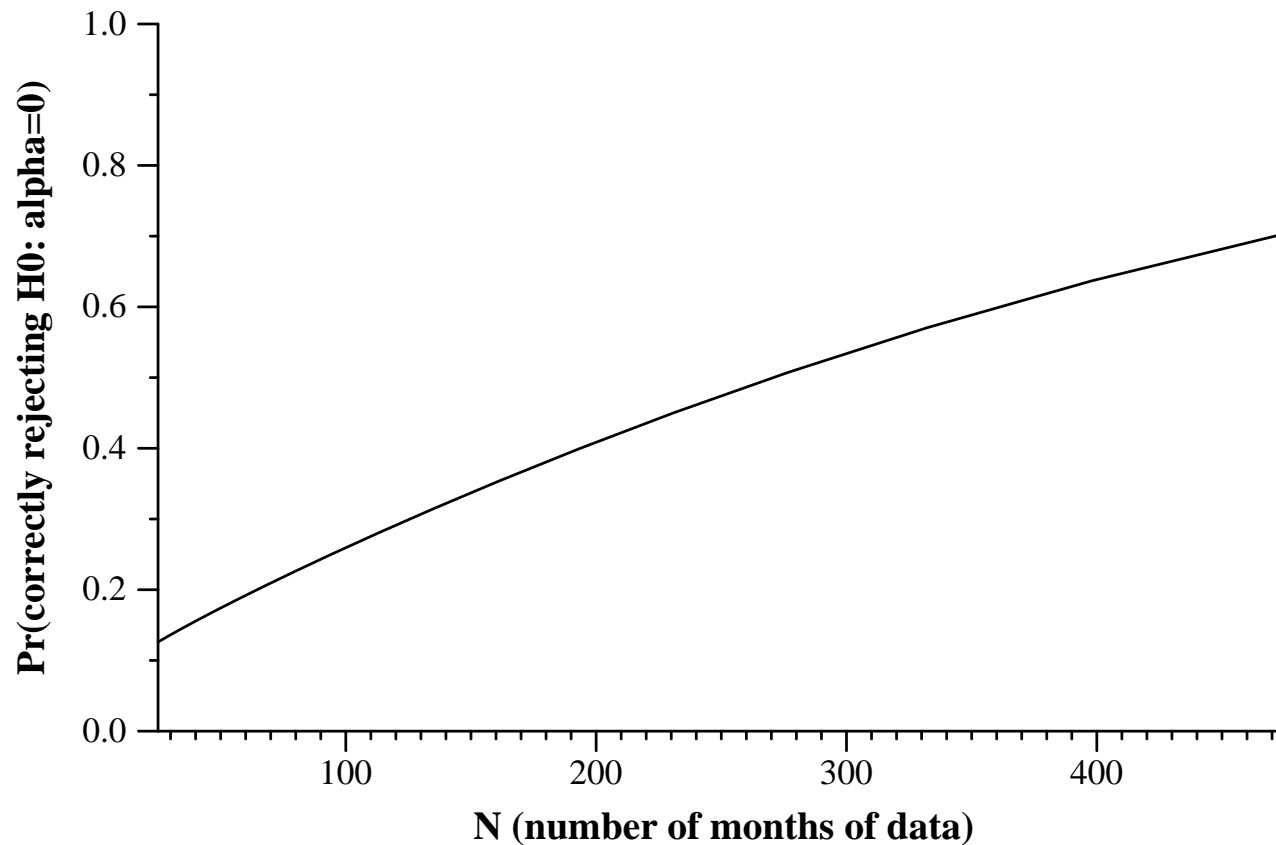
How to improve fund management outcomes

A 'board of directors' analogy

- Create a ‘trustee company’ to supervise the fund managers.
- In India, we are moving towards professional trustee companies, who can bring a greater operational capacity to bear on the problem.
- However, it does not ultimately address the underlying problem of the poor signal-to-noise ratio, which distorts our decision choice of fund manager.

The need for better data

Suppose F_1 has a huge α of 0.2%/month. Picture shows probability of rejecting $H_0 : \alpha = 0$ at $\sigma = 2$.



Better transparency

- Better data on fees, expenses, performance will help the principal know better about what is going on.
- Getting this data is difficult.
- However, it does not completely address the underlying *mathematical* problem of the poor signal-to-noise ratio.
- We would like to pick F_1 who delivers the best returns-risk ratio over the long horizon.

Index funds

- Reduce the degrees of freedom of evaluating the performance of the fund manager. Easier to benchmark performance on (a) returns, (b) costs.
- Daily accountability. If Nifty went down 2.7%, fund must also go down 2.7%.
- Low fees and expenses.
- Commoditisation of fund management – direct comparability of competing products.

In India: Build machinery to prevent outright theft

- Reduce OTC trading by the AMC.
- Focus more on anonymous, limit order book market.
- Make a mandatory requirement that all orders should be matched on the screen.
- This limits off-market prices.
- This has been done in India for the equity market with great success. However, the bond market remains a big weak link.

Guidelines suggested for governance

(From Srinivasan and Thomas, 2003, EPW XXXVIII(8).)

1. Define objectives of investments rather than mechanistic investment rules.
2. Define and monitor *processes* for investment.
3. Mandate full and frequent disclosure of the fund portfolio.
4. Establish distance between the State and the pension fund. Fund managers should be employed based on their expertise in fund management in as competitive a setting as possible.
5. Restrict role of the state to regulation of the pension fund management industry.