

Study looks at differences between institutional and retail mutual funds

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Long-only equity strategies may have recouped most of their 2009 YTD losses, but there is little question the past year has left them with a volatility only their mothers could love. The FT [reports](#) this week that UK pensions are “paying the price for an equity bias”. Reports the paper:

“...UK company pension schemes are among the most heavily invested in equities when compared with employers based elsewhere. The average allocation to equities was 48 per cent at the end of 2008 – a figure that reflects the collapse in stock markets – and is higher than that in any other country where the private sector accounts for a significant proportion of pension schemes.”

At the same time, Hedge Funds Review [points](#) to a survey showing that pensions continue to allocate to equities. Reports the magazine:

“On the issue of active management, 27% said their allocations to active management would be reduced. A further 37% said they would increase their allocations but only if fee terms rewarded actual, not expected, out performance.”

Meanwhile, Pensions & Investments [reports](#) that European pensions are actually giving a “cold shoulder” to equities...

“In Germany...where de facto regulations have forced institutional investors to keep very low levels of investment risk, equity exposures have fallen to new lows...In the U.K., equity allocations have fallen steadily since 2003 to 54% of total assets as of Dec. 31, down from 68%...”

Against this backdrop, the Spring edition of the Journal of Investing contains an interesting article by Kent Baker of The American University, John Haslem of the University of Maryland and David Smith of the State University of New York at Albany called “*Performance and Characteristics of Actively Managed Institutional Equity Mutual Funds*” (available [here](#)).

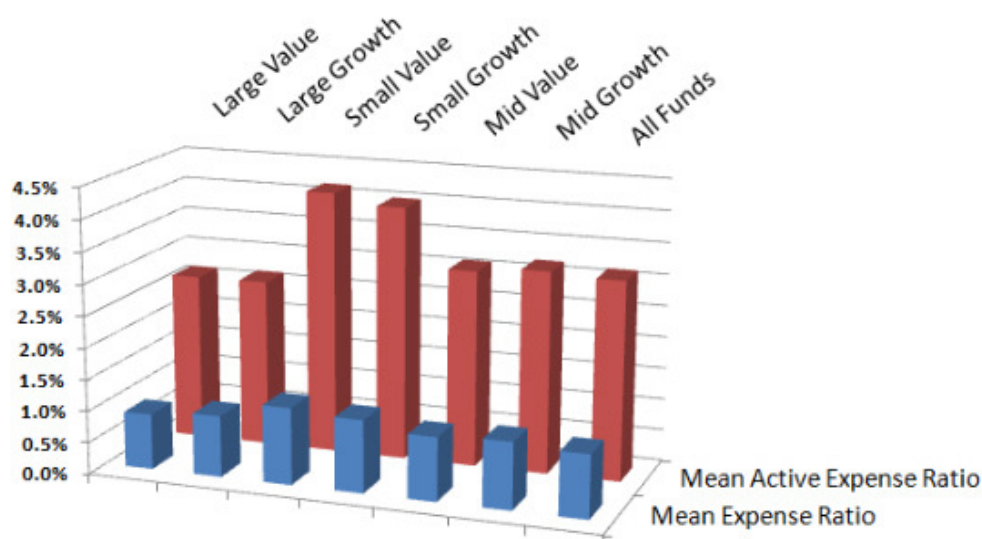
Retail mutual funds are a roughly \$10 trillion business in the United States alone. By comparison, institutional mutual funds manage only about \$1.3 trillion according to the authors.

(Most US institutions opt for separately managed mandates rather than pooled funds for their allocations.)

The authors examine fees and alpha to determine the value added by these funds. But instead of simply using the posted fees for each fund, they use the “active alpha” expense ratio measure developed by Smith’s SUNY Albany colleague Ross Miller (see [must-read paper on this topic](#)).

We have written about Miller’s metric several times. Essentially, it measures the fee paid per unit of active management – ostensibly what an investor is actually paying for (vs. the passive component of returns).

When applied to institutional mutual funds, this technique yields similar findings to those of retail mutual funds – fees per unit of active management are multiples higher than posted fees. We created the chart below from Exhibit 2 in the article to show you what we mean:



As expected, the high correlation between most institutional mutual funds and equity markets means that the fee attributable to active management is actually many times higher than the listed rate. This is about the same as a hedge fund with a 1.5% management fee and a 20% performance fee in a year when the total fund return is 10%. Only the hedge fund fee would drop to 1.5% if the return was 0% while the fee for the mutual fund, of course, remains at the same level.

In any event, the authors also find that larger funds outperform smaller ones – and not just because they enjoy economies of scale. Instead, they suggest that larger funds have more institutional investor oversight. Smaller institutional funds, by contrast are “*offered primarily to trust accounts and through for-fee financial advisors.*”

Finally, and somewhat counter-intuitively, Baker, Haslem and Smith find that large cash balances are associated with higher returns among institutional mutual funds. The causation remains in question, however, as they propose two hypotheses for this: 1) higher cash balances reduce trading friction surrounding asset inflows and outflows, or 2) better returns leads to more inflows and more uninvested cash.

Unfortunately, the bottom line is that institutional mutual funds as a group, fall victim to the same problems as retail mutual funds. As the authors conclude:

“Consistent with previous studies involving actively managed retail equity mutual funds, we find strong evidence that the average actively managed institutional equity mutual fund cannot beat a representative benchmark after expenses.”