

Who Chases Returns? – Retail vs. Institutional Investor Behavior

By David Adler

Retail investing differs from institutional along many dimensions including portfolio construction and access to asset classes. Determinants of investment flows to managers *within* an asset class, such as to domestic equity funds, can illuminate key differences between the two types of investors.

Returns-chasing behavior, as the main driver of investment flows, is one central difference between the two types of investors. Retail investors typically are perceived as naïve return chasers, rushing after last year's—or month's—hot fund. Institutional investors, on the other hand, are by definition more sophisticated and hence are believed to be less easily swayed by simple returns.

Though these stereotypes may hold some truths, a fuller analysis of retail versus institutional investing reveals a more-complex and nuanced picture. Returns chasing is characteristic of both groups, but to varying degrees: It turns out one main distinction between institutional and retail investing is not merely the role of returns in driving inflows, it is the role of returns in *outflows*. The results also highlight the opportunities or even need for advisors/consultants to each group to improve their clients' investment behaviors.

Inflows

Flows can tell us, by revealed preferences, what is important to both types of investors and can indicate some of the criteria each group is using to make investment decisions. One thing that is clear from many studies is that retail investors chase performance. “That is a fact. It's been documented over and over. It's no longer really a question,” says Diane Del Guercio of the University of Oregon. Del Guercio is one of the few academic researchers who study determinants of investment flows. She has found when calculating performance that retail investors do not appear to factor in appropriate benchmarking and risk adjustments. “Raw performance is virtually everything,” she says. Moreover, retail investors are evaluating returns using shorter and shorter time frames with monthly (as opposed to just annual) performance becoming important.

Are inflows from institutional investors so naïvely determined? “It's not true that institutions don't chase returns,” says Barton Waring, chief investment officer, emeritus, of Barclay's Global Investors. “Hence the interest in hedge funds. What is true is that institutions begin with a good policy statement and individuals rarely do.”

This policy statement could limit inflows to or even force outflows from superbly performing managers or asset classes. Louis Finney, a senior consultant at Mercer in Chicago points out that many institutional investors follow a disciplined rebalancing policy. “If an asset class goes down, they will allocate more so the investment gets back in line—they may appear to be reverse return chasers.”

In terms of hiring a manager within an asset class, institutional investors do consider performance. The relationship, however, is complex. In their Federal Reserve Bank Atlanta

working paper, “The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds versus Pension Funds,” Paula Tkac of the Atlanta Fed. and Diane Del Guercio quantify these relationships. They find that for institutional managers, beating a benchmark is key. But excess returns beyond the benchmark don’t seem to drive additional flows unlike in the retail world where the magnitude of the excess return is determinative. Additionally, institutional investors use risk-adjusted performance measures rather than raw returns. Compared to retail investing, they find “the relationship between performance and flow is much noisier in the pension segment.”

Tkac explains that for institutional investors, performance appears to act primarily as a filter to see if the manager makes a short list for further consideration. Beyond this screen, she says many of the determinants of institutional investment flow can’t be quantified. Once the manager has made the quantitative cut based on past performance, qualitative characteristics drive the final manager hiring decision and hence further inflows.

Outflows

For retail investors the redemption or outflow picture is more complicated than the returns-chasing behavior found in inflows. Retail investors tend not to redeem out of underperforming funds. For them, returns-chasing behavior is a one-way street. Says Jason Karceski, associate professor of finance, University of Florida, “Retail investors tend to let their underperforming investments sit.”

These funds are underperforming relative to other funds or a benchmark, rather than to purchase prices. Hence inertia rather than the behavioral “disposition effect” (where investors sell winners but hold on to losers) is at work here, since investors perceive the funds as still being up. But they aren’t up enough to attract new flows, which go to higher-performing funds.

Empirically this creates “a kinked curve tracking the relationship between flow and performance,” says Karceski. When performance goes up inflows go up. But when performance goes down, new flows go down but redemptions don’t necessarily change, flattening out the curve.

In contrast, institutional investors don’t share the same hesitancy to redeem. Says Karceski, “On the institutional side, money flows in and out more smoothly.” Underperforming managers are punished. So are managers with high tracking error or those who deviate from their original investment policy. In essence, plan sponsors don’t exhibit the same inertia as retail investors and if anything are hyper-vigilant when it comes to underperformance. Therefore, says Karceski, “If the relationship between flows and performance for retail investors is convex, for institutional investors it is a straight line.”

Does this Matter?—What’s an Advisor To Do?

Returns-chasing behavior is not necessarily an irrational or imprudent strategy if the trends persist. Assets could end up being transferred to superior managers who are able to continue to beat the benchmark. Whether domestic equity managers, either institutional or retail, are able to persist in generating excess returns is an extremely contentious topic. The longer the time period, the more elusive is the evidence of persistence of excess return by managers. The academic

literature on this debate is vast. Stepping aside from this complex argument, how does returns chasing play out in practice?

In general, it is safe to say most retail brokers and planners view returns chasing as an irrational bias. They also claim to be immune from it. In a 2004 ICI survey, 82 percent of brokers agreed with the statement “I am not concerned about short-term fluctuations in my mutual fund investments.” However, their actual investment behavior reveals a different story: An analysis by Daniel Bergstresser of Harvard Business School and several colleagues found that “fund flows in the broker sold segment do not show any less return chasing than those in the direct sold segment.” Inflows for these broker-managed accounts appear to be strongly correlated with lagged performance.

Returns chasing, by both retail clients *and* advisors, is well documented and well researched, and yet also is acknowledged to be very dangerous. “It really begs the question, of why people do it?” says Harold Evensky, often credited as one of the fathers of retail financial planning. He points to overconfidence rather than naïveté among advisors as the driver here. Practitioners are aware of concepts of market efficiency and perhaps elusiveness of persistence among retail managers. But the advisors and their clients are misled by overconfidence: They believe past performance indicates they have found a manager who can beat the system. Or as Evensky less generously puts it, “A fool and their money are easily parted.”

Evensky says there are a few simple tools practitioners can use to protect themselves and their clients from this heuristic. Appropriate framing is central. Instead of just listening to a manager’s story, he urges that the results be compared to an appropriate benchmark. This could reduce reliance on raw returns, and possibly overcome the inertia commonly found in retail redemptions. Counsels Evensky, “Use a benchmark, compare results to an ETF, there is no reason not to because it is relatively easy for practitioners to do so today.”

Institutional investors already are using sophisticated benchmarks to evaluate performance. So in practice, does performance chasing (in its complex institutional form) pay off for institutional investors?

In their *Journal of Finance* paper, “The Selection and Termination of Investment Management Firms by Plan Sponsors,” Amit Goyal of Emory and Sunil Wahal of Arizona State examine this issue in detail. They write: “Plan sponsors hire investment managers after large positive returns three years prior to hiring. However, this returns chasing behavior does not deliver positive excess returns thereafter...and on average are indistinguishable from zero.”

Actually their larger conclusions are darker than this. Not only do hired managers tend to drop off in performance, some fired managers bounce back and begin to exhibit positive returns after being terminated. There is considerable variation across managers. With newly hired managers slipping down to the benchmark, and newly fired managers often outperforming, they conclude, “If pension funds had stayed with managers they fired, they would have had larger excess returns than from the managers they hired.”

Though institutional investors don't naïvely extrapolate returns the way retail investors do, they still seem to hire—and also fire—managers at exactly the wrong point in time. Goyal cautions that these results shouldn't be over interpreted to mean decisions by pension funds are necessarily irrational. Performance among institutional managers could be a useful screening tool. More importantly, hiring and firing could be a useful disciplinary tool as well, spurring fired managers to improve their actions. “At the end of the day there does seem to be some kind of sub-optimality but we don't want to claim these are irrational decisions,” says Goyal. His own conclusion is that pension funds are too quick to hire and fire, are “trigger happy.” He argues they may not be completely cognizant of the transactions costs and likely performance which arise from a change in managers.

The one exception to Goyal and Wahal's findings about hiring are for decisions aided by consultants. “Consultants add value,” says Goyal, primarily for small plan sponsors. Consultant supporting hiring decisions led to a three-year post-hiring return ranging from 1.5 percent to 2.7 percent depending on the specifications. Consultants he has spoken to believe that returns chasing by plan sponsors lies at the heart of their frequently poor hiring decisions.

Goyal's suggestion for institutional investors is that they factor in the costs as well as the benefits associated with hiring and firing. Says Goyal, “It's my feeling they haven't been doing enough cost-benefit analysis. They may be confident (based on past returns or other factors) that the new guy is going to do a much better job. But they should make sure the excess returns are enough to overcome transaction costs.” He estimates these costs could reach as high as 2 percent to 3 percent of a transaction.

Goyal and Wahal conclude that for both retail and institutional investors, “It is clear that over-reliance on performance isn't a good thing.” Perhaps someday, both institutional and retail investors—and their advisors—will move from being performance chasers to become cost-benefit chasers.

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