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International Fund Managers' Viewpoints, Perception and Investment Behavior: Empirical Evidence

Von

Torben Lütje

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To my parents

Preface

Financial assets grow faster in modern economies than real assets leading to an increase in the financial sectors' relative importance. A driving force explaining this change is the increasing division of labor in the financial realm, representing a reasonable specialization. An outcome and at the same time an engine in this process are asset managers, i.e. specialists in managing financial assets. Among asset managers, fund managers form a group of particular relevance. They manage funds mainly as mutual funds for the general public or as special funds for more particular purposes, such as pension funds. These fund managers are the issue of interest in Torben Lütje's dissertation.

His final research question asks about the degree of efficiency which fund managers show in their decision making. The author uses a questionnaire that has been especially developed for this purpose and that has been sent to numerous fund managers in Germany, Switzerland, and the United States. The design of such a questionnaire requires the conducting of a series of interviews with experts in order to identify useful formulation of questions and statements. It has to be ensured that the questionnaire will be regarded as professional and well-balanced with respect to the fund managers' interests. In the end, academics cannot provide many incentives to this well-paid and time-restricted target group and thus have to rely on their voluntary cooperation. Fortunately, the author was able to win the attention of several high ranking professionals. In particular, the German investment and asset management association BVI helped this research project by contributing a support letter. Altogether, Torben Lütje generated 453 questionnaires, providing a unique and promising database. Response rates as well as structural relations demonstrate that this is indeed a reliable and largely representative source which will help to significantly improve our understanding of fund managers' behavior.

Economists are often skeptical about the usefulness of survey data as they prefer to analyze what people do rather than what they say. However, we can often observe behavior but are ignorant about motivation or the circumstances of decision-making. In this respect, other sciences more "naturally" rely on survey evidence as a complementary source of information. I would thus like to provide examples from this dissertation as to why survey evidence can be useful:

Chapter 3 analyzes the herding behavior of fund managers. It is one of the core problems of more traditional research to distinguish between herding due to common information or due to following others (without having the same set of information). A survey can circumvent this identification problem by directly asking fund managers about their views. It is, indeed, found that herding in the sense of rationally following others without sharing their information is a widespread behavior. This behavior – or more precisely: those fund managers showing this behavior – can then be analyzed in more detail to learn about possible motivation and consequences of herding.

Chapter 5 addresses bonus payments in this industry and asks whether they shape behavior and if so, whether this may be rather good or bad for market efficiency. A core problem being related to research on explicit incentives is data shortage. An anonymous survey can overcome this bottleneck and thus allows us to learn about the determinants of bonus payments and also about their possible impact.

Chapter 6, finally, examines the home bias puzzle from a new angle. Earlier research investigates the international allocation of portfolios which may be influenced by factors such as transactions costs, legal restrictions, and preferences of customers or investment advisors: in short, there is an identification problem. This can be solved in a survey by asking fund managers about their preferred asset allocation without being restricted by any of these factors.

The findings of this research provide new insights about fund managers: regarding the herding phenomenon it can be shown that those fund managers who tend towards this behavior reveal characteristics that will negatively affect their performance. Herding has a "bad" attribute from this point of view. High bonus payments, by contrast, are a "good thing" as they seem to create a kind of behavior that supports market efficiency, although too high bonus size may require careful limitation of risk taking allowed. The evidence on home bias is mixed: the good news is that fund managers show much less home bias than ordinary investors, which clearly demonstrates their professionalism. The downside is that those fund managers who prefer home assets are most probably not motivated by any rational consideration. On the contrary, home bias of fund managers is an indication of professional inferiority.

Thus, the study does not only generate lessons of academic interest but also provides material that can help fund managers to improve their behavior and thus in the last instance their performance. I would therefore wish this research the attention it deserves in both quarters: academic as well as fund management business.

Hannover, December 2004 Prof. Dr. *Lukas Menkhoff*

Acknowledgments

This dissertation has been written during my stay at the University of Hannover as research and teaching assistant at the Chair for Money and International Finance from October 2002 to October 2004. I would like to emphasize that I am deeply grateful to my supervisor Prof. Dr. Lukas Menkhoff. He encouraged my research intentions very much and gave me professional as well as personal advice at any time.

I also would like to thank Prof. Thomas P. Gehrig, Ph.D. (University of Freiburg and CEPR London) for the second review of my dissertation and all his helpful comments. Moreover, I appreciate Prof. Dr. Michael Melvin's (Arizona State University) support very much, who gave me the opportunity to prepare the joint survey of the US-American fund management industry at his university.

In addition, I would like to thank all the fund management professionals who participated in the survey and who were available as interview partners, respectively. Without their contribution it would have never been possible to generate such a large data sample, which has been proven as representative for the fund management industries in the United States, Germany, and Switzerland.

Furthermore, I would like to thank all my colleagues at the University of Hannover, Chair for Money and International Finance. They provided a familiar working atmosphere and contributed with productive discussions to the success of my research project.

The financial support of the survey in Germany by the "Wissenschaftsförderung der Sparkassen-Finanzgruppe e.V." as well as the financing of the surveys conducted abroad by the "VolkswagenStiftung" are gratefully acknowledged.

Last but not least, I am indebted to my parents who always supported my doctorate, allowed great latitude and kept me grounded. This dissertation is dedicated to them.

Hannover, December 2004 *Torben Lütje*

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1. Introduction

1.1 Motivation and contribution of this dissertation

International asset managers have become major players in global capital markets and possess not only strong influence on asset pricing, but also on economic development. The importance of professional asset managers will consistently increase as they gain further market share in financial markets, and the latter grow faster than commercial markets. The value of worldwide assets under management in (mutual) investment funds has reached €11.05 trillion by the end of 2003 (see FEFSI, 2003). Due to comparative advantages to private investors, particularly regarding portfolio size and availability of information, asset managers are an engine of financial globalization. The structural change in financial markets is only assessable if these professional market players and their investment behavior are analyzed in detail, too.

Especially in respect of their informational advantage and professional experience, it is thought-provoking to realize that asset managers often fail to "beat the market", as found in numerous different studies (e.g. Lakonishok et al., 1992, Malkiel, 1995, and Carhart, 1997). This empirical result is surprising, since asset managers are expected to be skilled and experienced market participants, and they have access to the relevant information about listed companies and financial markets. Thus, it is important to learn more about these decision makers – their personal viewpoints, perception and investment behavior.

The approach of behavioral finance provides several explanations for biased behavioral patterns of participants in financial markets that are possibly responsible for observed underperformance of professionals. A lot of research has been done on transaction data, but investors' transactions are only the final result of a stepwise investment process, being influenced by several factors. Hence, it is essential to examine this process as well. Apart from theoretical models (like e.g. De Long et al., 1990), experimental research and surveys can provide empirical evidence on investment behavior. Unfortunately, there are only few studies that directly focus on professional decision makers in asset management. For instance, Chevalier and Ellison (1999, 1999a) consider investment performance in connection with fund managers' age and education. With regard to fund managers' heterogeneity, the consideration of personal characteristics should not be limited to these two items. More detailed information about fund managers' points of view and perceptions would help to better understand their investment decisions and the related consequences. So, what are main drivers in decision making? Which behavioral biases typically exist?

This study aims to shed light on these questions. A survey is the adequate method to perform respective analyses.[1] Such an approach can provide complementary evidence to more conventional empirical research methods. The comparative advantage of a survey is its broad scope and identification of groups amongst market players as well as motivational clusters. Thus, it enables analyses of driving forces for specific investment behavior. So, we conducted questionnaire surveys with fund managers in the United States, Germany and Switzerland in 2003/04. The choice of target countries also reflects the importance of these three investment management markets and its big players worldwide: The United States and Europe clearly dominate the global market with a market share of 53.1% and 33.5%, respectively (see FEFSI, 2003). In Europe we focused on Germany and Switzerland, as they are the home markets of important global players in fund management.

Based on hypotheses from the literature, the questionnaire was designed to provide personal information about *(i)* respondents' characteristics such as gender, age, education, professional experience and position, about *(ii)* respondents' views on the fund management industry, as well as about *(iii)* their personal risk taking and investment behavior. In order to provide incentives to participate in the survey we developed a rather short questionnaire and offered to provide the research results when completed.

The quality and significance of the answers given does not only critically depend on a suitable selection of questions, but also on their correct formulation. Thus, we discussed draft versions of the questionnaire with professional fund managers in numerous personal interview meetings in each country in order to avoid misinterpretations. In detail, we interviewed a lot of fund managers in New York, Boston and San Francisco in the United States; in Frankfurt, Hamburg and Hanover in Germany; as well as in Zurich in Switzerland. The interviews could contribute to specify the hypotheses from the literature and to assess their applicability for a written survey. The latter could finally be confirmed in conducted pretests.

During the period of April to August 2003 the fund management companies in Germany and Switzerland were repeatedly contacted. The German investment and asset management association 'BVI' supported our research with a letter of recommendation to all its member firms. Thereafter, from September

[1] Prominent work includes Shiller (1989), Shafir, Diamond and Tversky (1997), Blinder (2000) as well as Howitt's (2002) survey on labor market research.

2003 to February 2004, we collected questionnaires from fund managers in the United States.[2] In total, our survey provides a comparatively large data set of 453 responses from professional fund managers[3] – comprising 148 questionnaires from the United States, 263 from Germany and 42 responses from Switzerland.

We were able to persuade fund managers to act as multipliers by forwarding the questionnaire to their colleagues and ask for participation. Hence, we cannot report a response rate concerning the number of sent out questionnaires. We rather would like to emphasize the high participation rate of 37.8% of investment companies.[4] In detail, we sent our questionnaires to the top 250 US firms ranked by worldwide assets under management and we received response from fund managers of 74 different firms (participation rate of US firms: 29.6%). In Germany we sent questionnaires to 66 member firms of the 'BVI' with major investment segments in equities and bonds, respectively, and fund managers of 51 different companies participated in the survey (participation rate of German firms: 77.3%). The high participation rate of German companies is also attributable to the letter of recommendation by the 'BVI'. In Switzerland 18 of 62 active member firms of the 'Swiss Funds Association' with major investment segments in equities and bonds, respectively participated (participation rate of Swiss firms: 29.0%). Strategic answers are not expected due to guaranteed anonymity of participants. The sample is representative for the investment industries in these markets and provides a lot of interesting findings.

1.2 Outline

The remainder of this dissertation proceeds as follows: Section 2 starts with a review of the questionnaire survey conducted with 263 fund managers in Germany. This section is structured according to the major items of the investment process – influence of incentives, use of information and decision making. It is found that professional market players perceive distinctive herding

[2] We would like to thank Michael Melvin from the Arizona State University for his kind cooperation regarding data collection in the United States.

[3] For example, Baker (1998) conducted an interview study with 64 fund managers in the United Kingdom, the survey of institutional investors by Shiller and Pound (1989) is based on a sample of 71 responses. Recent questionnaire survey studies of the German fund management, by Brozynski et al. (2004) and Arnswald (2001) comprise 117 and 275 (via the authority of the Deutsche Bundesbank), respectively.

[4] This is a good result compared to the response rates in e.g. Shiller and Pound (1989) and Bodnar et al. (1996) of 45% and 18%, respectively.