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ASSET MANAGEMENT

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How 'Greedy' Asset-Gathering Undermines Performance

New research shows how rising assets pump up fee income but reduce alpha and investor performance.

By Staff

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For active managers, rising assets under management means more income from management fees and higher profits. For investors, it can mean underperformance.

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Research published by Duke University offers new evidence on how increasing fund size can be detrimental to returns.

According to "Does Scale Impact Skill?" by Campbell Harvey, from Duke's Fuqua School of Business, and Yan Liu of Texas A&M University's finance department, alpha diminishes significantly as individual funds grow and as industry assets under management rise.

This weakening in performance occurs as managers "get greedy and take more assets than they can handle," the authors write.

Although the belief that the asset-management business suffers from decreasing returns to scale is not new, Harvey and Liu provide new empirical evidence in support of the theory, using fund data from The Center for Research in Security Prices, focusing on active, domestic equity funds operating between 1991 and 2011.

For an average fund that doubled its size relative to the industry over the course of a year, alpha fell by 20 basis points annually. Excess returns also decreased by five basis points for the average fund with each 1 percent increase in overall industry size per month.

Still, the two researchers found that investors are skilled at identifying funds suffering least from decreasing returns to scale, a fact reflected by fund flows.

"Funds with the best performance attract a disproportionate amount of capital only if they display a low sensitivity to decreasing returns to scale," Harvey and Liu write.

However, the mere fact of investors allocating the most to those particular funds — raising their assets under management—caused them to perform worse in the future than funds with a high degree of decreasing returns to scale.

"Decreasing returns to scale should be of first-order importance in the decision to allocate to a particular fund," the authors conclude. "Investors must be aware of the degree of decreasing returns to scale to allocate their capital efficiently."