

# Behavioral Biases of Institutional Investors Under Pressure from Customers: Japan and Germany vs. the U.S.

by

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## MAIN POINTS

Behavioral biases in fund management using **survey methodology**

Conclusions point to

- Investment myopia
- Herding
- Greater risk aversion

among Japanese and German fund managers, but ***not*** among U.S. fund managers

# REPORT LAYOUT

The conclusions are certainly consistent with the responses from the survey of fund managers – however, I believe the paper can be strengthened by controlling for other factors that can affect a fund's investment style. I discuss these under **specific comments**.

I start first with a set of **general comments** concerning the methodology employed in the study.

I end my discussion with a list of suggested additions to the papers that in my opinion will improve the study.

## GENERAL COMMENTS: SURVEY METHODOLOGY

Refreshing methodology – sometimes just asking managers what they do can tell us a lot about their actual behavior.

That unfortunately is also a criticism of the survey methodology, particularly in situations where responses to sensitive issues are elicited – without being a lawyer, I can imagine the potential for lawsuits if U.S. fund managers admit to churning portfolios, or to their own lack of skill in managing delegated assets.

In this study, if I make the assumption that Japanese fund managers are on average **more conservative in their responses**, the adverse conclusions about their self-admitted myopic investment strategies and lack of confidence compared to American fund managers become difficult to defend.

# SURVEY METHODOLOGY

Overall, to mitigate these concerns, I would like to see the survey methodology described in greater detail, in particular describe the steps taken to

- ensure anonymity of respondents
- analyze clustering of responses
- triangulate responses to similar questions framed differently

## SURVEY METHODOLOGY

E.g., responses to questions on herding suggest that Japanese fund managers would be the most ardent indexers, followed by the Germans. However, when asked about indexing skill, fund managers in all three countries provide remarkably similar responses – if anything, the Japanese fund managers responses display the *lowest* level of indexing skill !

Furthermore, while the U.S. response shows a higher skill level of indexing, the actual practice of indexing elicits a lower response from U.S. fund managers. While this result is at odds with the response on indexing skill, it is consistent with *greater confidence* among U.S. fund managers.

## SPECIFIC COMMENTS: SHORT TERM OUTLOOK

Survey responses clearly show a shorter investment forecasting horizon used by Japanese fund managers vis-à-vis their German or U.S. counterparts. The authors argue that is due to pressure from customers to produce high returns in the short-run. Two issues need to be addressed here:

1. What is the validity of the presumption that Japanese investors are less patient than German or U.S. investors? It seems almost counter to conventional wisdom where Japanese corporate practices are seen to foster long-term investments.

## SPECIFIC COMMENTS: SHORT TERM OUTLOOK

2. What implication does this have for longer-term performance? In rational markets, cumulating short-run performance ought to *exactly* equal long-run performance.

Perhaps Japanese investors are more prone to behavioral effects such as the disposition effect. This should manifest itself in time series properties of equity returns (e.g. more positive auto-correlations at shorter intervals). What is the evidence on the comparative time series properties of Japanese, German, and U.S. equity returns?



## SPECIFIC COMMENTS: HERDING

Herding can be perfectly rational where firm-specific information is not sufficiently precise. My suggestion would be to do the following:

1. First, establish the actual level herding by comparing clustering in cross-sectional fund returns for J/G/US. This would be a very interesting result if confirmed. I suspect it is tied to **incentive compensation** for fund managers in J/G/US.
2. Information environment for equities: although I haven't seen a direct comparison of the quality of firm-specific information in J/G/US, a study of stock price response to dividend changes by Dewenter and Warther (1998 JF) suggests that Japanese shareholders may in fact have better information than their more arm's length U.S. counterparts.

## SPECIFIC COMMENTS: RISK AVERSION

The survey questions tend to show that Japanese fund managers are very risk averse ---

- Is this related to compensation systems in the three countries?
- E.g., asymmetric performance based systems that reward positive performance but do not penalize negative performance to the same degree are a sure recipe for creating portfolios long on volatility.

A brief description of how fund managers are compensated in J/G/US would be very helpful to the reader.

## TO DO LIST – Analysis by Fund Type

Pension funds tend to have long duration liabilities, so their asset mix ought to reflect this. In Canada, until the 1990s, pension assets were largely in fixed income. The move towards equity has come at a price – their very size that gives them clout also makes it difficult for them to express displeasure by voting with their feet.

So generally speaking pension funds tend to do a lot of letter writing – moral suasion if you will. They tend to be very patient – see Wahal (JFQA 1996) and Carleton, Nelson and Weisbach (JF 1998) on the type of proposals brought forth by pension funds in the U.S. The general message here is that pension funds work behind the scenes on long-term governance related issues, and are not obsessed with short-term performance.

## TO DO LIST – Analysis by Fund Type

Proposal: Repeat analysis, specially tests based on forecasting horizon responses, by type of fund. Is there greater similarity in fund management styles after controlling for fund type?

The authors note that client heterogeneity maybe based on distance – I submit that heterogeneity based on client type is equally, if not more, important in forcing a particular investment style on fund managers. Differences across J/G/US that can be explained by differences in client type are not the focus of this paper.

## TO DO LIST – Analysis by Gender

About 10% or more of the respondents in Germany and the U.S. are female – is there a distinct behavioral pattern here? Do women fund managers eschew active management and (wisely!) pursue indexing?

How about brash young managers vs. seasoned old ... ?

Incidentally, there appear to be missing rows in Table 3 panel dealing with professional experience – please check and fill in.

## CONCLUDING REMARKS

Two important contributions of the study:

One, direct solicitation of trading behavior from fund managers. What they say may not line up 100% with what they do, but it is revealing nonetheless. Given the distinct fund types in the survey, the paper can separate the intended management styles for different fund types. Remaining differences are then more likely to reflect culture etc.

Two, the wealth of descriptive statistics on changes in governance practices in J/G/US over the last decade made the paper both fun and informative to read.