Asset Management: Overview

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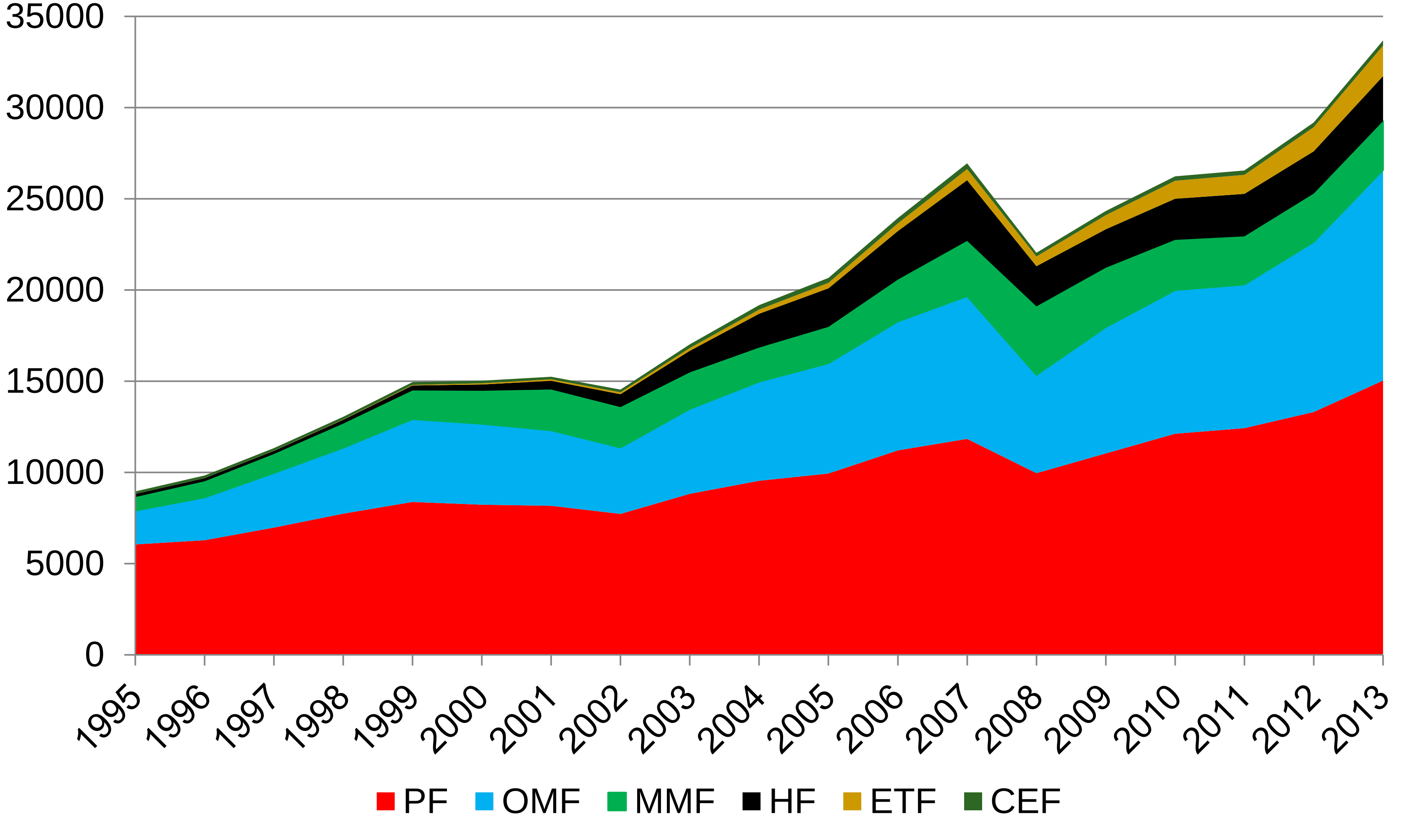
Global Asset Management

EXHIBIT 1 | Global Assets Under Management Grew to a Record $68.7 Trillion in 2013

Source: BCG Global Asset Management Market Sizing Database, 2014.
Note: Sizing corresponds to assets under management (AuM) sourced from each region and professionally managed in exchange for a fee. AuM includes captive AuM of insurance groups or pension funds if those assets are delegated to asset management entities with fees paid. Forty-three markets were covered globally, including offshore AuM. North America = Canada and the United States; Europe = Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey, and the United Kingdom; Asia = China, Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand; Middle East and Africa = selected sovereign-wealth funds of the region, Morocco, and South Africa; Latin America = Argentina, Brazil, Chile, Colombia, and Mexico. For all countries whose currency is not the U.S. dollar, we applied the average 2013 exchange rate to all years. AuM numbers differ from those in last year's report mainly as a result of differences in the exchange rates and also because of revisions in country data. Any apparent discrepancies in growth rates are due to rounding.

Asset Management Trends in the U.S.



Source: Federal Reserve; ICI

Asset Management: Major Themes

- Asset Managers as Investors
  - Value of active management
  - Risk-taking incentives
  - Implications for asset prices
- Asset Managers as Monitors
  - Corporate activism
  - Disclosure
- Asset Managers as Advisers

Theme I

Investment Value

The Value of Active Management

- Do asset managers add value?
  - Relevant for household finance and market efficiency
  - Vast evidence that active managers (mutual funds and hedge funds) cannot beat passive benchmarks (gross/net of expenses)
  - Evidence taken as a voice against active management

Active Fund Performance

	Median returns ending 10/31/2014		
	1 Year	3 Years	5 Years
Large Cap Equity Funds	14.34%	18.12%	15.04%
CS Hedge Fund Index	6.02%	6.55%	6.36%
S&P 500 Index	19.55%	22.82%	15.60%

Asset Manager Selection

Dave Klug for Barron's

In Search for Skill

- Asset managers differ in their skills: Average does not mean all (cross-sectional studies)
- Measurement problems
  - Existing performance measures may be noisy
  - Benchmark specification
- Focus on more powerful techniques to detect skillful managers
  - Holdings-based measures
  - Information-targeted measures

Optimist's View

- A subset of managers consistently outperform by:
  - Following star funds (Cohen et al. 2005)
  - Taking bold bets (Kacperczyk et al. 2005, Cremers & Petajisto, 2009; Zheng et al., 2014)
  - Relying less on public info (Kacperczyk & Seru, 2007)
  - Choosing star companies (Polk et al., 2014)
  - Switching across different shocks (Kacperczyk et al., 2014)
- Fund performance interacts with fund/industry size
  - Berk & Green (2004); Chen et al. (2004); Pástor et al. (2012, 2014); Berk & van Binsbergen (2014)

Risk-Taking Incentives

- The role of contracting environment
  - Convex (option-like) contracts induce risk taking
  - Chevalier & Ellison (1997): mutual funds
  - Panageas & Westerfield (2009); Drechsler (2014): hedge funds
  - Kacperczyk & Schnabl (2013): money funds
- The role of macroeconomic environment
  - Monetary policy affects risk taking (similar to banking)
  - Chodorov-Reich (2014): pension funds
  - Di Maggio & Kacperczyk (2014): money funds

Risk-Taking Incentives

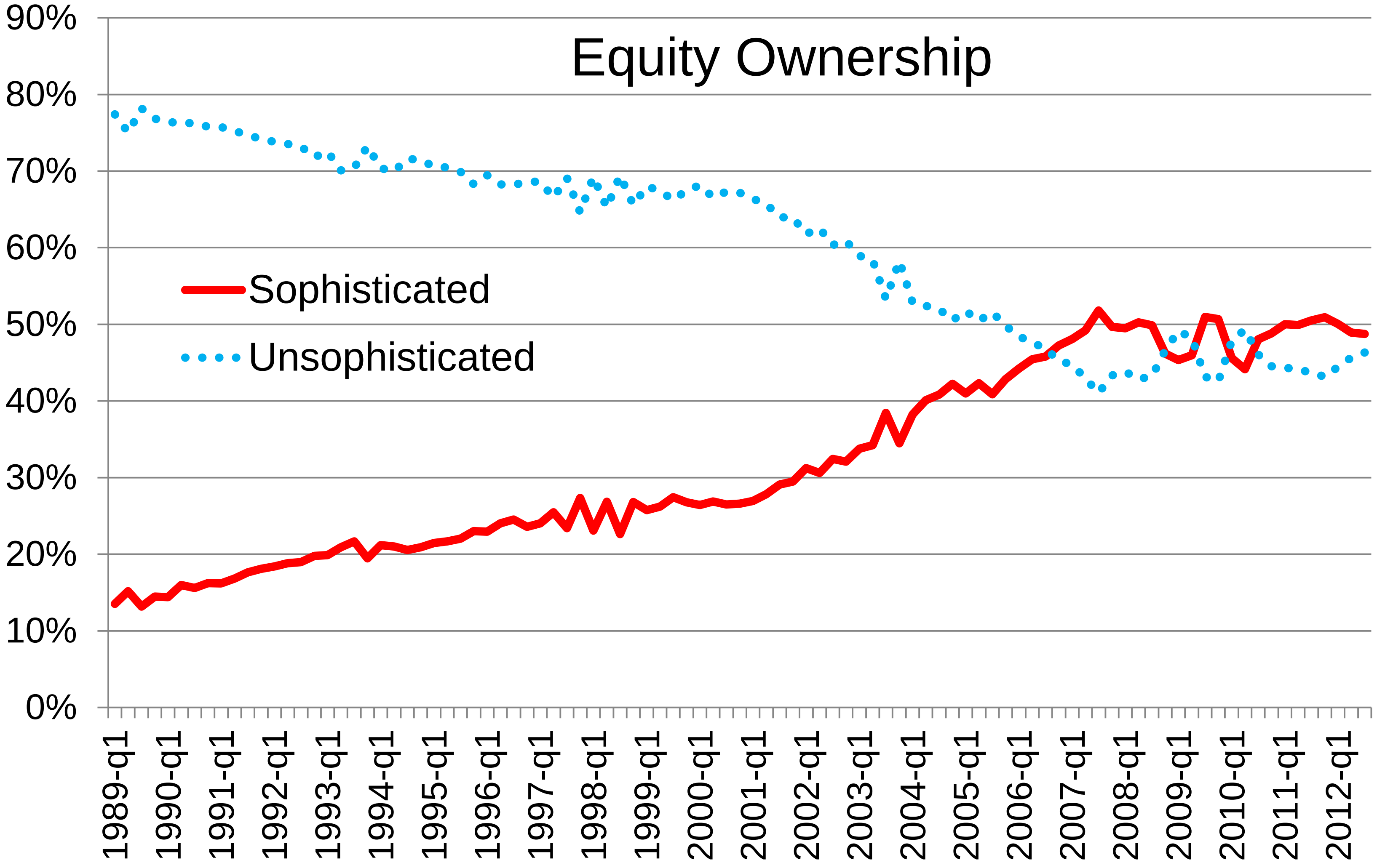
- The role of career concerns
  - Termination risk moderates risk taking (Chevalier & Ellison, 1999; Dangl et al, 2008)

- Relative performance evaluation
  - Benchmarking induces tournament-like behavior (Brown et al., 1996; Kempf & Ruenzi, 2008)

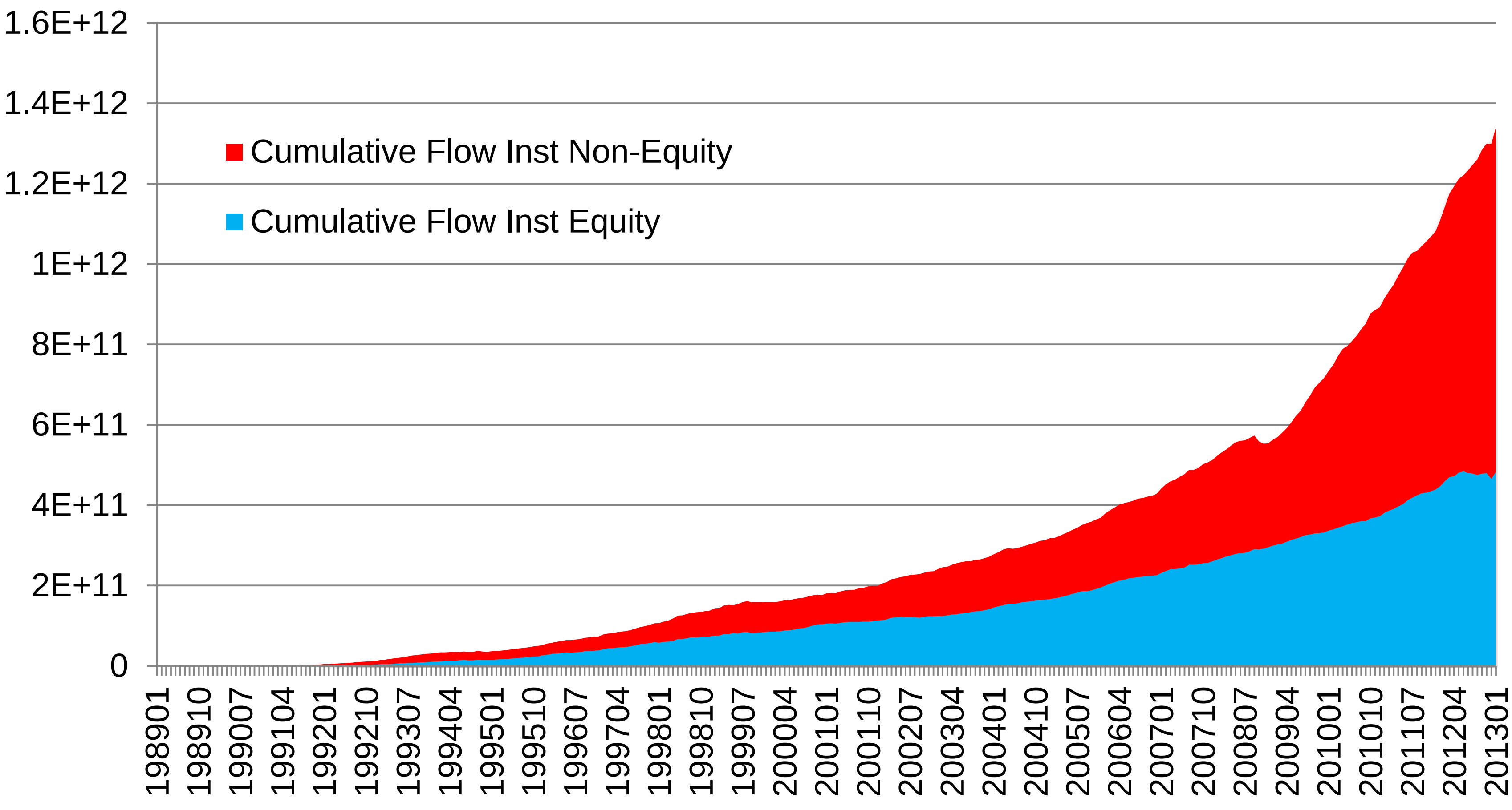
Implications for Asset Prices

- Asset managers as information producers
  - Grossman-Stiglitz (1980) predictions on asset prices with costly information acquisition
  - Kacperczyk et al. (2014a,b) implications of limited attention for asset prices
  - Stambaugh (2014) the role of institutional ownership for asset prices
  - Berk & van Binsbergen (2014): inferring investor preferences for asset pricing tests

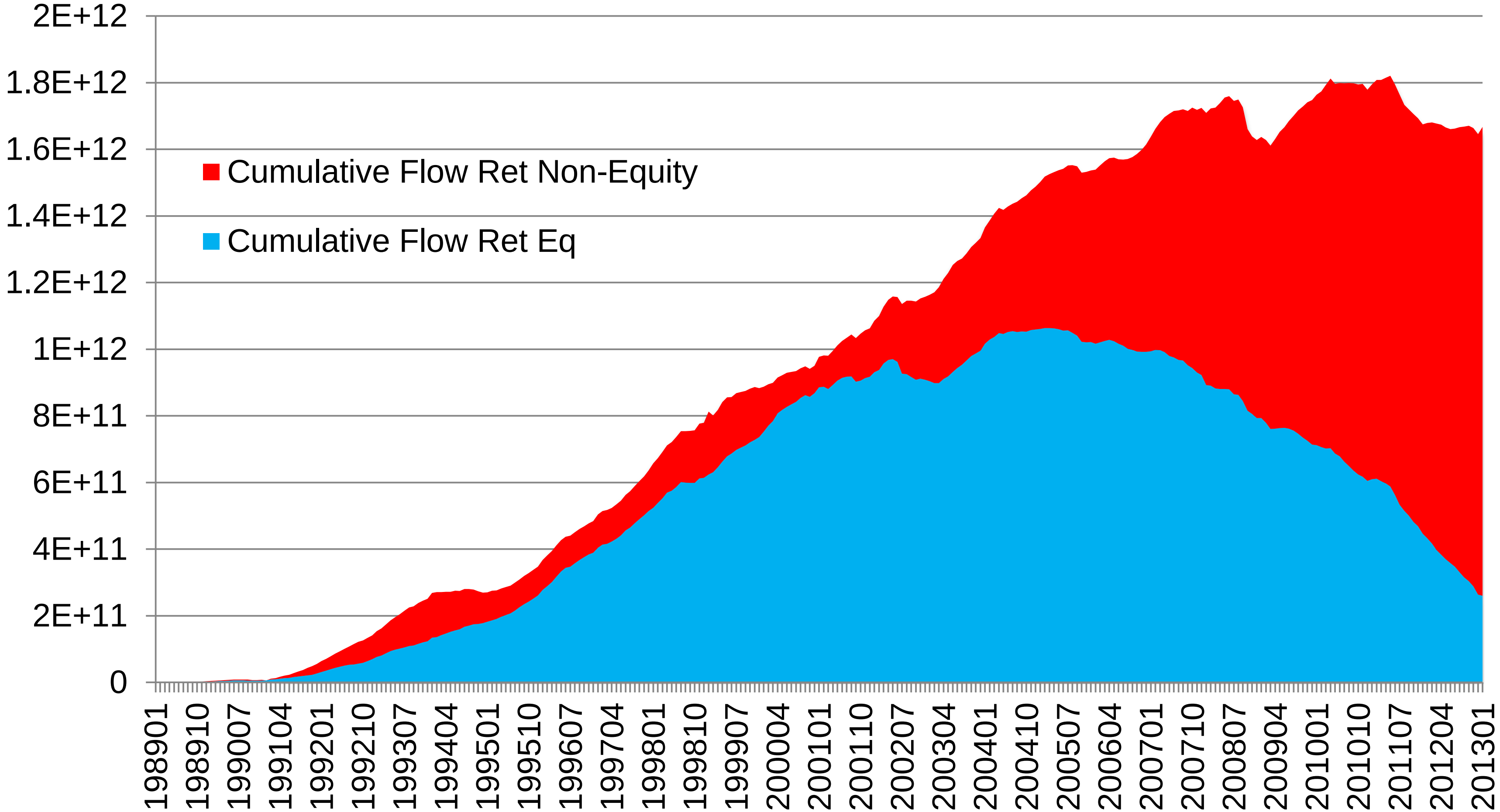
The Rise in Sophisticated Ownership



Mutual Fund Institutional Flows



Mutual Fund Retail Flows



Implications for Asset Prices

- The role of institutional constraints
  - Allen & Gorton (1993): agency conflict between managers and investors leads to price bubbles
  - Basak & Pavlova (2013): the role of benchmarking for higher asset prices volatilities
  - Guerrieri & Kondor (2012): the role of career concerns for bond price volatility
  - Kaniel & Kondor (2013): effect of delegation on market Sharpe ratios
  - Vayanos & Wooley (2013): the role of delegated portfolio management for momentum and reversals

Theme II

Monitoring Value

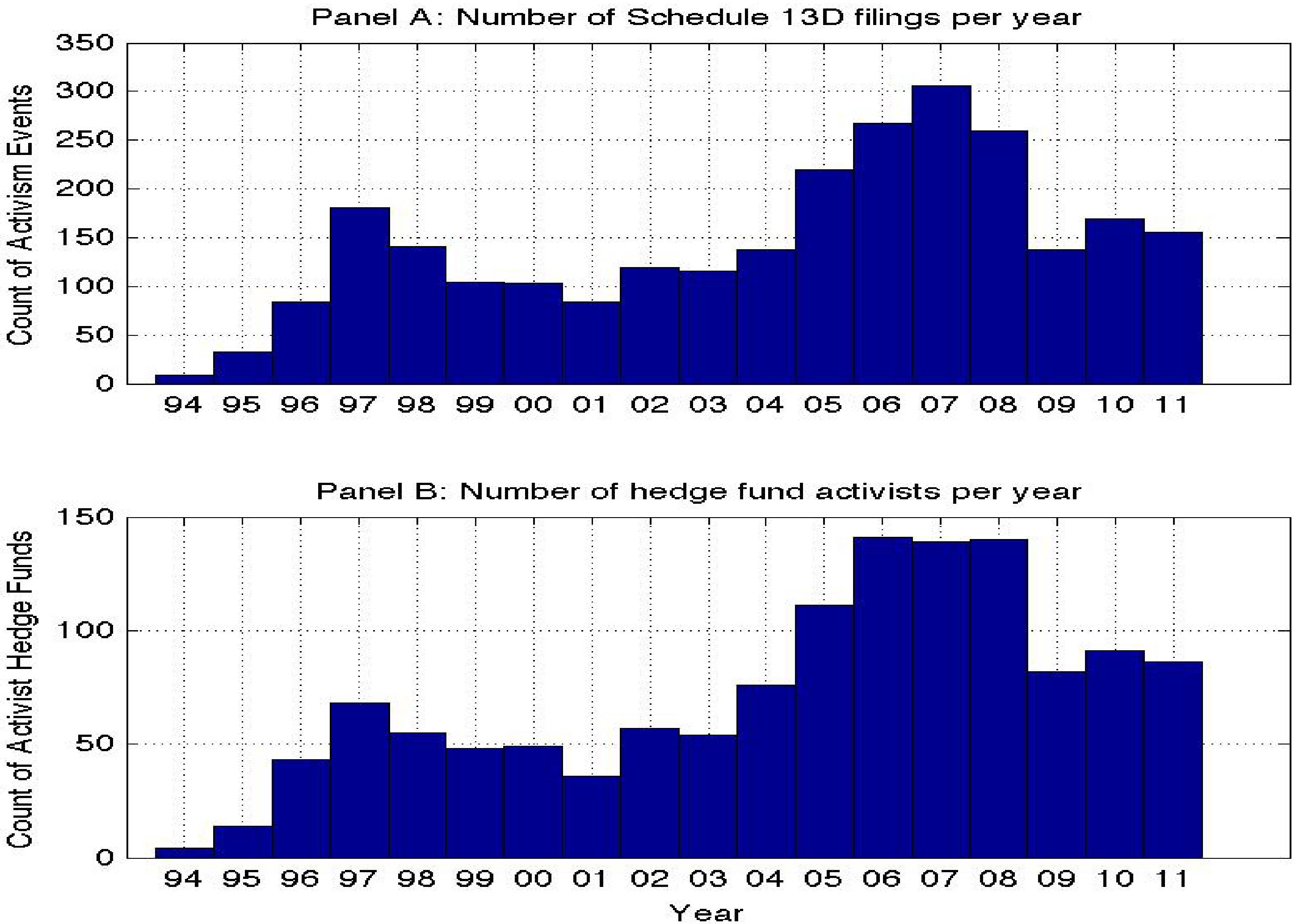
Monitoring Role

- Asset managers influence corporate decisions (corporate governance channels)
  - Agency conflicts + separation of ownership and control (Shleifer & Vishny, 1986)
  - The role of large shareholder:
    - Free-rider problem (Grossman & Hart, 1980) for dispersed owners
    - Liquidity issues for large shareholder (Holmstrom & Tirole, 1993)

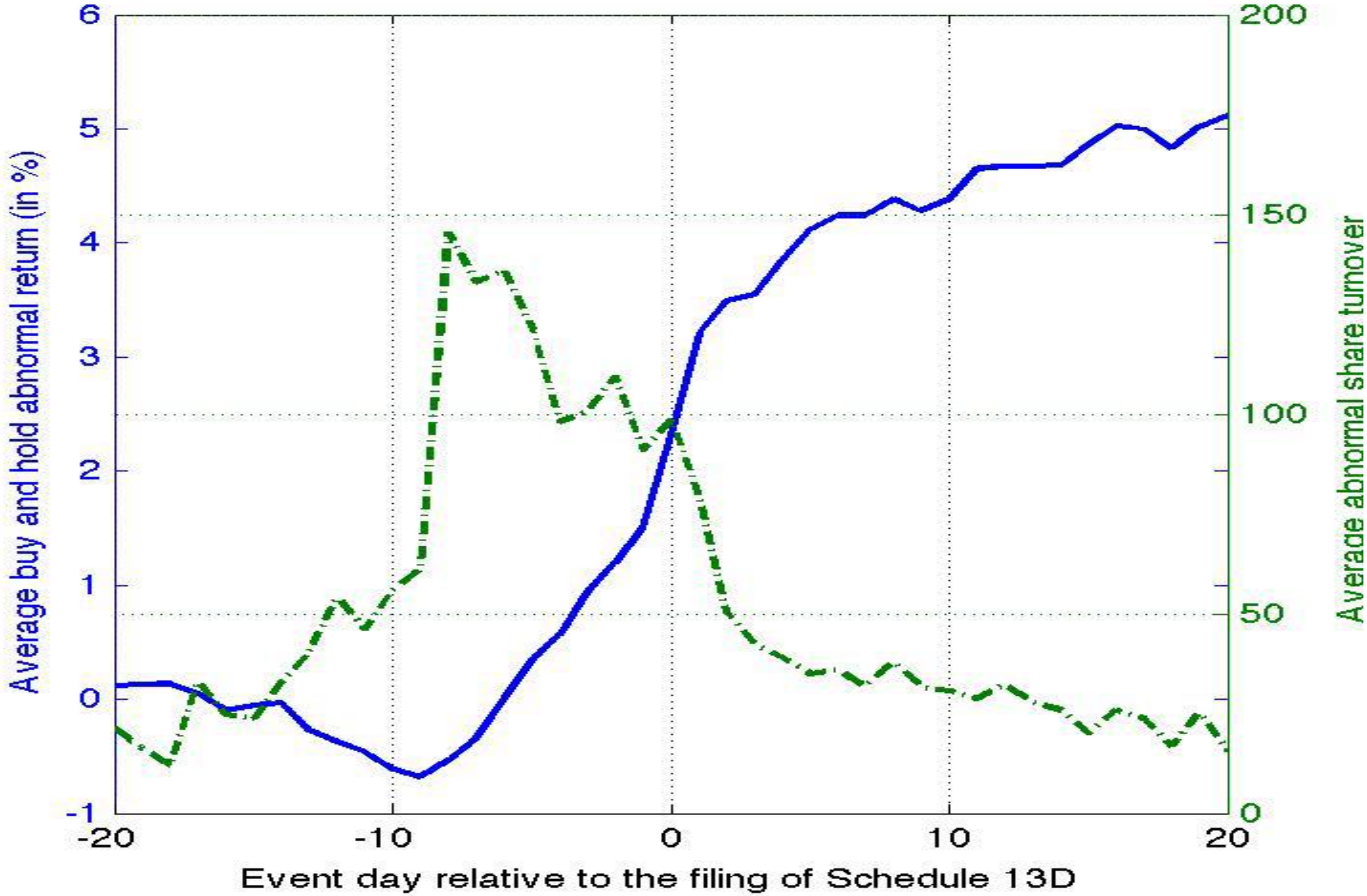
Monitoring Role: Disciplining Forces

- Passive monitoring (Exit)
  - "Voting with your feet" (Admati & Pfleiderer, 2009; Sias et al., 2001; Parrino et al., 2003)
- Active monitoring (Voice)
  - Proxy voting (Gillan & Starks, 1998)
- Corporate activism
  - Mutual fund activism (Black, 1998): little effect
  - Hedge fund activism (Brav et al., 2008): major effect

Activism Intensity (Brav et al., 2013)



Return on Activism (Brav et al., 2013)



Monitoring the Monitor

- Asset managers are prone to operational risk and insider trading (systemic consequences)
  - Measurement issues (Brown et al., 2011, 2013; Kacperczyk & Pagnotta, 2014)
- Benefits of mandatory disclosure
  - Mandatory disclosure limits shady activities
  - Some parts of the market are more exposed: operational risk in hedge funds (Brown et al., 2011)
  - Effect on window-dressing activity
- Costs of mandatory disclosure
  - Free-riding off information collection (Poterba et al., 2003; Brown et al., 2013)

Theme III

Advising Value

Advising Role

- The role of investment advice
  - Contracting nature between manager and adviser: inefficient outcome (Stoughton et al., 2011)
  - Pandering to investors' beliefs (Gennaioli et al., 2015)

- Empirical evidence on investment advisers suggests the presence of large inefficiencies
  - Promoting underperforming funds (Bergstresser et al., 2009)
  - Selling expensive investment products and hot sectors (Mullainathan et al., 2012)
  - Unbiased advice ignored (Bhattacharya et al., 2012)