Jack of all trades or master of none? Impact of specialization on returns

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Does specialization have implications for investors' wealth. Credit: Pixabay (Creative Commons)

A new study has found that specialist active management firms outperform those that have a more mixed offering of active and passive products, with the benefit of specialisation being 0.7 per cent a year on average.

It is the first study to explore the impact of specialisation and is published this month in the journal *International Review of Financial Analysis*.

Using a sample of more than 2100 fund families internationally, and more than 20 years of data, the study led by Dr. Lorenzo Casavecchia of UTS Business School found that funds with a greater percentage of total assets under active management outperformed those less concentrated on active management.

The outperformance was 70 basis points a year, on average, before fees. This excess return is economically significant considering that it is risk adjusted.

A "fund family" is a group of funds under the banner of one brand—for example, an investment management house like Fidelity, Vanguard, BlackRock, or Legg Mason. Fund families diversify across active and passive management to a remarkable extent, Dr. Casavecchia explains. Even a business like Vanguard that's known as an "index manager" has actively managed funds within its family of products.

Some fund families like to diversify more than others across active and passive to minimise redemption risk at times of market disturbance—when investors might flee certain types of funds—or to maximise fee revenue, he says. On the other hand, fund families like US-based T.Rowe Price pride themselves on having a high degree of specialisation. In the study period it had 94 per cent of fund assets under active management.

"The question for us—and for investors—is whether specialisation has implications for investors' wealth," says Dr. Casavecchia, a researcher with the Finance discipline group in the Business School.

The study found that active specialisation of the fund family does generate value and, investigating where that value comes from, points to a robust association with "manager skill" at the fund family level.

"Our study shows that fund families with greater asset-based focus on the active segment are more likely to possess better managerial skills at running their active funds," says the paper, co-authored with Macquarie University Ph.D. candidate Georgina Ge.

That is derived in part from the expertise that comes from specialising, from the size of their research infrastructure, and from the resources dedicated to private information production."These fund families were significantly less likely to rely on public information," says Dr. Casavecchia.

The findings were supported by an experiment where the researchers looked at what happened to funds that were sold, intact, out of a more actively-focused fund family into a less specialised one. After the move, such funds slipped in performance. The converse was also true.

This is not an "active versus passive" study, Dr. Casavecchia notes, and it is not about the impact of fees.

But for those investors who have already decided they want to be in the active sector, it suggests they are better off seeking out true-to-label, focused active management specialists.

"The findings highlight the significant performance drag experienced by an average equity fund investor if the operational scope and investment philosophy of their fund family isn't aligned with the primary objective of active funds—to outperform the index," the paper says.

Investors should also diversify by using a range of actively-focused specialists, rather than sticking with just one brand, Dr. Casavecchia adds. That's because the study found the dark side of specialisation is greater exposure to losses in periods of severe market stress.

The study involved 2137 fund families, over the period from 1993 to 2015. The source data was from the US because of the greater detail available there, but Dr. Casavecchia says the findings would apply in Australia.

More information: Lorenzo Casavecchia et al, Jack of all trades versus specialists: Fund family specialization and mutual fund performance, *International Review of Financial Analysis* (2019). DOI: 10.1016/j.irfa.2019.01.013

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