Patient capital is in short supply, research finds

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Investors demand returns—and many want them to materialize overnight. But not every investment opportunity has that kind of potential. Some take years to pay off, but yield big results when they do.

Mutual fund managers often choose not to add stocks like this to their portfolios, even when they know they exist. This is because fund managers are incentivized to plan for the short term by the structure of their compensation packages and the day-to-day obligations of managing a mutual fund.

But research from the University of Notre Dame's Rafael Zambrana argues that mutual fund fee structures can be set up to incentivize long-term thinking, and this yields better results for investors with the patience to commit their capital.

"In the 1960s, investors held stocks for an average of eight years. Today, the average is just six months," says Zambrana, an assistant professor of finance at the Mendoza College of Business.

"And that number includes securities held by institutional investors like mutual funds. When institutional investors like hedge funds participate in high-frequency trading, they promote a short-term investment horizon. And that seems to be what investors are demanding in the asset management industry. Patient capital is in short supply," Zambrana continues.

Fund managers' compensation is often based on their performance relative to a benchmark and usually measured over a short period of time. This can be one year or even less, and fund managers are incentivized to think on that timeline. Concerns about the evaluation of their own performance can impact their decisions. They may choose not to purchase some stocks because they won't perform well in the short term.

Fund managers also need to consider investor behavior. The underlying investors in mutual funds can withdraw their money at any time, and fund managers need to provide it to them when they do. That means managers might need to sell stocks to pay investors, and this makes profitable illiquid stocks less attractive. A more liquid stock can easily be bought and sold with minimal effect to its price. If a fund manager needs to sell them quickly, it won't drive the stock's price down too much.

In "Capital Commitment and Performance: The Role of Mutual Fund Charges," in the *Journal of Financial and Quantitative Analysis*, Zambrana proposes a model that analyzes the performance of mutual funds with different sales fee structures. The research found that fee structures that incentivizes the underlying investors to be more patient with their investments allows fund managers to better take advantage of long-term opportunities, and especially stocks with lower levels of liquidity. This ultimately makes investors more money.

"The main challenge for portfolio managers is a mismatch with the investment horizon of value investing," says Zambrana.

"Even if they believe a stock is undervalued and will appreciate, they may not want to add it to their portfolio because of the short-term obligations of managing a fund. We argue that the willingness to invest for the long term should be rewarded. We call that committed capital, and it provides insurance to portfolio managers, so you should reward it."

When retail investors buy shares in a mutual fund, they are putting their trust in a fund manager who manages the fund's assets with the goal of beating the market. To obtain this service, the underlying investors pay a fee. These fees are typically charged annually, but by front-loading the fees, mutual funds can attract more long-term investors.

When a higher fee is charged at the time of investment, and a discount offered on annual fees, there is less incentive for people to withdraw their money, because they have already paid a larger amount of their fees. This helps prevent outflows of money caused by underlying investors cashing in. It also allows the fund managers to lock more capital into good long-term investments, such as companies that are R&D intensive or invest in tangible assets like real estate. Shares in these companies are sometimes likely to appreciate over the long term, but are difficult to sell quickly.

In Zambrana's model, funds with sizable front-loaded fees outperformed funds with higher annual fees.

"Patient capital is the source of outperformance. Mutual funds that have more of it can take on more risk. It allows portfolio managers to invest in stocks that are less liquid," says Zambrana.

"It is not really a concern if they will have a harder time selling, because they won't need to sell in the short term. That leads to better returns. Fund managers can invest with a longer duration, and wait until the investment capitalizes. The underlying mechanism is that patient capital allows portfolio managers to take advantage of their skills to beat the market."

More information: Juan-Pedro Gómez et al, Capital Commitment and Performance: The Role of Mutual Fund Charges, *Journal of Financial and Quantitative Analysis* (2022). DOI: 10.1017/S0022109022001235

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