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Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry

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ABSTRACT

We test the hypothesis that when their compensation is linked to relative performance, managers of investment portfolios likely to end up as "losers" will manipulate fund risk differently than those managing portfolios likely to be "winners." An empirical investigation of the performance of 334 growth-oriented mutual funds during 1976 to 1991 demonstrates that mid-year losers tend to increase fund volatility in the latter part of an annual assessment period to a greater extent than mid-year winners. Furthermore, we show that this effect became stronger as industry growth and investor awareness of fund performance increased over time.

A TOPIC THAT HAS been of considerable recent interest within both the academic and professional communities is how portfolio managers adapt their investment behavior to the economic incentives they are provided. Most of the studies that address this issue (for example, Cohen and Starks (1988), Golec (1992), Grinblatt and Titman (1987, 1989a), Grinold and Rudd (1987), Kritzman (1987), and Starks (1987)) focus on the behavior elicited by incentive fee contracts. In this paper we argue that even without incentive fee contracts, the competitive nature of the mutual fund environment alone can affect a manager's portfolio decisions. Specifically, we suggest that viewing the mutual fund market as a tournament in which all funds having comparable investment objectives compete with one another provides a useful framework for a better understanding of the portfolio management decision-making process. Similar to the payoffs for golf and tennis competitions, the amount of remuneration that a fund receives for "winning" this tournament depends upon its performance relative to the other participants.

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