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Special Situations Report

Unmasking Superstar Fund Managers: Beyond the Glitz, Glamour, and Greed

Summary

The allure of extraordinary returns and relentless media coverage can overshadow the underlying risks and eventual downfall of superstar fund managers. Human nature is naturally drawn to captivating narratives, and the financial media often emphasizes the success stories of these managers while downplaying the associated risks. It is crucial for investors to delve deeper into these stories, considering the long-term risks and implications associated with investing in superstar fund managers.

It is important to recognize that the financial press is driven by the need for captivating narratives that attract attention and advertisers. This voracious imperative may prevent financial reporters from delivering sensible information and objective analysis, further highlighting the need for investors to conduct thorough research. This investment summary provides a detailed **analysis of the risks associated with superstar fund managers and the hidden dangers that lie beneath their success stories**, often glorified by the financial media. Drawing on historical examples such as Cathie Wood, Bill Ackman, David Einhorn, and Mario Gabelli, we illustrate the potential pitfalls of investing in these managers.

To support our findings, we also refer to the academic research paper titled, "Superstar Fund Managers: Talent Revelation or Just Glamor?" by Parwarda and Tan.¹ This study examines the effect of winning the Morningstar Fund Manager of the Year (FMOY) award on a manager's status, money flows, performance, compensation, and risk-taking activities. The researchers identify a sample of FMOY award winners and finalists from 2001 to 2012 in the domestic stock category. Their analysis explores whether the award identifies superior performers or

¹Parwarda, Jerry T. and Tan, Eric K. M., Superstar Fund Managers: Talent Revelation or Just Glamor? (February 14, 2016). 29th Australasian Finance and Banking Conference 2016, 8th Conference on Financial Markets and Corporate Governance (FMCG) 2017, Asian Finance Association (AsianFA) 2017 Conference, Available at SSRN: ssrn.com/abstract=2732363

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represents mere glamor synonymous with media publicity effects.

The research findings indicate that award-winning managers experience positive money flows up to six months after receiving the FMOY award. However, there is no evidence that these managers are able to generate positive performance compared to finalist managers when using various performance metrics. The study does find some evidence that award-winning managers are able to leverage their increased notoriety to extract higher compensation. Moreover, there is no indication that these managers take on more risk or increase trading turnover due to overconfidence following receipt of the FMOY award. While the study focuses on using the FMOY award as a signal for media attention, we can generalize their findings to encompass all forms of hyped media attention, including appearances on various media outlets or sensational articles in financial media. **These findings suggest that managerial skill exists and investors recognize it by investing their capital with award winners. However, given limited investment ideas, the additional money flows may not be placed to productive use, subsequently diminishing the outperformance of superstar fund managers.**

One significant reason for the diminished performance of superstar fund managers is asset bloat, which occurs when a fund grows significantly in size, posing challenges for maintaining performance. The law of large numbers comes into play as the fund's increasing size attracts more investors and accumulates higher assets under management (AUM). With a larger pool of capital, the fund manager faces challenges in maintaining previous levels of outperformance. As the AUM grows, investment opportunities become limited, and the manager may be forced to invest in more stocks, diluting the impact of their decisions. **Consequently, the law of large numbers implies that the fund's performance may tend to converge towards market average returns as it grows, contributing to the diminished performance experienced by superstar fund managers with asset bloat.**

Additionally, as a fund becomes larger, executing trades without impacting stock prices becomes harder, leading to impact costs that erode returns. For instance, when buying or selling a large block of stock, the fund's transactions can move the market due to the scarcity of available shares at the current price. **This outcome results in the need to pay a higher price to attract sellers or accept a lower price when selling a large block of stock. The resultant drag on performance, known as "impact cost," can significantly impact the returns of a large fund, further exacerbating the challenges faced by superstar fund managers with substantial asset bloat.**

While critics may argue that superstar fund managers can demonstrate exceptional skill and generate significant returns, the evidence presented in this paper shows that even managers with initial success can encounter challenges that lead to their downfall. It is essential to focus on the risks and potential pitfalls rather than solely on short-term success stories.

In conclusion, investors should approach the allure of superstar fund managers and media hype with caution and delve into the long-term implications of their choices. **Rather than being swayed solely by captivating narratives surrounding established stars, exploring a curated index of ambitious emerging managers, akin to the "Peter Lynch's of the future," can unlock substantial benefits for investors.** Emerging managers possess the agility to capitalize on overlooked opportunities and access high-return small-cap stocks, giving them a competitive edge. Recognizing the importance of staying small for older funds in maintaining performance, investing in emerging funds before they are closed to new investors becomes paramount. The innovative and adaptive nature of emerging managers to prevailing market conditions enhances their potential for success. While higher returns may come with increased

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idiosyncratic risk, emerging managers offer a unique source of alpha for investors, notwithstanding potentially higher minimum investment requirements. By prudently opting for emerging managers and considering their potential for superior returns, investors can pave the way for long-term investment success.

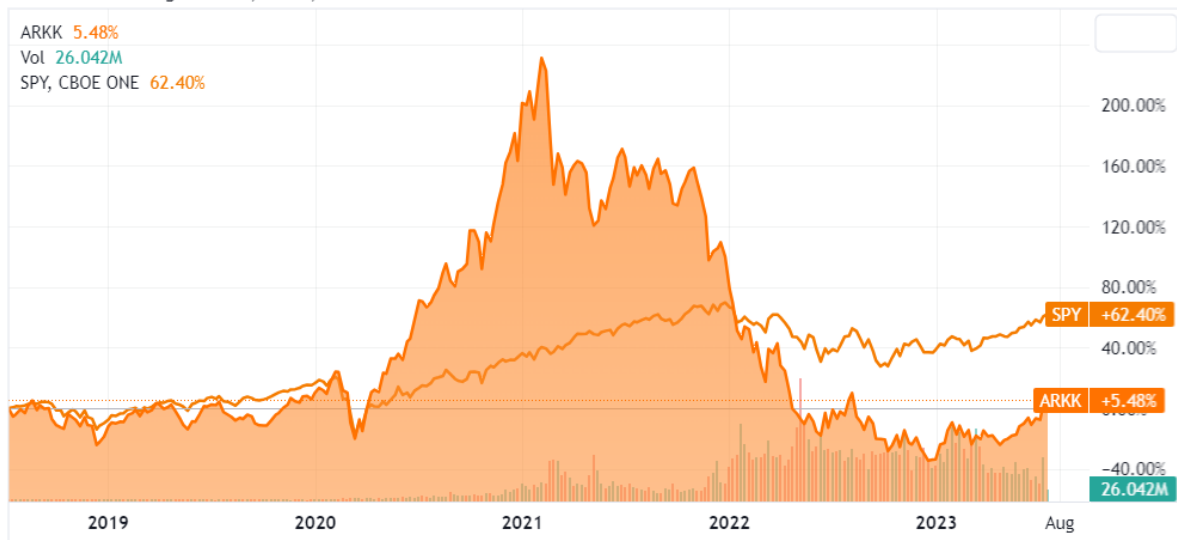
To facilitate the identification of emerging managers, a range of hedge fund databases has been tailored to suit diverse target audiences. For comprehensive hedge fund research and invaluable insights and analysis can be gleaned from sources such as **BarclayHedge**, **HedgeFundDirectories.net**, **Standard and Poor's Hedge Fund Evaluator**, **EurekaHedge**, and **EuroHedge Database**. A noteworthy addition to this list is **eVestment**, serving as a key resource for not only finding emerging managers but also consultants.

Historical Examples

This analysis focuses on the performance of media-sensationalized fund managers and their investment vehicles to emphasize that there are periods when these managers underperform, potentially eroding their previous records and posing significant risks to investors. Historical examples, such as Cathie Wood of ARK Investment Management, Bill Ackman of Pershing Square, David Einhorn of Greenlight Capital, and Mario Gabelli of GAMCO, are examined. Initially, the investment vehicles managed by these individuals achieved exceptional returns, surpassing the performance of the S&P 500. However, in subsequent years, the performance of these funds experienced a significant decline, resulting in losses for investors. This data underscores the importance of timing investments with these managers, as despite their initial hype and status, their performance has failed to catch up with the broader market. Therefore, it is crucial for investors to carefully assess the risks and potential pitfalls associated with relying solely on the sensationalized success stories of these fund managers.

Cathie Wood's ARKK (7/18 – 7/23)

Published on TradingView.com, Jul 19, 2023 03:23 UTC-4



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Bill Ackman's Pershing Square Holdings (7/15 – 7/23)

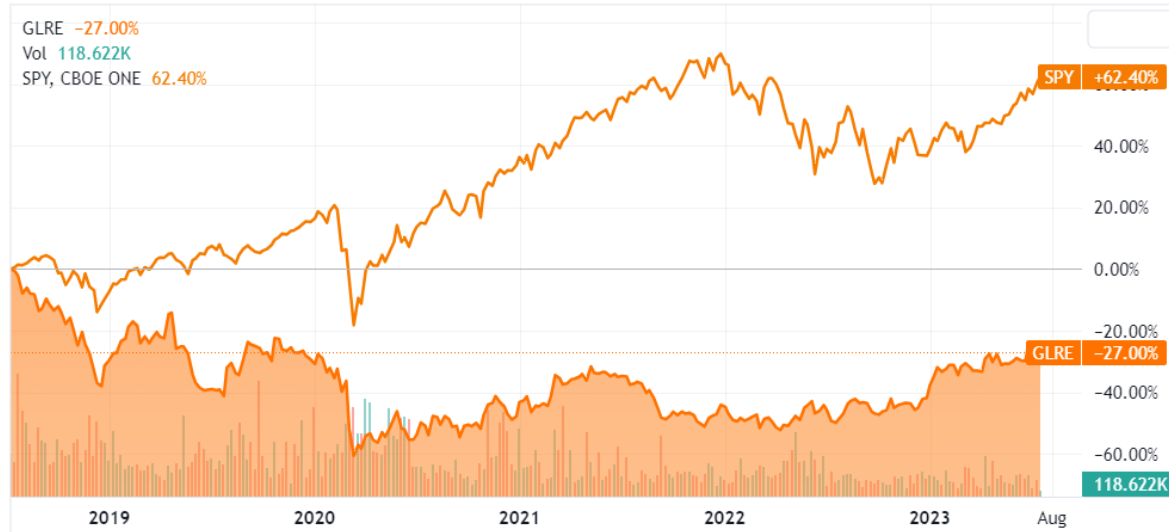
Published on TradingView.com, Jul 19, 2023 03:27 UTC-4



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David Einhorn's Greenlight Capital (7/18 – 7/23)

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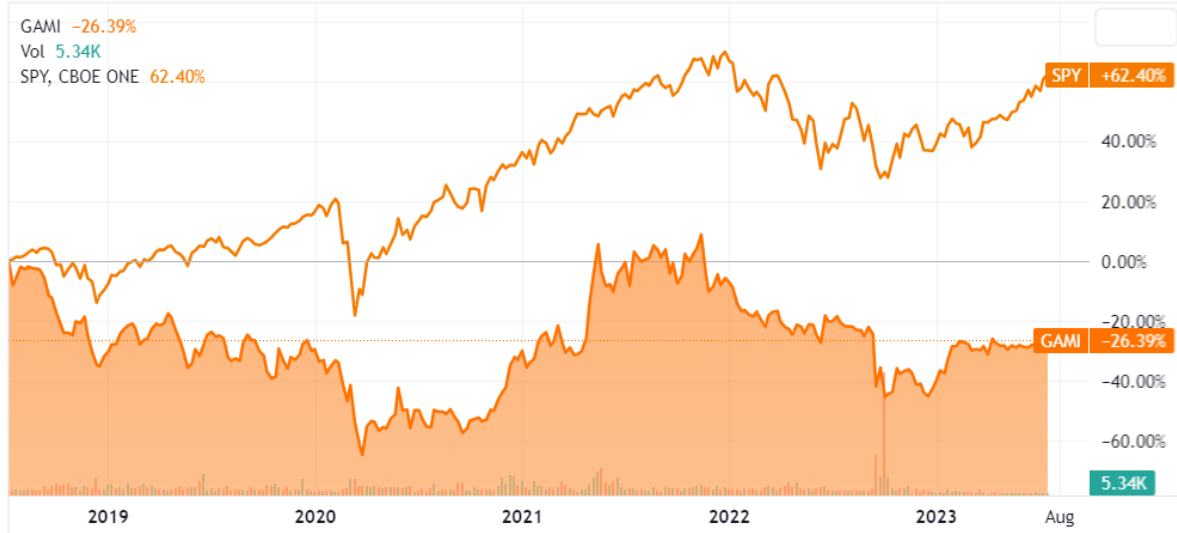


TradingView

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Another Barron's Roundtable regular Mario Gabelli's investment vehicle (7/18 – 7/23)

Published on TradingView.com, Jul 19, 2023 04:03 UTC-4



TradingView

What this data underscores is the dramatic underperformance and losses experienced by retail investors from peak to trough, accentuated by the media hype surrounding these managers. Despite their elevated status, if investors mistimed their investments with these managers, their performance fails to catch up to the broader market, resulting in substantial losses.

Academic Research Findings

To support our assertion, we have also incorporated the findings of an academic research paper by Jerry T. Parwada and Eric K. M. Tan. Their study titled "Superstar Fund Managers: Talent Revelation or Just Glamor?"² addresses the question: Do public fund manager accolades reveal fundamental information about portfolio managers' performance? The study further explores the effect of mutual fund managers' superstar status on various aspects of their funds' outcomes.

The research specifically focuses on the Fund Manager of the Year (FMOY) award, which has been announced annually by Morningstar since 1988. The FMOY award is highly regarded in the industry and aims to recognize fund managers with a proven track record of exceptional performance and responsible stewardship of investor capital. Notable recipients include Peter Lynch of Fidelity's Magellan Fund and Bill Gross of PIMCO. The award attracts significant attention from media sources such as Bloomberg, Business Week, CNBC, Forbes, Reuters, and the Wall Street Journal and is prominently featured in fund managers' biographies and marketing materials.

²Parwada, Jerry T. and Tan, Eric K. M., Superstar Fund Managers: Talent Revelation or Just Glamor? (February 14, 2016). 29th Australasian Finance and Banking Conference 2016, 8th Conference on Financial Markets and Corporate Governance (FMCG) 2017, Asian Finance Association (AsianFA) 2017 Conference, Available at SSRN: ssrn.com/abstract=2732363

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By targeting the FMOY award, the study isolates the real effects of winning the award on fund outcomes such as money flows, performance, compensation, and risk-taking behaviors. The researchers compare these outcomes in funds managed by award winners to those of non-awardees, utilizing a hand-collected list of FMOY finalists. This approach avoids potential biases associated with matched control sample methods, ensuring that the findings primarily reflect the changes in fund managers' status (the superstar effect) rather than the coverage of the FMOY award (the visibility effect).

The study's main findings reveal that award-winning managers experience positive money flows for up to six months following the FMOY award. This outcome holds true even when using an abnormal fund flow measure, which was constructed using an event study methodology to isolate the incremental flow due to the award's announcement. Although the study focuses on the FMOY award, we can extrapolate these results to all forms of hyped media attention, such as appearances on CNBC, Bloomberg TV, or financial media outlets, as well as sensational pieces in Barron's or WSJ. However, it is important to note that there is no evidence to suggest that these managers generate positive risk-adjusted returns compared to finalist managers after receiving media attention. Despite their recognition, award-winning managers do extract higher compensation. Interestingly, the study found no indication that these managers take on increased risks or engage in more active trading due to overconfidence induced by media accolades.

The study's insights contribute significantly to our understanding of the relationship between superstar status, media coverage, and fund outcomes. It highlights the heightened risk that investors may face due to attention-grabbing information and sheds light on potential agency problems between fund managers and investors linked to fund manager stardom. By delving into the impacts of increased publicity on individual fund managers based on performance metrics rather than relying solely on ranking lists, the research expands on existing literature and further elucidates the superstar phenomenon in the mutual fund context, encompassing its effects on investors, performance, compensation, and risk-taking.

Amidst the allure of superstar fund managers, recognizing the impact of investor behavior on their returns is crucial. Retail investors, influenced by a constant stream of financial news and their inherent biases, often fall into the "behavior gap," purchasing at market peaks and selling at market lows, resulting in significantly lower returns compared to a simple buy-and-hold strategy. DALBAR, a financial services market research firm studying investor behavior since 1994, quantifies this gap. Their research reveals that the average equity mutual fund investor underperformed the S&P 500 by a considerable margin of 4.35% per year over the past two decades (ending December 31, 2020).³ The gap has further widened in the first half of 2021, indicating the impact of emotional decision-making during volatile periods. Even amidst the pandemic's aftermath in 2020, investors struggled to mitigate their losses, leading to a 1.11% gap between the average equity fund investor and the S&P 500 for that year (17.29% for the average equity fund investor and 18.40% for the S&P 500). **This data serves as a stark reminder of potential capital destruction for retail investors influenced by media hype and financial narratives. To protect themselves, investors must delve deeper into the underlying risks and implications associated with superstar fund managers, making informed investment decisions to avoid falling victim to the behavior gap's detrimental impact on their investment returns.**

³"Quantitative Analysis of Investor Behavior", DALBAR, Inc, June 30 2021, www.dalbar.com/QAIB/Index

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Asset Bloat

The underperformance of most active equity mutual funds has been a subject of research, and the findings reveal some surprising answers. **Contrary to popular belief, it is not due to managers lacking stock picking skill or high fees, but rather the structural decisions made by fund companies. Asset bloat, closet indexing, over-diversification and the exorbitant fees on the large AUM are the real culprits** behind underperformance.

Asset bloat occurs when a fund grows significantly in size, posing challenges for maintaining performance. As funds become larger, executing trades without impacting stock prices becomes harder, leading to erosion of returns through impact costs. This issue was observed in the cases of fund managers like Bill Miller of Legg Mason, ultimately contributing to their downfall.

The study shows that fund performance declines as the fund size, measured by assets under management (AUM), increases.⁴ This result is due to the limiting aspects of managing an active equity portfolio. Fund managers with a focused investment strategy end up with a small number of "best idea" stocks, often fewer than 20. However, as the fund grows, it becomes increasingly difficult to effectively trade these limited stocks. At some point, the fund must either limit its size or start investing in stocks that are not the best ideas. Unfortunately, industry incentives, such as compensation based on AUM, often lead to the transformation of active managers into closet indexers.

Asset bloat in mutual funds can be better understood in the context of the law of large numbers. As a mutual fund's size grows substantially due to increased investments, the law of large numbers comes into play, highlighting potential challenges for the fund's performance. Initially, the fund may attract attention and show impressive returns, but as it becomes larger, managing the fund effectively becomes more difficult. The law of large numbers suggests that with a larger pool of assets, the fund manager may face limitations in finding suitable investment opportunities, leading to potential dilution of the fund's performance. As a result, the fund's returns may decline, underperforming compared to its earlier success and the broader market. Investors need to be aware of this phenomenon and carefully consider the long-term implications of asset bloat on the fund's ability to maintain its past performance levels.

It can be caused by an influx of new money into the fund due to superior performance or organic growth through investment gains. However, it can become problematic when the fund's size becomes too large for the manager(s) to effectively handle. For example, the Fidelity Magellan Fund managed by Peter Lynch saw significant asset growth during Lynch's tenure, but after his departure, the fund's performance never reached the same levels. This result can be attributed, at least in part, to the massive growth in assets.

This phenomenon is particularly challenging for funds that invest in small and mid-cap stocks. As the fund size increases, it becomes difficult for managers to find enough good stock ideas within the fund's mandate, leading to a decline in performance that initially drove the asset

⁴Parwada, Jerry T. and Tan, Eric K. M., Superstar Fund Managers: Talent Revelation or Just Glamor? (February 14, 2016). 29th Australasian Finance and Banking Conference 2016, 8th Conference on Financial Markets and Corporate Governance (FMCG) 2017, Asian Finance Association (AsianFA) 2017 Conference, Available at SSRN: ssrn.com/abstract=2732363

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growth. Some small and mid-cap funds have even transitioned to investing in larger stocks or shifted their investment style from mid to large cap as they grew in size.

In summary, asset bloat is a key factor behind the underperformance of most active equity funds. Understanding and addressing these structural issues are crucial for improving fund performance and delivering value to investors.

Conclusion

In conclusion, the allure of extraordinary returns and the media's relentless coverage often overshadow the underlying risks and eventual downfall of superstar fund managers. It is not just human nature's preference for captivating narratives, but also the combination of fund company greed and media "cult personality worship" that fuels this phenomenon. The drive for ratings and increased ad revenues can lead to capital destruction for many retail investors who become influenced by the hype surrounding these managers. Therefore, it becomes imperative to look beyond the surface and delve deeper into these stories to make informed investment decisions. The financial media's focus on exceptional returns while downplaying associated risks can be a dangerous trap for unsuspecting investors, and understanding the true motivations behind the hype is crucial to protect their investments.

Numerous studies and market observations support the existence of the superstar manager pothole. Academic research demonstrates that actively managed funds, often associated with superstar managers, struggle to consistently outperform passive index funds. Market data further reveals the negative impact of asset bloat on fund performance, validating the notion that managing large funds can be detrimental to long-term returns.

While it is true that not all superstar fund managers will face the same pitfalls, the historical examples and evidence strongly suggest that investors need to exercise extreme caution and go beyond captivating narratives.

Critics may argue that superstar fund managers can demonstrate exceptional skill and generate significant returns. However, the presented evidence shows that even managers with initial success can encounter challenges that lead to their downfall. Therefore, the focus should shift towards acknowledging the risks and potential pitfalls rather than solely relying on short-term success stories.

Proposal

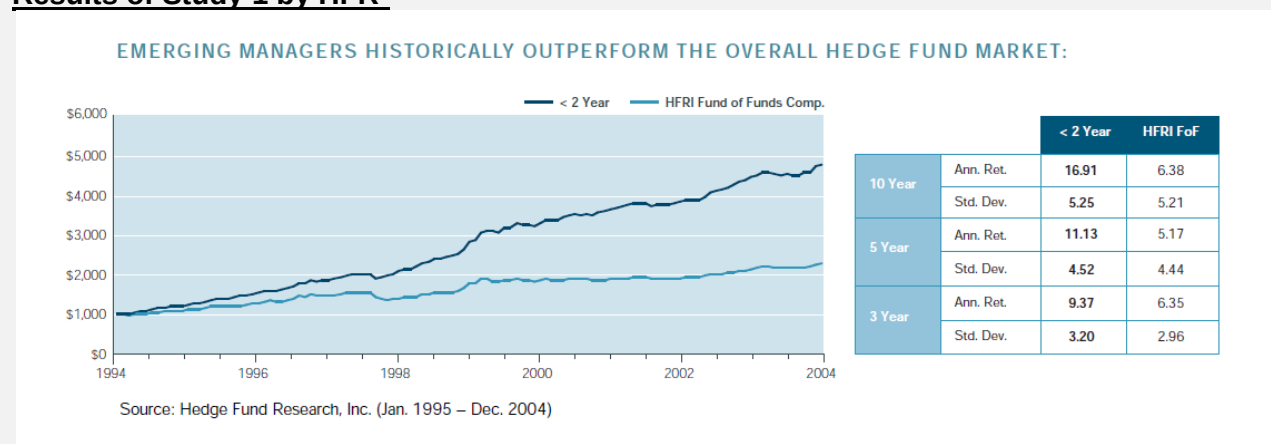
In the world of hedge fund investing, the allure of superstar fund managers and their media hype can be tempting, but it comes with hidden dangers for investors. Instead of being swayed by the glitz and glamour, a more prudent approach involves seeking out an index of emerging managers, which can offer substantial benefits over their media-savvy counterparts.

Emerging managers have consistently proven their ability to outperform other fund managers, thanks to their nimbleness and willingness to invest in overlooked ideas, particularly in small-cap stocks with historically higher returns. Staying small is a key strategy for older funds to maintain high performance, and investing in emerging funds before they close to new investors becomes crucial to capturing their potential outperformance.

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What sets emerging managers apart is their innovation. By starting with new ideas that yield higher profits, they can outperform larger and more established funds. **Furthermore, these managers remain responsive to current market conditions, as evidenced by their outperformance before, during, and after the 2008 financial crisis.** Their commitment and lack of conflicts of interest contribute to their drive for success. One striking aspect of emerging managers is their impressive track record of outperforming larger, blue-chip funds. **Data from HedgeWeek demonstrates that emerging managers have consistently performed 4.8% better than hedge funds on average over 2019-2022 period.**⁵ This trend showcases the promising potential these managers hold, proving their capability to deliver superior returns.

Results of Study 1 by HFR⁶



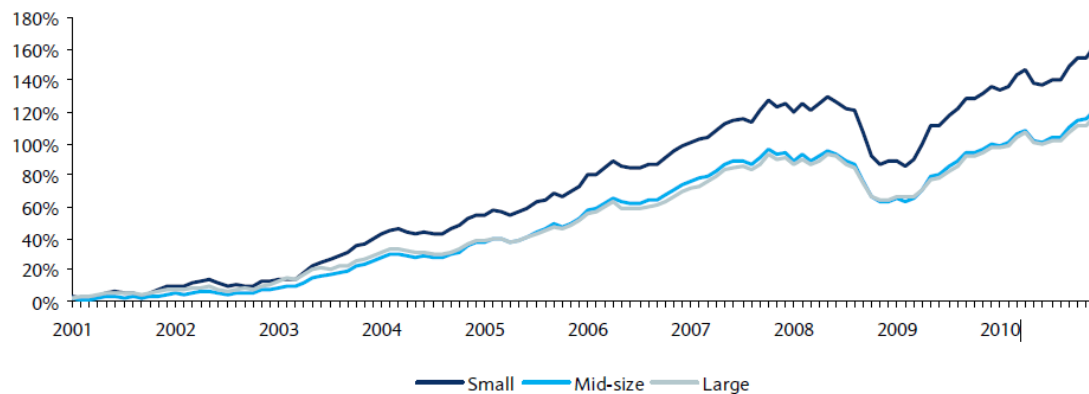
⁵McNally, Fiona. "Emerging managers struggle to capture investors' attention". HEDGEWEEK, 27 June 2022, www.hedgeweek.com/2022/06/27/315593/emerging-managers-struggle-capture-investors-attention

⁶"Emerging Managers: Good Buy or Good Bye", Barclays Capital's Capital Solutions Group, April 2011, www.managedfunds.org/wp-content/uploads/2011/08/HF-Pulse-Emerging-Mgrs-Apr-2011-A4.pdf

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Results of Study 2 by Strategic Consulting Analysis⁷

Figure 2: Cumulative Returns of Sized-Based HF Indexes, Jan. 2001-Dec. 2010



Source: Strategic Consulting Analysis

While emerging managers do produce higher returns, it is important to acknowledge the increased idiosyncratic risk that comes with it. For institutional investors, however, emerging managers present a unique source of alpha, although their relatively high minimum investment requirements can pose a challenge for most investors. The key lies in choosing emerging managers wisely, as doing so can open the door to higher returns and long-term success.

Moreover, **emerging managers offer a unique value proposition in diversification**, particularly within the alternative sector of a portfolio. Their novel approaches to ESG and investment processes **align with the growing demand for mission-based investing and transparency**, making them an attractive option for investors seeking fresh perspectives and innovative strategies.

Though concerns over track records and the ability to replicate success may cause some investors to hesitate, the evolving definition of emerging managers, including diverse-owned and mission-based funds, is gaining traction. These managers naturally fall within the emerging manager classification, making them well-positioned to address the priorities of diversity and inclusion and sustainable investing, attracting institutional investors in the process.

Furthermore, **emerging managers are actively adapting to investors' expectations by offering discounted fee structures** and earlier allocations, demonstrating their commitment to accommodating early-stage investors. This presents a unique opportunity for investors to be "first to fund" and secure favorable terms in a competitive talent market.

In conclusion, investors should not be dissuaded by the challenges that emerging managers face during their initial launch. Instead, investors should recognize the immense

⁷"Emerging Manager Out-Performance: Alpha Opportunities from the Industry's Newest Hedge Fund Managers", HFR Asset Management. 2005, www.hedgeweek.com/sites/default/files/import_attachments/Emerging%20Manager%20Outperformance.pdf

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potential and unique benefits these managers offer, from outperforming larger funds to introducing innovative strategies aligned with ESG and mission-based investing. By considering emerging managers, investors can diversify their portfolios, align with their values, and potentially secure compelling returns. As the industry continues to evolve, embracing emerging managers becomes a strategic move for investors seeking growth and innovation in their investment endeavors.

In the pursuit of identifying emerging managers, a range of hedge fund databases has been tailored to suit diverse target audiences. **These databases offer an extensive array of information on hedge funds, encompassing performance data, contact details, and investment mandates. For comprehensive hedge fund research** and effective marketing to hedge funds, invaluable insights and analysis can be gleaned from sources such as **BarclayHedge, HedgeFundDirectories.net, Standard and Poor's Hedge Fund Evaluator, EurekaHedge, and EuroHedge Database. A noteworthy addition to this list is eVestment**, serving as a key resource for not only finding emerging managers but also consultants. The quarterly report known as Emerging Manager Monitor, provides valuable and up-to-date information, allowing investors to stay on the cutting edge of emerging manager opportunities and trends.

-Gowshihan Sriharan, CFA, "The Rover"

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