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Investor Preferences Are the Signal in the Fund Flow Noise





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Distilling investor preferences from fund flows lead to better outcomes for asset managers

There may be no industry so inundated with data as asset management, yet asset managers still underwhelm with their ability to create commercially successful products, suggesting that asset managers struggle to draw insight from the data available to them. Investor preferences may be the most important measure for asset managers given their impact on every facet of the business. In this paper we investigate how asset managers measure investor preferences and find that a more rigorous statistical approach could yield significant financial benefits for asset managers.

Our key findings include:

- Fund flows are not equivalent to investor preferences and should not be treated as such.
- Asset managers make poor decisions about investor preferences. Just 42% of new fund launches ever reach \$100 million or more in assets under management (AUM)
- There are 5.5 times more new products launched on average into categories in the top quartile of flows over trailing one- and five-year periods.
- Investor preferences are five times more persistent than fund flows from one year to the next.
- Using a factor model is the appropriate way to distill fund flow data into investor preferences.

Of ice cream and fund flows

You like ice cream. On a hot summer day, you find yourself walking by the beach and, to your great satisfaction, you see two ice cream stands in front of you on the boardwalk. The first ice cream stand only sells your favorite flavor, chocolate, for \$5.50 per scoop. The second sells vanilla—not your favorite—for \$0.50 per scoop. Which stand do you buy from?

As it turns out, you do not like chocolate enough to justify paying \$5 more per scoop, so you fork over \$0.50 for your vanilla scoop and go about your day. Of course, you are not the only transaction that day. An enterprising ice cream industry analyst is observing both stands, and, at the end of the day, tallies the total scoops sold by each stand. More scoops of vanilla were sold than chocolate, so the analyst concludes that consumers prefer vanilla to chocolate.

By now, you should be very concerned about the analytical abilities of this so called "ice cream industry analyst." Clearly, price plays a role in the purchasing decision in addition to flavor, so the analyst should not simply sum up the scoops sold to judge whether vanilla or chocolate is preferred. Yet this is the same mistake asset managers make when they sum up fund flows as a gauge of investor preferences for a particular fund characteristic.

In statistical parlance, flavor and price would be explanatory variables for the quantity of ice cream sold. So how can we know which one truly had the most sway over sales? How much did the preference for flavor weigh against the preference for paying less money? In order to answer these questions, we need to use a statistical regression model which will disentangle the effects of each one.



Investor preferences are of paramount importance to asset managers

Before we get too deep into statistics, let us define an investor preference.

An investor preference is the amount by which investors prefer a certain characteristic of investment products exclusive of the impact of all other characteristics.

For example, we could say that investors *prefer* lower fee funds such that funds in the bottom quartile of fees can expect six percentage points of organic growth in excess of funds in the top quartile of fees.

No employee of an asset manager can afford to be ignorant of investor preferences. Product developers must understand the difference between long-term trends and fads to build successful products. Marketers must understand which of their products will appeal to investors today to achieve the highest return on investment (ROI) for their efforts. Wholesalers need to understand what the advisor they are speaking to today might like about their funds versus that of their competitors. Portfolio managers need to understand where herding behavior might take investors as a means of understanding the risk in their portfolios.

Still, despite their importance, many asset managers are not taking serious steps to measure investor preferences rigorously. As we will see with fund launches, this is a costly mistake.

The curious case of fund launches

Inarguably, the asset management industry's track record on fund launches is abysmal. As fees have fallen, the AUM threshold that a fund must overcome to reach profitability is increasingly out of reach. Only 42% of funds reach the \$100 million of assets threshold that has traditionally indicated a successful fund. However, given the state of falling fees, a \$200 million threshold may be more appropriate—which just 31% of fund launches ever reach. Those that do not are costly for asset managers, tying up human resources in launch planning and seed capital which could be better allocated to more profitable ventures. This is especially detrimental for small firms, where human capital and seed capital are in short supply.

A very low percentage of funds ever reaches a profitable level of assets under management.



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One reason for these failures is the misestimation of demand for the new products being launched. A whopping 34% of new products are launched into categories with top-quartile flows over the trailing one- and five-year periods. Clearly asset managers look at short-term flows to gauge whether a category is currently in style and longer-term flows to ensure it is not a fad. Nobody ever got fired for launching a fund into a growing category, right?

34% of all launches happened in categories in the top quartile of 1- and 5-year flows. This is far above the average, suggesting that asset managers are paying attention to the sums of flows into categories when making product launch decisions.



Percentage of Fund Launches into Categories Divided into Flow Quartiles Over 1-year (columns) and 5-year (rows) Periods



Unfortunately, this is *exactly* the problem. The assumption underlying this launch into a high-flowing category is that these flows will persist into the future. Yet the flows that looked so attractive in a category may have been because that category performed well for a short period, or had lower fees, or was more passive. In other words, people may have been chasing the returns, low fees, or passive investing rather than the category itself. Consequently, when those other characteristics inevitable change, the flows dry up.





This difference between flows and preferences is bigger than one might imagine

There is no shortage of confounding variables that might affect an investors choice of funds. Investors care about a seemingly never-ending set of factors, including:

- Active vs. passive
- ESG
- Investment performance
- Management teams
- Asset manager brand reputation
- Fees
- Asset class and category

As it turns out, accounting for all of these preferences in a factor model of fund flows can lead to quite different conclusions than looking at the sum of flows. Let us look at one example.

Investor preferences can lead to very different conclusions than asset flows about what is truly impacting investing decisions.



We have two charts showing cumulative organic growth (i.e., asset flows) on the left-hand side, and cumulative investor preference as measured by Flowspring's factor model of organic growth on the right-hand side for the large-cap style box categories. Immediately, some differences are evident:



A product developer examining the left-hand chart might well conclude that a large-cap blend fund might do well given its historical positive growth. However, it is clear from preferences that none of the large-cap style box categories is attractive. Why is that? Let us look at some other explanations for flows into the Large Blend category.

It is hard to know what is really impacting investor decisions based on fund flows alone. It could be any number of factors—such as fees, passiveness or return, to name a few—beyond the single characteristic investors are examining.

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Asset-weighted Net Expense Ratio (left), Degree of Passiveness (middle) and Trailing 5-year Return (right) for Large-cap Style Box Categories



In the chart above, we see the asset-weighted average net expense ratio, degree of passiveness (as expressed by the r-squared to the best-fitting index), and the trailing five-year return for each of our three categories. That investors prefer lower fees is well established—investors have been pursuing passive investing at the expense of active strategies and generally chase trailing performance numbers. The Large Blend category has the lowest fees, the highest degree of passiveness and the highest trailing returns of the three categories—directly aligning the category with investor preferences on these other characteristics. Did investors therefore prefer the Large Blend category itself, or were they pursuing these other characteristics with their assets?

Similarly, Large Growth recorded the worst flows; similarly, the category has the highest net expense ratio of the three categories. While Large Value fell in the middle on fees, it had more active management and worse returns. Clearly, these characteristics deserve at least partial credit for the flows experienced by these three categories and that the preference for category alone is not responsible for the entire differential.

Now imagine that you are not just evaluating three categories for a prospective product launch, but also hundreds of Morningstar categories. The incorrect rank ordering of investor preferences across all categories will be much worse than it is with a small subset, naturally leading to incorrect conclusions about where to launch a fund with the highest odds of success.



A solution to our problem

Now that we have seen that asset flows can be misleading due to the entangled effects of various characteristics, let us explore how to disentangle these effects to distill investor preferences from flow data. The class of problem we are facing—explaining the variation in one variable (net flows) with other variables we think are important (category, net expense ratio, performance—is known as *regression*. Regression models allow us to express our dependent variable as a function of the other variables we believe are important. Developing a regression for fund flows model (or using one from a third party), while challenging, is precisely what asset managers should do to measure investor preferences, as they can account for the effects of all independent variables on the dependent variable simultaneously.



Once we have expressed the model in this fashion, the key is to find the parameters which make this function fit our data as well as possible. While these methods are outside the scope of this article, suffice is to say that both the functional form of your model and the error function you choose to optimize are critical factors when it comes to fitting a model that will generalize well to data points outside your training set.

When it comes to flows, one thing is clear: preferences are not linear. Consequently, a linear factor model for flows would be a poor choice. Let us take a look at the investor preference for net expense ratio to really drive this home.

Investor preferences for net expense ratio level out as you climb above 3%. Below that point, there is a strong preference for lower net expense ratios. The two distinct areas with separate slopes indicates the preference for net expense ratio is non-linear.



In the chart above, we see that the relationship between the investor preference for net expense ratio (y-axis) is not a straight-line function of the net expense ratio (x-axis). In fact, as expense ratio falls below 3%, the benefits to lower expense ratios increase rapidly, unlike expense ratios above 3%, where there is little difference in expected growth. We note similar non-linearity in preferences for many different factors, including degree of passiveness and sharpe ratio (pictured on the next page).

Like net expense ratio, the preferences for passive and for investment performance follow non-linear curves.

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Investor Preference (expressed as an expected organic growth ate) for Various Levels of Degree of Passiveness (left) and Sharpe Ratio (right)



Moreover, investor preferences are not uniform across time and subsets of funds. This intuitively makes sense because some variables should be more important to investors in some categories than in others. In statistical parlance, this means that the variables that affect flows exhibit interaction effects, i.e., investor preferences for explanatory variables interact with each other to determine the flows. Below we see the investor preference for Degree of Passiveness across various asset classes.

The preference for passiveness is non-linear, but it also differs depending on the asset class. While more passiveness is always preferred among equities, that is not the case in fixed income, where highly active funds are attractive to investors as well.





It is interesting to note that investors clearly prefer highly passive funds to active, but within the fixed income asset class, the active class does not suffer as much as other asset classes. While there are many possible explanations for this, the most convincing is that active managers have an easier time beating benchmarks in fixed income than they do in equity, as constructing efficient fixed income benchmarks is exceedingly difficult due to the idiosyncrasies and liquidity constraints of fixed income securities. The fact that this shows up in our purely data-driven investor preferences is evidence that our model is picking up on very nuanced bits of human behavior.

Is it worthwhile to care about this?

Non-linearities, interaction effects, and regression models-oh my! This is certainly intimidating for asset managers without a quant or data science team on staff. Is there really enough of an economic benefit to warrant taking such a rigorous approach to investor preferences? You bet there is.

The persistence of investor preferences means that any decision based on investor preferences is inherently more forward-looking than one based on fund flows.

Persistence of Fund Flows (left) and Investor Preferences (right) As Expressed by the R-squared Between One year's Measure (x-axis) and the Following Year's Measure (y-axis) Where Each Dot Represents a Fund Category



Persistence of fund flows by category

Persistence of investor preferences by category

10%

20%

Embedded in decisions reliant upon backward-looking data is the implicit assumption that the past will persist into the future. Unfortunately, fund flows exhibit very weak persistence from one year to the next -- the prime reason that asset managers misestimate demand for their products.

Conversely, there is a much stronger persistence in investor preferences from one year to the next. In fact, as measured by the r-squared between year-over-year observations, investor preferences are five times more persistent.

Recall, for a moment, our ice cream example. Prices for chocolate and vanilla might fluctuate daily- causing big fluctuations in demand for a particular flavor-but the actual preference for those flavors is likely to be much more persistent through time.

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In a more concrete sense, a category with 50% organic growth over the last 12 months is expected to earn 12% organic growth cumulatively over the next five-year period. On the other hand, a category with 50% investor preference is expected to earn 36% organic growth cumulatively over the ensuing five years. Surely a category with a three times higher expected growth rate is a better place to launch a new fund, and could well mean the difference between achieving profitability or a painful rationalization for the asset manager and their investors.

Conclusion

Despite the importance of investor preferences to the commercial success of asset managers, they are not measured with a level or rigor proportionate to their importance. To be fair, asset managers do not deserve all the blame. More should be demanded of industry experts and data providers to embed greater intelligence in the information they offer.

For our part, we recommend that asset managers use a more robust factor-model based methodology that will yield pure investor preferences for product characteristics and a better understanding of what is driving investor decisions. Investor preferences distilled from fund flows via a factor model are significantly more persistent than fund flows themselves, leading to much better forward-looking inputs to the decision-making process. Moreover, the insights we can gain about non-linearities and interaction effects in investor preference can be invaluable in shaping product strategy.

In a time when asset managers are under pressure from lower fees, more concentrated assets and a changing technological landscape, it is critical that they work smarter to make better decisions. A factor-based approach to investor preferences is a great step in that journey.

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