

On the Industry Concentration of Actively Managed Equity Mutual Funds

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ABSTRACT

The value of active fund management recently has become a central debate among researchers and practitioners. Mutual fund managers can deviate from the passive market portfolio by concentrating their holdings in specific industries. We investigate whether mutual fund managers are motivated to hold concentrated portfolios because they have investment skills that are linked to specific industries or whether they are motivated by agency problems that induce them to hold poorly diversified portfolios.

Using U.S. mutual fund data from 1984-1999, we study the relationship between the industry concentration of mutual funds and their performance. Our analysis indicates that mutual funds differ substantially in their industry concentration, and that concentrated funds tend to follow distinct investment styles. Managers of more concentrated funds overweigh growth and small stocks, whereas managers of more diversified funds hold portfolios that closely resemble the total market portfolio.

We find that more concentrated funds perform better after adjusting for risk and style differences using various performance measures. Mutual funds with an above median concentration yield an average abnormal return of 0.33 percent per year after deducting expenses, whereas mutual funds with below median concentration yield an average abnormal return of -0.77 percent. We establish that the superior performance of concentrated funds is not due to their greater responsiveness to macro-economic conditions. We also measure the performance of mutual funds based on their portfolio holdings using characteristic-based benchmarks. The results indicate that the superior performance of concentrated mutual funds is primarily due to their superior stock selection ability.

To test the robustness of our results, we also examine the trades of mutual funds. We find that the stocks purchased by mutual funds tend to outperform the stocks sold. Moreover, we show that the return difference between the buys and the sells of mutual funds increases significantly with the industry concentration. This finding indicates that concentrated mutual funds are more successful in selecting securities than more diversified funds.

Our results show that the industry concentration of a mutual fund, a specific measure of active management, is positively related to fund performance. This finding lends support to the hypothesis that investment ability is linked to specific industries.