Peer Effects in Investment Manager Selection: Evidence from University Endowments

Extended Abstract - Charikleia Kaffe*

Introduction

This paper examines peer effects as a determinant of external investment manager selection in the institutional investor space. Literature has previously focused on peer effects and herding in security or asset class selection of individual and institutional investors, as well as in strategic firm decisions and corporate policy. This paper is the first to address behavioural considerations in the external investment manager selection of institutional investors. Such an analysis is enabled through a novel hand-collected dataset on university endowment manager appointments that spans over 30 years.

University endowments are entities that manage nonprofit assets. Endowments are substantial investors with very long-term horizons, are run by experienced professionals, and have served as investment role-models for many individual and institutional investors. Each endowment has an investment office that decides on investment policy and can choose to manage the funds itself (internally) or to delegate management to external asset management firms. All endowments in my sample in 2008 adopt the external management approach (at least for a part of their portfolio) and delegate mandates to investment managers expecting them to deliver performance. If they do not, then they are often fired.

I investigate external manager hiring and firing decisions by endowments which compete against each other on investment performance and inputs such as students and faculty (Acharya and Dimson (2007)). Since they effectively participate in a tournament, their investment strategies and external manager hiring and firing decisions are likely to be influenced by the behavior of their peers, and determining the degree of this institutional investor herding is important. Furthermore, since some endowments appear able to pick skilled managers (Lerner et al. (2008)), I consider whether others are able to follow their decisions through peer networks.

More specifically, this paper studies the influence of the network of university peers in external manager hiring and firing decisions. In particular, I examine the following three research questions: (i) what are the determinants of the commonalities in external manager appointments among endowments; (ii) whether the frequency of manager hirings and firings by an endowment is affected by the behaviour of its peers; and (iii) what influences how fast endowments respond to hiring and firing decisions of other institutions.

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1The 2016 total market value of non-profit endowments was $0.7 trillion (Dahiya and Yermack (2018)).

2NACUBO reports about higher education institutions contain comprehensive investment choice and performance metrics that endowments use as a benchmarking tool to compare themselves to their self-selected peer groups.
Related Literature

This paper lies in the intersection of the literature on investor behaviour, peer effects and networks, investment manager selection by institutions, and endowment investing.

Early literature on herding has shown that managers tend to “go with the flow” and invest similarly to other managers in their peer groups (Lakonishok et al. (1992), Maug and Naik (1995), Grinblatt et al. (1995), Hong et al. (2005)). Recently, Jiang and Verardo (2018) showed a negative relationship between herding behaviour and skill in mutual funds, while other papers have examined herding behaviour in different types of institutional investors (such as pension funds (Blake et al. (2017)) or passive funds (Fisch et al. (2018))) and markets (such as futures (Boyd et al. (2016)), bonds (Cai et al. (2019)), or global assets (Clare et al. (2016))). This literature examines herding in the selection of financial assets, while this paper is the first to address herding in the selection of external investment managers. This analysis becomes possible with my novel data on the external managers hired by a cross-section of endowments over an extended period.

Moreover, social learning and peer effects have gained increased attention in many areas of economics and finance and have been investigated in recent studies of firms, individual and institutional investors. Social networks play a significant role in identifying information transfers in the security markets (Cohen et al. (2008), Ozsoylev et al. (2014)), and peers can influence investor asset purchases due to social learning and social utility from owning the same assets (Bursztyn et al. (2014))3. Moreover, literature has shown that network centrality measures of venture capital firms and pension plans are positively related to investment performance (Hochberg et al. (2007), Rossi et al. (2018)), and that networks play a role in hiring board of directors members (Kuhnen (2009), Nguyen (2012)). In corporate policy, peer firms can influence critical decisions such as capital structure, financing, stock splits and provisions of earnings forecasts (Leary and Roberts (2014), Kaustia and Rantala (2015), Matsumoto et al. (2018))4. These studies suggest that peers play a critical role in strategic firm decisions, and exploring whether a similar pattern exists in institutional investor external manager selection is important.

With regards to manager selection and termination decisions in the institutional investor space, literature has shown that plan sponsors screen for managers that beat benchmarks but their selection does not generate excess returns (Heisler et al. (2007), Goyal and Wahal (2008), Cornell et al. (2017)). This paper examines manager selection including another decision-making factor, namely the behaviour of peer institutions.

Finally, the focus of this paper is university endowments, which operate in a highly competitive environment. The U.S. endowment model, often attributed to Yale University, is an investment approach relying on diversification, active management, equity orientation and illiquid assets (Chambers and Dimson (2015), Chambers and Dimson (2013), Chambers et al. (2015), Kaffe (2018)). Prior literature has commended endowment investment decisions, security selection and performance (Lerner et al. (2008), Lerner et al. (2007), Barber and Wang (2013)), while also suggesting that endowments adjust their asset

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3Papers on the commonalities of investment fund portfolios are also Antón and Polk (2014) and Getmansky et al. (2018).

4Other papers that fall into the social networks and peer effects literature are Hong et al. (2004), Gaspar and Massa (2011) and Kaustia and Knüpfer (2012).
allocations to catch up with competing institutions (Goetzmann and Oster (2012)).

All the above suggest that, among university endowments, external manager selection is an important strategic decision and make it reasonable to expect that peer effects play a critical role in manager hirings and firings. This paper provides evidence towards this.

Data

I employ a novel dataset of endowment external investment managers across all the main asset classes for each year over 1978-2008. The main source of endowment investment managers is NACUBO, which stopped including managers in their reports after 2008. I am able to infer all manager hiring and firing events each year from annual changes in the lists of managers employed. The network of university peers is identified through a study of U.S. universities and colleges conducted by the Chronicle of Higher Education in 2012, in which they were asked to name which institutions they considered to be their peers.

This data is supplemented by existing datasets on endowment characteristics (NACUBO) such as the market value of the endowment, asset allocation, and nominal returns of the portfolio\(^5\). Moreover, I source university characteristics such as location, Carnegie Classification, age, income and assets from IPEDS\(^6\), and separate account investment manager characteristics from PSN Enterprise, Broadridge Marketplace, and Nelson’s Directory of Investment Managers.

The final sample consists of 1,386 institutions employing around 5,800 external investment managers spanning various asset class categories (equities, bonds, alternative assets, real estate, cash and sub-categories of all the above) over 30 years.

Peer Effects in External Manager Selection

I explore peer effects in manager appointments using three different specifications.

First, I show that similarities in endowment characteristics between pairs of endowments can explain commonalities in manager appointments. I find that the scaled number of common managers per endowment pair is determined by their characteristic “distances”. In other words, the more similar the endowments are (especially in terms of Carnegie Classification, location and market value) the more likely they are to hire the same managers.

Second, I find that endowments are more likely to hire and fire managers if their peers hired or fired managers with greater frequency. Poisson regressions show that a higher average number of past hirings and firings by peers has a positive effect on the number of manager hiring and firing events by an endowment during the following year\(^7\). In separate regressions, the number of manager hiring and firing events also rises when peer endowments are hiring or firing more managers on average than the whole sample of institutions (isolating the differential effect of peer decisions from the general trend)\(^8\).

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\(^5\)A more detailed description of this part of the NACUBO data is provided by Brown et al. (2010). The NACUBO data are not backfilled and are virtually free of survivorship bias, as discussed in Barber and Wang (2013).

\(^6\)Integrated Postsecondary Education Data System, data submitted to the National Center for Education Statistics (NCES) and available since 1984.

\(^7\)Examples of studies that have used Poisson regressions to model count data include Lerner (1995), Hermalin and Weisbach (1988) and Yermack (1996).

\(^8\)Peer institutions on the baseline specification are identified through the Chronicle of Higher Education data. The robust-
Finally, I show that endowments respond faster to hiring and firing decisions of other endowments when their institutional characteristics are similar. Looking at the managers hired by two or more endowments, I track the time interval between pairs of endowments appointing the same manager and find that when differences in characteristics are smaller, the interval between appointments or terminations of the same manager is shorter. This shows that endowments track more closely the specific manager hiring and firing behaviour of endowments similar to them.

These results are preliminary and are open to alternative interpretations in a behavioural finance context. For example, the fact that endowments in the same location are more likely to hire the same manager may represent irrational herding. However, it might be entirely rational if the managers are also local to these endowments since it improves monitoring. This question can be addressed through further tests exploiting data on the geographic distance between managers and peer endowments. Lastly, the paper will also address the benefits or costs in following peers by examining whether this tendency produces greater average returns for endowments or not.

**Concluding Remarks**

This is the first paper to provide evidence that the behaviour of peer institutions plays a role in decisions of external investment manager appointments and terminations. Using unique data on university endowments, I show that endowments with similar characteristics are more likely to appoint the same external managers, that endowments follow peers in the frequency of external manager hiring and firing, and respond faster to the specific appointment and termination decisions of endowments in their peer groups. Overall, this study suggests that institutional investor herding effects are prevalent not only in decisions about their financial assets, but also in decisions about the investment managers of their portfolios.

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nness of the peer result is checked using a variety of other peer classifications based on university/endowment characteristics.
References


