

Fund managers' institutional background and the birth of investment management companies

Robert W. Faff
Monash University

Jerry T. Parwada
University of New South Wales

Joey W. Yang
University of Western Australia

Where do entrepreneurial fund managers come from?

Company Name	Number	Company Name	Number
Fidelity Investments	15	Batterymarch Financial Management	4
Bankers Trust	9	Clarica Life Insurance	4
Loomis Sayles & Co	8	Fox Asset Management	4
Delaware Investment Advisers (DIA)	7	Goldman Sachs	4
Meridian Investment Company	7	IDS Financial Corporation	4
Oppenheimer Management Corp	7	Invesco	4
Firststar Corp	6	John Hancock	4
Lazard Asset Management	6	Merrill Lynch	4
Stein Roe & Farnham	6	Merus Capital Management	4
TCW Asset Management	6	Morgan Stanley	4
The Boston Company	6	Munder Capital Management	4
Associated Bank	5	National City Corp	4
Barnett Capital Advisors	5	Provident National Bank	4
Canterbury Capital Services	5	Scudder, Stevens & Clark Inc	4
Janus Twenty	5	Stratton Management Company	4
Salomon Smith Barney	5	Strong/Corneliuson Capital Management	4
Standish, Ayer & Wood	5	T.Rowe Price Associates	4
Axe-Houghton Associates	4	Templeton Investment Counsel	4



Theory

- Employees have access to variable resources that can be expropriated and used to start their own firms (Rajan and Zingales (1998, 2001))
- Empirical support (Gompers, Lerner and Scharfstein (2005); Bhidé (2000))



Findings

- Characteristics of parent firms (size, reputation, strategic diversity) and market conditions matter for both the startup process and operations during firms' early life.
- On product strategies we find significant levels of common stock holdings between startups and their principals' previous employers explained by number of founders from the same parent and the size of the startup.



Hypotheses

- Null 1: Institutional background does not contribute to the emergence of entrepreneurs.
 - Alt 1.1: Firm size
 - Gompers, Lerner and Scharsftein (2005) – all sizes
 - Cooper (1985), Hvide (2005) - small firms
 - Fund industry – large, bureaucratic firms
 - Alt 1.2: Reputation
 - Audretsch and Stephan (1996) - founders and prior affiliations
 - Gompers Lerner and Scharfstein (2005) – growth profile and history of entrepreneurship
 - Alt 1.3: Strategic diversity
 - Lazear (2003 and 2004) – balanced skills
 - Hellman (2005) – multi-task incentives
 - Alt 1.4: Market conditions
 - Hellmann (2005) – entrepreneurial conditions
 - Banerjee and Newman (1993) etc – resource constraints



Hypotheses (contd)

- Null 2: A founder's institutional background has no bearing in a startup's time to market
 - Alt 2.1-2.4: size, reputation, strategic diversity, market conditions all matter
 - Alt 2.5: ties to parents matter
 - Networking (Gompers, Lerner and Scharfstein (2005))
 - Distance (Jaffe, Tratjenberg and Henderson (1993))



Hypotheses (contd)

- Null 3: Institutional background and parent ties should not influence commonality in stock holdings
 - Alt 3: Institutional factors matter



Data

- Hand collected data on entrepreneurs
 - Lexis-Nexis, Factiva and ABI-Inform
 - SEC's Form ADVs
 - Morningstar discs
 - Entrepreneur, startup, parent details (identities, tenure, dates, locations).
- Portfolio holdings data (CRSP and CDA Spectrum)
- Matching entrepreneurs and portfolio holdings data leaves us with 199 entrepreneurs 1980-2003
- *Institutional Investor* America's Top 300 Money Managers Surveys
- IPO market activity (Jay Ritter)



Variables

- Firm size
 - Assets under management (AUM) and asset growth
 - Number of funds (firm wide and by asset class)
- Reputation
 - Frequency of appearance in four *Institutional Investor* America's Top 300 Money Managers Surveys
 - Return track record (Characteristic Selectivity Measure)
- Strategic diversity
 - Index of a company's presence in four asset classes (Balanced, Growth/Income, Growth, Other) ranging from 0.25 to 1
- Market conditions
 - Returns on S&P 500
 - Federal Reserve money market rate
 - IPOs

Which firms produce startups?

Descriptive statistics

	Parent Firms	All Firms	
Mean Asset Size	17.556	15.277	***
Mean Asset Growth	0.236	0.931	
Mean Top Money Manager Profile	2.233	0.688	***
Mean Ln(1+No. of Balanced Funds)	0.630	0.169	***
Mean Ln(1+No. of Growth/Income Funds)	1.159	0.289	***
Mean Ln(1+No. of Growth Funds)	2.020	0.748	***
Mean Ln(1+No. of Other Funds)	1.309	0.754	***
Mean Focus	0.760	0.411	***
Mean Return Track Record	8.595	2.140	***



Regression analysis

- Pooled logistic and Poisson regressions
- Dependent variable is a 1,0 indicator of a firm that produces an entrepreneur
- Independent variables – motivated from theory

Results – Characteristics of firms spawning startups: H1 (Table 3)


Variable	Logisite Specification			Poisson Specification		
	Coefficient	Std. Error		Coefficient	Std. Error	
C	-13.266	2.94	***	-12.521	1.096	***
Asset Size	0.062	0.077		0.074	0.029	**
Asset Growth	-0.019	0.066		-0.019	0.026	
Top Money Manager Profile	0.162	0.058	***	0.144	0.022	***
Ln(1 + No. of Balanced Funds)	-0.4	0.227	*	-0.428	0.085	***
Ln(1 + No. of Growth/Income Funds)	0.572	0.179	***	0.457	0.067	***
Ln(1 + No. of Growth Funds)	0.496	0.158	***	0.416	0.059	***
Ln(1 + No. of Other Funds)	-0.067	0.126		-0.103	0.048	**
Diversity	1.931	0.582	***	2.158	0.215	***
Return Track Record	0.007	0.012		0.002	0.004	
Federal Interest Rate _t	0.039	0.104		0.011	0.039	
Federal Interest Rate _{t-1}	0.025	0.072		0.032	0.027	
Ln(No. of IPOs) _t	0.481	0.283	*	0.383	0.105	***
Ln(No. of IPOs) _{t-1}	0.481	0.271	*	0.402	0.101	***
Market Return _t	0.341	0.674		0.286	0.249	
Market Return _{t-1}	1.407	0.827	*	1.227	0.312	***
McFadden R ² /PseudoR ²	0.24			0.22		
-Log Likelihood	-574.74			-4083.8		

Results – institutional background and startup births (contd)

- Null of non-relevance of institutional characteristics rejected for size, reputation, strategic diversity and market conditions
- Notable insignificant coefficients
 - Asset growth
 - Return performance
- Robustness checks (Table 4 & 5)
 - Use number of entrepreneurs as dependent variable
 - Use number of funds as an alternative for size
 - Use size² to check for non-linear relations
 - Interaction of institutional background with market conditions

Institutional background and time to market – Empirical design

- Cox duration regressions
 - Dependent variable is time between startup date and the attainment of \$100 million in assets (per CDA/Spectrum institutional portfolio holdings).
 - Dependent variable is right censored (at the end of the analysis window).
 - Independent variables
 - Size, reputation, diversity and ties to parents (tenure; distance between startup and parent)
 - Controls – market variables



Institutional background and time to market – Results: H2 (Table 6)

Variable	Time to market
Asset Size	+
Asset Growth	-
Top Money Manager	□
No. of Balanced Funds	□
No. of Growth/Income Funds	+
No. of Growth Funds	-
No. of Other Funds	□
Strategic diversity	□
Return Track Record	□
Founders Ex-Same Parent	-
Years Service	□
Distance to Parent < 1km	-

Founders' background and strategic similarities with parents (H3)

- Tobit regressions with common stock holdings (Common Holdings) between parent and startup firms as the dependent variable.

- Common Holdings are measured as:

$$CommonHoldings(A, B) = \sum_i \min(X_{Ai}, X_{Bi})$$

- The sum of the minimum fraction of the portfolio held in any stock i between matched parent and startup firms, sampled at the end of the first year in which a startup reports significant assets under management to the Securities and Exchange Commission (SEC).
- Explanatory variables:
 - Founders Ex-Same Parent
 - Distance to Parent < 1km dummy
 - Years Service
 - Fincenter Top Money Manager Profile.
 - Total Assets

Determinants of common stock holdings (Table 8)

- Tobit regression results
 - #Founders from same parent +
 - Distance to parent < 1km -
 - Years service □
 - Top money manager -
 - Fincenter □
 - Parent size □
 - Startup size +



Conclusion

- We find that size, reputation, strategic diversity and market conditions matter for both the startup process and operations during firms' early life.
- Common stock holdings between parents and startups are high explained mostly by number of founders coming from the same parent firm and startup size.