Inside the minds of fund managers: exploring professional investor sense making through “close reading” of mutual fund annual reports

Arman Eshraghi∗ Richard Taffler#

Version 1.3: 6 April 2011

Abstract:

In this paper, we explore how fund managers, as a significant and representative group of professional investors, construct satisfying narratives and in particular stories, to help them “make sense” of their investment performance, and maintain belief in their investment processes in a highly uncertain, stressful and threatening environment. Through “close reading” a number of typical commentaries written by fund managers for their investors, we illustrate how they generically adjust their reporting styles based on prior investment outcomes. We argue that the way fund managers characterize events, use metaphors, attribute causality, manifest critical silences and express their emotions in these narratives are all part of their attempt to explain their added value to clients as well as their involvement with internal identity construction processes.

Initial presentation: Behavioral Finance Working Group Conference
Cass Business School, London
7 – 8 April 2011

∗ University of Edinburgh Business School, 29 Buccleuch Place, Edinburgh EH8 9JS, A.Eshraghi@ed.ac.uk
# Warwick Business School, Scarman Road, Coventry CV4 7AL Richard.Taffler@wbs.ac.uk (corresponding author). The views in the paper are solely the responsibility of the authors and all mistakes remain ours.
Inside the minds of fund managers: exploring professional investor psychology through “close reading” of mutual fund annual reports

1. Introduction

In its Dear Lucy column in the Financial Times (March 20, 2008) a 34 year old fund manager offered the following cri de coeur under the heading “I’m not motivated with my work”:

I have been a fund manager for 10 years…. The job is great: flexible and well paid. My problem is that I genuinely don’t believe it is possible to do this job – outperforming other fund managers and equity indices – with any consistency. I believe the industry is based on the lie that fund managers add value through skill, rather than luck. This makes it hard for me to keep motivated. Should I move – even though I can’t think of anything else I want to do – or should I accept the idea that work is not meant to be meaningful?

There were 79 responses on the associated Financial Times blog. Many were not very sympathetic. However the question struck a chord. It was quite clear that several of the respondents had similar feelings and concerns and were trying to find ways in which they, themselves, could make sense of their role.

Professional fund managers work under extreme pressure in a confusing and highly demanding environment. They are expected to outperform other equally able managers and their benchmarks on a consistent basis although being aware all the time, on one level, that this is not really possible. Underlying this task is the enormous complexity of the markets in which they operate and where there is ultimately little relationship between the decisions they make and the performance of their funds. In addition, there is great difficulty in deciding whether investment returns are due to skill or luck.

Conventional finance views fund managers in terms of “rational” actors in the marketplace using formal methods of asset valuation in an attempt to identify those stocks or other assets which may be mispriced, even though, on the other hand, markets are viewed traditionally as efficient. However, in contrast, the world of the real investment manager is one where she is swamped by information, is subject to acute information asymmetry, is under intense
competition, and, in the end, has to rely to a large extent on subjective judgement, intuition and “gut feeling”. Added to this are the many imponderables which are outside her control and may largely drive her investment performance. Ultimately, the professional fund manager is required to do a job which is very difficult if not impossible to do, and is under constant threat of dismissal if the returns she earns are not deemed satisfactory.

In this very preliminary paper we test the proposition that the way in which fund managers deal with their highly stressful, unpredictable and threatening environment is, as we all do, to construct satisfying narratives, and in particular stories, to help them make sense of what they are doing.

2. Sense making, narratives and stories

The thesis of this paper is that fund managers, in their reports to clients, seek to make sense of the uncertain and opaque world in which they operate through a constructed process of sense making using the medium of narrative, and in particular story. Sense making is an integral part of the fund manager’s search for meaning. It is “fundamentally tied to processes of individual identity generation and maintenance” (Brown, Stacey and Nandhakumar, 2008:1037). “Sense making is a search for plausibility and coherence that is reasonable and memorable, which embodies past experience and expectations, and maintains the self while resonating with others. It can be constructed retrospectively, yet used prospectively, and captures thoughts and emotions” (Brown et al., 2008:1038). It renders the subjective tangible. Sense-making is the process by which we mould our own identity in an ambiguous world and “tell” ourselves who we are. It is grounded in our constant struggle to construct our own identities. As the quote at the beginning of this paper points out, if we are unable to construct a desired identity, we don’t know who we are or why we are doing what we are doing!

As well as seeking to persuade their investors that their funds are being well and competently managed (Jameson, 2000), we suggest that the manner in which fund managers report on their performance is, also, part of the process by which they seek to make sense of the impenetrable world in which they are located. The way fund managers construct the cognitive schema they require to be able to do their job in the face of continued threats and reverses is by constructing narratives. As Brown et al. (2008:1036) point out, narrative “constitutes the basic organising principle of human cognition”. Sense making is a narrative
process where narrative is “the primary form by which human experience is made meaningful” (Polkinghorne, 1988:1).

Although many authors use the terms narrative and story synonymously, in line e.g., with Czarniawska (2004) we view “story” here as a sub-genre of narrative. Narratives, broadly defined, are texts, spoken or written, that usually involve a sequence of actions and events in a chronological and generally logically consistent manner. They involve temporal chains of interrelated events or actions, undertaken by characters (Gabriel, 2008:194). Narrative truth is fundamentally different from factual truth but nonetheless real in that narratives allow us to make sense of situations. More broadly, in terms of the accepted rather than contested nature of financial markets, market participants also make sense of the environment in which they collectively operate through “jointly negotiated” narratives. Narratives carry the market’s “common-sensical stock of knowledge” (Brown et al., 2008:1040).

Gabriel (2000:239) defines stories as “narratives with plots and characters, generating emotion in narrator and audience…. Story plots entail conflicts, predicaments, trials, coincidences and crises that call for choices, decisions, actions and interactions, whose actual outcomes are often at odds with the characters’ intentions and purposes.” The plot functions to transform a chronicle or sequence of events (a narrative) into a story knitting together the events so that we can recognise a deeper significance of an event in the light of other events (Gabriel, 2008:195). Stories are powerful devices for managing meaning and thus, potentially, an essential part of the fund manager’s sense making process. Through the medium of story the unexpected can be transformed into the “expectable”, and the fund manager can feel, on one level, the unmanageable future is “manageable”. Interestingly “…the truth of a story lies not in the facts, but in the meaning. If people believe a story, if the story grips them, whether events actually happened or not is irrelevant” (Gabriel, 2000:4). The key is its “plausibility” rather than its “accuracy”. Importantly, in stories “unpredictability” does not imply “inexplicability”.

We hypothesis in this paper that through the use of stories and the broader narratives of group sense-making fund managers are able to engage in the process of identity construction and make sense of their impenetrable work task in terms of their needs for self-esteem and purpose, i.e., who they are. Brown et al. (2008:1040), summarising the literature further, argue more generally that such activities can also be analysed using notions of “impression management” and “attributional egotism” (self-attribution bias). The former refers to the self-
presentation behaviours that individuals employ to influence the perceptions that others have of them, and the latter the tendency of individuals to attribute favourable outcomes to their own actions and unfavourable outcomes to external factors.

In this paper we provide a very preliminary analysis that seeks to test whether fund managers’ search for meaning in an environment where they are required to be exceptional but over which, ultimately, they have little control, can be explained through their use of story and narrative using the epistemology of close-reading (Amernic and Craig, 2009). We hold the belief that the language fund managers employ in explaining their performance “matters”, since their words are carefully chosen and often convey strategic intent.¹ We highlight the role of stories and narratives in this sense making process and, in the spirit of Tuckett (2011) and Tuckett and Taffler (2011) who report on the results of depth interviews with fund managers, describe how fund managers weave reason and emotion together in the reports they write to investors and, implicitly, themselves.

The approach used in our paper complements that of Jameson (2000) who also studies shareholder reports of mutual funds but focuses on the process by which fund managers engage with the readers of their reports and how they seek to manage the way in which the text is experienced. In addition, she studies funds whose total returns are high in absolute terms but low in relative terms. We, however, look at the full range of possibilities in terms of outperformance and underperformance relative to benchmarks and in absolute terms, and thereby distinguish four different types of commentaries written by fund managers. Importantly, we are directly concerned with how fund managers appear to be using their narratives not only to convince the reader that their investment in the fund is being appropriately and prudently managed, but particularly as a means of helping them make sense of their task and individual identity construction.

We also explain that the way fund managers describe their investment strategies and related processes ex post depends, to a large extent, on their prior investment outcomes, and this is an essential part of how they build their own desired self-image and confirm their beliefs in the rationale of their investment process even when their performance is disappointing. If the investment outcome is perceived as favourable i.e. the fund outperforms the market or its

¹ In their study of CEO-speak, Amernic, Joel, and Russel Craig, 2006. CEO-Speak: The language of corporate leadership (McGill-Queen's University Press). similarly argue that the words managers use “are not chosen in a perfunctory way to report some objective reality. Rather, the words and language are powerful and seductive rhetorical implements for fashioning outlook and opinion.”
benchmark, the manager takes credit for her investment strategies and (consciously or unconsciously) seeks to portray herself as the hero(ine) of the investment story. However, if things go wrong, the manager typically attempts to explain why the strategy is still right but external factors wrong-footed the underlying processes, and in doing so she depicts herself often as the unfair or undeserving victim of a tragedy type investment story.

3. Narratives and stories in business organizations

Stories are important elements of sense making in organizations, among internal and external stakeholders. As Boje (1991) points out, “people engage in a dynamic process of incremental refinement of their stories of new events as well as on-going reinterpretations of culturally sacred story lines.” He also explains that the storytelling activity is sometimes political since “part of the collective processing involves telling different versions of stories to different audiences.”

We make our entry into the rich literature of organizational storytelling by focussing on a generic framework for studying organizational narratives. This framework investigates three types of narrative coherence, namely, (1) argumentative-structural coherence which relates to the internal logic of the story being told, (2) material coherence which corresponds to the inclusion of all facts and counterarguments, and (3) characterological coherence which is concerned with the believability of the authors or the narrators. Shortcomings associated with either type of coherence may be a sign of bad writing or mental duress, but can also be interpreted in the context of impression management and/or self-serving attribution bias.

From another perspective, Gabriel (2000) studies narratives by focussing on their literary implements through differentiating rhetorical from poetic implements (or tropes). Under rhetorical implements, Gabriel lists metaphors, metonyms, synecdoches, and ironies, while under poetic implements; the author lists eight types of attribution, namely, attribution of motive, causal connections, responsibility, unity, fixed qualities, emotion, agency, and finally, attribution of providential significance. Gabriel points out that without these poetic implements, “no amount of symbolic, rhetorical, or narrative elaboration can be effective.”

---

2 Metaphor is a figure of speech in which an expression is used to refer to something that it does not literally denote in order to suggest a similarity. Metonymy is a figure of speech used in rhetoric in which a thing or concept is not called by its own name, but by the name of something intimately associated with that thing or concept. Synecdoche is a figure of speech by which a part of a thing is put for the whole, the whole for a part, the species for the genus, the genus for the species, or the name of the material for the thing made, and similar.
Further studies on close reading financial and accounting narratives include the methodological recommendations for analysing CEO communication proposed by joint authors Amernic and Craig. For example, Amernic and Craig (2006) explore the metaphors and persuasive language used by a number of well-known business leaders in their book titled CEO-speak and show that CEOs are often portrayed as heroes fighting the “wars of business” who are capable of astonishing miracles of financial performance and reinvention. In a methodological paper, Craig and Amernic (2009) recommend that any attempt on close reading CEO narratives should reveal (1) the metaphors used by, (2) the ideology adhered to, (3) the rhetoric implemented by the CEO as well as any (4) critical ‘silences’, (5) dichotomies and (6) false distinctions made by the executives. Amernic, Craig and Tourish (2010) add to this list (7) the CEO’s mindset and (8) his or her attitude to risk exposure and risk management.

While it can be argued that close reading fund manager narratives should be similar to investigating CEO communication, some distinctions need to be highlighted. Understanding these differences is helpful in comparing and contrasting the results of academic studies on these two related sets of textual data.

Firstly, it is important to recognize that fund managers operate in one industry, the investment industry, whereas corporate executives, operate in different industry sectors. Thus, compared to CEOs, one expects to find more homogeneity in the core stories, rhetorical dimensions, and the lexis used by fund managers in their narratives. This feature lends more validity to inter-sample comparisons of fund manager commentaries.

Secondly, fund managers typically invest in a wide range of securities in many different sectors, each with their own distinct features, resulting in a range of potentially different investment sub-stories. Therefore, arguably, the fund manager may be better positioned, compared to a corporate executive, to be able to engage in constructing a complex meta-narrative of several dimensions when reporting investment outcomes, and better equipped to make rationalizations, find scapegoats and engage in false attributions and dichotomies in case of poor performance. By engaging in this type of storytelling, the narrator can indeed represent accidental actions and events as necessary, thereby overestimating what Goffman (1974) describes as the “causal fabric of experience.”

Irony is a rhetorical device in which there is a sharp incongruity or discordance that goes beyond the simple and evident intention of words or actions.
4. Structure of the narrative data used in our study

We draw our evidence to support the above hypotheses from a pool of fund manager commentaries sourced from the SEC Edgar database. Our data includes mutual fund annual reports filed with SEC since 2003, the starting year for such mandatory disclosures. There are on average around 3000 mutual fund annual reports filed in each of the sample years. We select a 2% random sample of these funds for further manual analysis, excluding passive funds. Hence, the fund manager commentaries that drive our anecdotal evidence consist of 60 actively-managed US equity mutual funds.

The body of mutual fund annual reports filed in SEC Edgar typically consists of several sections, among which only the president’s letter and fund commentaries by individual fund managers contain non-quantitative information useful for the purposes of this study. Often, the president and the fund manager narrate different but complementary chapters of the investment story, which demonstrates the concept of contrasting narrators (Jameson, 2000). Since the individual fund managers are often solely responsible for making investment decisions, we believe the fund manager commentaries, compared to the president’s letter, are likely to provide more leverage in understanding any relation between the manager’s state of mind and past or future performance. Although the president’s letter can provide investors with a useful big picture of the investment company’s present circumstances, it is often too broad to be helpful for our study purposes. In contrast, the fund manager commentary is an information-rich section of the annual report which helps explain the past performance of the fund and portray its likely short-term and long-term future performance.

Fund manager commentaries often include sections on investment strategy, market environment, discussion past performance and the fund outlook. Although these sections of the commentary often follow each other to form a single narrative, sometimes, particularly in the face of underperformance, fund managers choose the sub-genre of question and answer to communicate to investors. In this format, the manager answers questions on a variety of issues often covering the above sections, which are then transcribed to form the commentary. An important feature of this narrative structure is the reduced distance between the narrator and the reader. As Jameson (2000) explains, the question-and-answer sub-genre invites the reader to imagine himself or herself as the interviewer posing the questions to the narrator, and also permits the narrator to use a more informal tone of voice. Therefore, employing this
sub-genre leads the reader to empathize with the narrator and possibly discount the subpar performance.

It is important to emphasize that not all fund manager commentaries contain stories; rather some are purely factual and mostly concerned with performance figures in a narrative format. This may not be surprising given the fact that the funds have to file these official disclosures with the SEC. We, as in Gabriel (2000), distinguish between descriptions that deal with facts-as-information, and stories that deal with facts-as-experience for both narrators and listeners. While in the former, the chronicler is committed to accuracy, in the latter, the storyteller is committed to effect.

5. Understanding how fund managers maintain conviction by close reading fund commentaries

Combining the notion of narrative coherence with the close reading procedure recommended by Craig and Amernic (2009), we propose that critical reading of fund manager communication should involve a search for the following themes:

1. Contextualisation of the narrative: fund characteristics, performance history, overall market conditions
2. Narrative’s structural-argumentative coherence: attribution of causality, evidence of self-serving attribution
3. Narrative’s material coherence: critical silences, dichotomies and false distinctions
4. Mindset and ideology of the narrator: attitude to risk and uncertainty, metaphors employed

The above themes may be more effectively explored when looked at in conjunction with the generic story types (or poetic modes) proposed by Gabriel (2000), i.e. Epic, Tragic, Comic and Romantic. Of these four, the epic and tragic modes adequately represent most of the stories fund managers narrate in our sample. The characteristics of each of these poetic modes are displayed in Table 1.
Table 1: Two unifying story themes extracted from Gabriel (2000)

<table>
<thead>
<tr>
<th></th>
<th>Epic</th>
<th>Tragic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Protagonist</strong></td>
<td>Hero</td>
<td>Non-deserving victim</td>
</tr>
<tr>
<td><strong>Other characters</strong></td>
<td>Rescue object, assistant, villain</td>
<td>Villain, supportive helper</td>
</tr>
<tr>
<td><strong>Plot focus</strong></td>
<td>Achievement, noble victory, success</td>
<td>Undeserved misfortune, trauma</td>
</tr>
<tr>
<td><strong>Predicament</strong></td>
<td>Contest, challenge, trial, test, mission, quest, sacrifice</td>
<td>Crime, accident, insult, injury, loss, mistake, repetition, misrecognition</td>
</tr>
<tr>
<td><strong>Poetic Tropes</strong></td>
<td>1. Agency</td>
<td>1. Malevolent fate</td>
</tr>
<tr>
<td></td>
<td>2. Motive</td>
<td>2. Blame</td>
</tr>
<tr>
<td></td>
<td>3. Credit</td>
<td>3. Unity</td>
</tr>
<tr>
<td></td>
<td>4. Fixed qualities (nobility, courage, loyalty, selflessness, honour, ambition)</td>
<td>4. Motive (to the villain)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5. Fixed qualities by juxtaposition</td>
</tr>
<tr>
<td><strong>Emotions</strong></td>
<td>Pride, admiration, nostalgia, (envy)</td>
<td>Sorrow, pity, fear, anger, pathos</td>
</tr>
</tbody>
</table>

Hence, we suggest a standard close reading procedure which provides the link between the fund’s prior performance and the story type used by the fund manager in her commentary. Depending on significant outperformance or underperformance relative to the fund’s benchmark and the underlying market conditions, four different scenarios can be explored using the two major themes, i.e. epic and tragic.

### 5.1. The epic unifying theme

The common feature of narratives with an epic unifying theme is that fund managers writing such commentaries often attempt to attribute positive investment performance to their own investment ability, skill or talent, while ignoring or downplaying the role of favourable conditions in the macro-environment. The fund manager’s critical silences can be identified by observing what significant information on external factors conducive to positive performance happen to be either completely “left out” from the investment story or downplayed in terms of importance.

Epic stories are mostly commonly observed among funds that have outperformed their (self-designated) benchmarks in the fiscal year of the annual report. Their narrative features,
however, differ slightly depending on the absolute value of fund returns. As such, upon close reading these narratives, one of the two checklists below can be used. The first checklist addresses narratives of funds that have outperformed their benchmarks in a favourable market (hereafter referred to as Type A commentaries) and the second checklist focuses on narratives of funds in an unfavourable market (hereafter referred to as Type B commentaries).

Figure 1: Outperformance in a favourable market (Type A)

| Has the fund outperformed its benchmark in a favourable market? (positive returns in absolute terms) |
| Look for evidence of self-serving attribution |
| Examples: Personal causal attribution and numerous occasions of self-reference |
| Look for critical silences by the fund manager |
| Examples: Silence on exogenous growth and favourable economy |
| Look for evidence on the fund manager's mindset and ideology |
| Examples: Description of risk attitude as healthy and timely |

Figure 2: Outperformance in an unfavourable market (Type B)

| Has the fund outperformed its benchmark in an unfavourable market? (negative returns in absolute terms) |
| Look for evidence of self-serving attribution |
| Examples: Personal causal attribution and numerous occasions of self-reference |
| Look for critical silences by the fund manager |
| Examples: Silence on poor stock selection, sector weighting, timing, etc. |
| Look for evidence on fund manager’s mindset and ideology |
| Examples: Description of risk attitude as healthy and timely, Using the market or economy metaphor (e.g. the market punished us) |
We now proceed with evidence from a number of fund manager commentaries that represent the epic unifying themes and implement the above checklists. The following example is from a large-cap equity mutual fund that has managed to outperform its benchmark in the fiscal year prior to the publication of the annual report (hence a Type A commentary):

Against the fund’s benchmark S&P 500’s return of 26.46%, Disciplined Equity rewarded investors with a strong 32.50% gain. This was also ahead of its Lipper peer group, as the Lipper Large Cap Core Index rose 28.15%. With our portfolio currently allocated across S&P 500 sectors, the positive results against the S&P 500 and the Lipper Index were largely a function of our stock selection,³ as we were able to concentrate the fund in stocks which showed relative strength above their broader sector... Our goal is to own the highest quality companies we can in each sector of the market, a judgment made on an array of business metrics that boil down to a combination of attractive valuation and the ability to produce consistent, predictable earnings going forward. In many cases, this means selling a stock and replacing it with another we feel has greater potential... The market slump in the first quarter of the year did trouble us to some extent [but] the strength of our stock picking was evident in our outperformance in all ten S&P 500 sectors... With strong sector by sector performance, our only weak spots were a handful of companies that underperformed over our course of ownership.

(Madison Mosaic Disciplined Equity, 2009)

The protagonist of this story is the fund’s management team (or fund manager) who supposedly delivered superior returns relative to their self-designated benchmark. The story can be characterised as being in the epic genre with the protagonist as hero. Inter alia, the plot revolves around the market slump in the first quarter which constitutes a challenge or trial, despite which the fund manager is able to outperform her benchmark, or achieve success or, implicitly, a noble victory through the agency of her ability and skill. What is communicated to the reader is the emotion of pride and implicitly an expectation of admiration for the achievement.

In terms of causal attributions and critical silences, while we do not wish to imply that the fund manager’s description of the factors contributing to the fund’s superior performance is deceitful, we point out that no reference whatsoever is made to the generally favourable investment environment of 2009 as demonstrated by an almost uniform rise in S&P 500. Therefore, we conclude that the narrator is exercising critical silence on exogenous factors (the first instance).

³ Bold fonts are added by the authors to highlight the key points.
Another *critical silence* by the fund manager is revealed by the choice of benchmarks against which the fund manager measures relative performance. In the 2007 commentary on the same fund, the same fund manager writes:

*We were quite pleased to show a positive return of 9.05% for the period, *nicely ahead of* our S&P 500 benchmark, which was up 5.49%. We slightly trailed our official Lipper peer group, as the Lipper Flexible Portfolio Fund Index advanced 9.57%. However, as we have evolved our fund towards a more fully invested, all-sector approach, *a truer comparison can be made with the Lipper Large-Cap Core Index*, which was up 6.63%. With our portfolio currently allocated across S&P 500 sectors, the positive results against the S&P 500 were *largely a function of our stock selection*, while members of the Lipper Flexible Index may have had greater exposure to higher-returning asset classes, such as government bonds and foreign stocks.*

(Madison Mosaic Disciplined Equity, 2007)

The 2007 commentary above displays the fund manager’s *satisfaction* with her performance and implicit expectation of *admiration* in the similar context of the *epic* genre. The fund manager proposes in 2007 that the Lipper Large-cap Core index is the appropriate benchmark for the fund. However, this benchmark is up 39.3% in 2009 and it appears that the manager strategically chooses not to mention this fact (the second instance of *critical silence*).

In addition, while the manager attributes most of the 2007 outperformance to stock-selection, she rules out a similar possibility for members of the Lipper Flexible index, who are supposedly riding “higher-returning asset classes.” Also interesting is that the fund manager uses precisely the same attribution phrase to refer to stock-selection in both years which provides anecdotal support for our hypothesis that the writing style employed in the commentary is, to a large extent, a function of performance outcome *ex post*.

In commentaries with an epic unifying theme, fund managers typically end their reports with positive, optimistic remarks. For example, this is how a growth-oriented fund manager described his outlook in 2006, just before experiencing a sharp decline in share prices:

*We believe the Fund’s growth holdings have *above-average growth prospects*. It is hard to imagine repeating the stellar gains of this fiscal year in the coming year, although we began 2006 with an expected earnings growth rate more than twice that of the S&P 500 Index. The valuation of the overall market appears reasonable after two years in which earnings grew faster than share prices.*

(Jennison 20/20 Focus Fund, 2006)
The following vignette is an example of a fund manager commentary where the fund has lost in absolute terms but still outperformed its benchmark (hence a Type B commentary).

_Even more positive_ was our relative performance in the market downturn of the full fiscal year ending June 30, 2009. While declining a significant 18.77%, we provided a _sizable cushion_ relative to our performance benchmarks - just at the time when it counted the most (from a risk perspective). The S&P 500 Index declined 26.21% for the fiscal year, and the Lipper Large-Cap Core Funds Index declined 25.69%. Primary reasons for this outperformance were: a) a _slight tailwind by way of company size_ on the way down, b) significant benefit from our “roughly equal weighted” indexing strategy, which performs particularly well in a precipitous market fall and recovery, c) a _flight to “blue chip” quality_ in the first three quarters of the fiscal year...

(Blue Chip 35 Index Fund, 2009)

In framing this paragraph as an _epic_ story, the fund manager starts by emphasizing that the fund has _achieved_ to outperform its benchmark, although in the negative domain. While the reader may expect some “matter-of-fact” explanation as to why the fund has experienced negative absolute returns, the fund manager is _critically silent_ on this issue. Instead, the reader’s attention is drawn by the fund manager to the “sizable cushion” she has provided against the loss in benchmark.

In terms of _causal attributions_, the use of such vague terms as “a slight tailwind” to convey an external attribution of performance renders the argument ambiguous and borderline meaningless. The description of “the roughly equal weighted indexing strategy” makes it appear as if the manager has some skill in divining the volatility at the time and that it was not a coincidence that the “strategy” succeeded under those market conditions. Their “flight” to blue chip stocks presumably in anticipation of adverse market conditions has the same implication.

The following example is derived from the annual report of a value-oriented fund that has outperformed its benchmarks in 2004 (Type A commentary):

_During the twelve months ended September 30, 2004, Artisan International Value Fund returned 32.81% outperforming both the MSCI EAFE and MSCI EAFE Value Indices. The Fund’s return was _driven by the strength of the team’s security selection_ [while] two consumer companies negatively influenced performance during the fiscal year... As we have written on a number of occasions, we are value investors and our sole focus is the purchase of shares in companies that are selling at a meaningful discount to our estimate of economic value. This process is a constant one and does not change based on any prevailing macroeconomic or stock market trend. Over time, we believe our success will be a function of how effectively we value companies, and how disciplined we are at buying them at a discount to fair value, and selling them when they approach fair value... We _invest in companies of all sizes based on valuation and company fundamentals_. We believe that smaller companies
outperformed large companies in the past year because their valuations were more depressed at the beginning of the year, exactly the reason for their presence in our portfolio.

(Artisan International Value Fund, 2004)

Here the fund manager embarks on a lengthy discussion of the fund’s investing processes and makes the usual personal attributions of causality which is a common feature of Type A commentaries. The fund manager proposes that her success is best measured by how well she performs a number of tasks associated with being a portfolio manager. This of course “makes sense” to the fund manager but does not necessarily translate to investment returns for the clients, a point on which she manifests a critical silence. It is also interesting how the same fund manager seeks to explain the fund’s underperformance relative to benchmark in the following fiscal year:

The most noticeable aspect of the equity markets during the second and third quarters of 2005 was the absence of investor conviction. Trading volumes were low, held down by both the normal summer trading doldrums and by the high level of economic and geopolitical uncertainty... The earnings of small companies are particularly vulnerable to shifts in economic conditions, and small-cap stock prices have historically reflected this vulnerability. Small caps were strong toward the end of 2004, and they became weak when investor sentiment changed. The July decline of growth stocks was particularly marked in the small-cap market. Despite a September surge by small-cap Internet stocks, the Russell 2500 Index (a broad small-cap index) was still negative at period-end.

(Artisan International Value Fund, 2005)

The fund manager portrays herself as the undeserving victim in the 2005 commentary, by focussing on the numerous challenges she has had to face in that year. Lack of investor conviction, the uncertainty in the environment and the “summer trading doldrums” all qualify for implicit villains of the story. The stark contrast between the two narratives in explaining the behaviour of small-cap stocks indicates how the fund manager has changed his investment story based on performance relative to the benchmark. We will explore this point in more detail in the following section.

5.2. The tragic unifying theme

In narratives with a tragic unifying theme, one often observes intricate causal attributions to associate the fund’s underperformance with external factors beyond the fund manager’s control. The fund manager’s critical silences can be identified by observing what significant information on internal factors contributing to poor relative performance happen to be either
completely “left out” from the investment story or downplayed in terms of importance. These often include references to excessive risk-taking or poor stock-selection, sector weighting and timing decisions.

The following is a typical example:

> It has not been an easy year to make money in the market. The war in Iraq, natural disasters, record gasoline and natural resource prices, and fears of inflation, recession, terrorism, etc., have largely offset the positive impact of strong earnings growth resulting in the choppy market we’ve endured for the past 2 years.4
> (Masters 100 Fund, 2006)

Narratives with a tragic unifying theme are most commonly observed among funds that have underperformed their benchmarks in the fiscal year of the annual report. We study two separate scenarios here similar to the case of outperformance and propose two close reading checklists. The checklist in Figure 3 focuses on narratives of funds that have underperformed their benchmarks in an unfavourable market (hereafter referred to as Type C commentaries).

---

4 This can be contrasted with very few instances where fund managers appear to take some responsibility for their decisions, albeit cautiously, as in the example below:

> The Fund’s higher relative weight in the industrial sector proved to be a headwind for performance and lagged the benchmark by approximately 100 basis points. The improvement in GDP during the year, which followed signs of increased industrial activity, did not translate to better stock price performance out of this group... We’ve either been wrong or just early on our industrial sector positioning. We will actively monitor signs of industrial activity and the earnings progress of each company and adjust the portfolio holdings accordingly.
> (Baird LargeCap Fund, 2009)
The checklist in Figure 4 focuses on narratives of underperforming funds in a favourable market (hereafter referred to as Type D commentaries). This type of narrative is relatively more complex since returns are ambiguous, among other reasons. Jameson (2000) explains that such narratives typically use a nonlinear structure, contrast narrators to dramatize ideas, embed various sub-genres, and complement verbal with visual discourse such that readers are led to participate in constructing the investment story. We add to this list a number of other observations. Type D commentaries share some elements of epic narratives, since the fund manager often happens to take credit for having delivered positive returns in absolute terms, and does sometimes portray herself as a hero in that context. Hence, as complex as it may sound, this type of commentary may be said to have a tragic-epic unifying theme.
<table>
<thead>
<tr>
<th>Has the fund underperformed its benchmark in a favourable market? (positive returns in absolute terms)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Look for evidence of self-serving attribution</td>
</tr>
<tr>
<td>Examples: Personal causal attribution explaining positive returns and external causal attribution justifying benchmark underperformance</td>
</tr>
<tr>
<td>Look for critical silences by the fund manager</td>
</tr>
<tr>
<td>Examples: Silence on poor stock selection decisions, sector weighting, timing, etc as well as exogenous factors</td>
</tr>
<tr>
<td>Look for evidence on the fund manager’s mindset and ideology</td>
</tr>
<tr>
<td>Examples: Using the market or economy metaphor (e.g. the market punished us)</td>
</tr>
</tbody>
</table>

Figure 4: Underperformance in a favourable market (Type D)

Reports with a tragic unifying theme tend to display numerous indirect or implicit mentions of performance detractors. Simple phrases such as “underperformance” or “poor performance” are often replaced by various euphemisms such as: “the fund faced a few clunkers”, “we had only a blemish on performance”, “our stock selection left something to be desired”, “the fund was caught up in some investments we rather like to forget”, “the fund experienced a slight headwind”, “the fund absorbed an opportunity cost”, etc. Using euphemisms, metaphors as well as colloquial (sometimes humorous) phrases in explaining poor performance can be interpreted in the sub-genre of tragic-comic stories, and often serves to confound or obfuscate the underlying bad news. The following is an example:

*Overall, despite a fair amount of interim short-term return volatility, U.S. stock prices “marked time” for the ten month period. Equities were buoyed by a number of factors (e.g., low interest rates, relatively constrained inflation, strong housing markets, generally strong corporate profits and balance sheets, continued productivity gains, generally improving labor markets), but also were buffeted by a variety of concerns (e.g., the war in Iraq and other geopolitical matters, higher oil prices, generally subdued capital spending) that tended to gain the upper hand in terms of investor sentiment.*

(Enterprise Capital Appreciation Fund, 2004)

The above paragraph has a sentence with 69 words and a Flesch-Kincaid Reading Ease score of 24 which falls in the 0.0-30.0 score range of texts best understood by university graduates (for comparison purposes, the *Harvard Law Review* has a general readability score in the low 30s, which means it is still relatively easier to read than the above passage).
Another common feature of commentaries with a tragic unifying theme is the slow and careful development of the plot. As opposed to epic commentaries where the good news of outperformance is immediately broken to the readers, in the tragic scenario the fund manager often sets the scene for the bad news after a long and detailed description of the disastrous environment in which the fund operated and the predicaments it faced. The actual bad news can be hidden among plenty of other potentially confusing information, as can be seen in the following example:

Uncertainty in both equity and fixed income markets dominated this year. Volatility, which was slightly bolstered at the end of 2007, soared to unimaginable heights through the 3rd quarter of 2008. This environment was due to a confluence of decelerating global growth, energy and commodity price inflation and ongoing credit turmoil. While energy and commodity prices have retracted from speculative levels, credit problems and recessionary pressures persist...

Major U.S. equity indices declined more than 35% for the twelve months ended October 31, 2008. The S&P 500 Total Return Index was down -36.09%, the Russell 3000® Index down -36.60%, the NASDAQ Composite down -39.81%, and international markets fared worse, with the Morgan Stanley Capital International (MSCI) All Country World Index ex U.S. returning -48.53%. By contrast, bond indices were barely positive, with the 12-month return of the Barclays Capital Aggregate Bond Index at 0.30% and the Merrill Lynch U.S. Corporate, Government and Mortgage Index up 0.70%.

All four Pro-Blend Series continue to outperform over the current stock market cycle with solid absolute returns for long term investors. However, the one-year performance results versus the market and benchmarks were mixed for the year ended October 31, 2008 with the Pro-Blend Conservative Term Series and the Pro-Blend Maximum Term Series holding up slightly better than their blended benchmarks and the Pro-Blend Moderate Term Series and Extended Term Series underperforming...

(Pro-Blend Series, 2008)

Notice that only in the third paragraph and after a lengthy discussion of the how different benchmarks indices have performed is something written about the actual funds in question. No matter how negative and sometimes frightening a description fund managers provide of their operating environment in the face of poor performance, they typically end their narrative with a note of optimism or at least no major concern for the future. This is how the same fund manager ended his commentary in the immediately preceding fiscal year:

While volatility can be difficult to endure, it also provides investment opportunities for those who maintain a disciplined individual security selection process. Our bottom-up process, focused on longer-term trends, solid fundamental analysis, and time-tested investment strategies, is well suited to this type of environment.

(Pro-Blend Series, 2007)
The paragraph below is how a fund manager ended his 2006 commentary. In 2007, however, the fund suffered from a negative performance of -4.52% compared to a 7.72% rise in its benchmark, the S&P 500 index:

After three years of watching the companies in our portfolio grow earnings at double digit rates, but with little or no return to shareholders, it is refreshing to see the Fund beginning to perform better. In fact, we believe that we are entering a “catch up” period where our holdings should outperform both their respective fundamentals and the S&P 500 Index. Because of this, we look forward to the next year with optimism and continue to appreciate your support of our strategy through your holdings in the Fund.

(Thompson Plumb Growth Fund, 2006)

In framing her story in the tragic genre, the fund manager of the above fund appeals to the emotions of the clients in the hope of maintaining their trust in the fund. The manifestation of pathos is a characteristic feature of stories with a tragic unifying theme.

The following is an example of a fund that has outperformed one benchmark and underperformed another. In this example, the fund manager labels the 0.88% outperformance compared to the primary benchmark “quite an accomplishment”, and blames the size “headwind” for the lower performance relative to the fund’s peer benchmark.

For the six months ending June 30, 2009, our Fund appreciated 4.04%, beating our primary market benchmark - quite an accomplishment in a market dominated by small- and mid-size stocks - but lagging our peer benchmark. The S&P 500 Index rose 3.16%, and the Lipper Large-Cap Core Funds Index rose 5.35%. Considering we had a “headwind” of almost two percentage points due to the size of our holdings versus our primary market benchmark, we are quite pleased.

(Blue Chip 35 Index Fund, 2009)

The self-admiration expressed in this vignette is a characteristic emotion associated with such commentaries. The “sailing” and “flying” metaphors employed here are commonly used by fund managers to describe their investment strategies in their commentaries. This may signal an unconscious need on the part of the fund manager to believe in “the ability to control and change direction” in what is essentially a highly unpredictable environment.

The following excerpt is another example of a fund underperforming its benchmark in a favourable market (a Type D commentary). The narrative is interesting due to subtle critical silences of the fund manager:

For the 12 months ended October 31, 2009, the S&P 500 Index finished with a return of 9.80% while the average large-cap blend fund monitored by Morningstar, Inc. recorded an average 11.86% result... In the same 12-month period, John Hancock Sovereign Investors Fund’s Class A shares returned 8.75% at net asset value. During the market’s declining phases, the Fund outperformed its benchmark, as investors were on the defensive and focused on the kind of mega-cap, high-quality, dividend-paying stocks the Fund typically owns. However, the Fund lost ground versus the benchmark when share prices turned higher and
investors adopted a more speculative approach, favoring lower-quality names with smaller capitalizations. (Sovereign Investor’s Fund, 2009)

In terms of causal attributions, the fund manager starts by focusing on the period during the prior year when the fund was outperforming its benchmark but stops short of attributing this event to their superior stock selection. Rather, she portrays the fund as almost having a mind of its own that chooses to “typically own” certain stock. This defensive explanation is subsequently used the next statement to help the fund manager avoid taking responsibility when the market changes to a more speculative mode. Therefore, the critical silence by the manager is on the actual reasons leading to the fund’s underperformance, possibly including poor decisions on stock selection, sector weighting, timing, etc.

In seeking to explain underperformance and (consciously or unconsciously) obfuscating bad news, fund managers sometimes draw the readers’ attention to the fund’s performance potentials in the long term, which of course is an ambiguous phrase with no commonly-agreed definition:

The fiscal year was truly a tale of two markets. During the first four months of the fiscal year, equity markets experienced steep declines as severe problems in the credit markets, a rapidly weakening housing market, rising energy and food prices and a deteriorating outlook for corporate earnings led to a global economic recession. However, equity markets rapidly reversed direction beginning in March 2009 and rallied solidly through most of the remaining months in the fiscal year.

However, the Fund began to underperform the Russell 1000 Growth Index when equity markets hit a bottom and began to rebound in March 2009. It is important to note that while our investment process may temporarily underperform our peers at market inflection points, our goal is to outperform over a full market cycle. (AIM Large Cap Growth Fund, 2009)

The fund (manager) is again portrayed as the undeserving victim in this story, and the villain is supposedly the market with all its underlying uncertainty. Although the overall performance of the fund lags its benchmark, the dichotomy used by the fund manager to split the fund’s performance in two separate sub-narratives aids the reader in discounting the inferior performance. This phenomenon is explained by the mental splitting which occurs when subjects simultaneously analyse two pieces of contradictory information. Similarly, in the following Type D vignette, the fund manager is faced with the problem of justifying underperformance relative to benchmark:
The financial statements that make up the Annual Report give us an opportunity to review what has happened and gain some insight into what may happen. For the twelve months ending September 30th 2006, the Growth & Income Fund was up 5.40%. This was below the S&P 500 Index which was up 10.79%. Although the return for the last year was below average, a review of the last three years shows the Growth & Income Fund to be competitive, up an average of 11.26% per year. This compares with the Dow Jones and S&P 500 which had annual average returns of 10.02% and 12.30% respectively over the last three years.

It is always a tug-of-war in the securities markets with the negative forces of geopolitical events, natural disasters and corporate corruption pushing securities down. This is countered by man’s desire to grow, achieve, and innovate. The good news is that in the long run, the positives have prevailed... Our investment story has been, and continues to be, that the negatives are more than offset by a strong US economy and record corporate profits. Our optimistic investment outlook goes beyond the US border...

(Elite Growth & Income Fund, 2006)

The above fund manager avoids having to explain the fund’s underperformance by engaging in another dichotomy, this time between the fund’s prior one-year and the prior three-year record. The villains of the story are again the uncontrollable market forces which one can always blame for anything that has gone wrong. The fund manager also employs the “fighting” metaphor to stress the role of external factors. In the last paragraph, the fund manager takes on the mantle of a teacher explaining to the reader how securities markets generally operate, prior to ending the narrative with a rather uncalled-for and prophetic note of optimism.

Conclusion

In this paper, we used an adapted method for close reading fund manager commentaries to demonstrate that fund managers often engage in telling “stories” to their clients in order to help construct their identity, justify their added value and cope with the enormous pressures of a highly unpredictable and stressful working environment. In addition, fund managers use the medium of narrative, and in particular story, to make sense of the opaque world in which they operate through a constructed process of sense making. This process is an indelible part of the fund manager’s search for meaning.

A common set of unifying themes i.e. epic and tragic as well as a number of sub-themes motivate the stories that fund managers essentially narrate in their commentaries. Fund managers adjust, both consciously and unconsciously, the theme of the investment story, elements of the plot, critical silences, the tone of voice used, the readability of their
narratives, the level of obfuscation and other narrative features ex post depending on their investment outcomes. In this way, the stories and meta-narratives embedded in fund commentaries help fund managers explain what they do, both to themselves and to their clients, and maintain conviction in their performance and processes against the backdrop of a very uncertain macro-environment.

References