More Evidence Supports Manager Ownership

by David Kathman

When it comes to renting versus owning, conventional wisdom holds owners in higher regard. Condominium associations often prohibit owners from renting out their units, presumably because owners care for their condos better than renters. Many drivers put their rental cars through paces that they wouldn't dare with the family sedan. And countless rock bands have trashed hotel rooms during here-today-gone-tomorrow tours.

Morningstar has wondered whether that pro-owner conventional wisdom holds for mutual funds. It stands to reason that managers who invest in the funds they run show conviction in their strategies and are more likely to act in the long-term interests of shareholders. In a new study of manager ownership data, we've found support for this idea--core stock and bond funds whose managers have skin in the game have outperformed those whose managers don't invest in their funds.

Crunching the Numbers, Again

Morningstar has been studying whether managers invest in their funds since 2004 when we first rolled out our Stewardship Grades for mutual funds. At first we had to rely on fund companies to disclose this information voluntarily, but since 2005 the SEC has required all funds to disclose manager ownership of fund shares in their annual Statements of Additional Information in seven ranges: zero; $1 to $10,000; $10,000 to $50,000; $50,000 to $100,000; $100,000 to $500,000; $500,000 to $1 million; and more than $1 million.

This manager-ownership disclosure has provided a wealth of information, but making sense of it all is not an easy task. Back in 2008, Russ Kinnel, Morningstar's director of mutual fund research, took a preliminary look at the data, finding that a large percentage of managers had no reported investment in their funds and that the average manager investment in Morningstar's Fund Analyst Picks was much higher than in the Fund Analyst Pans. In a 2009 study for Morningstar FundInvestor, Morningstar found that funds with substantial manager ownership ($1 million or more) had significantly better five-year returns relative to their categories than funds with no manager ownership.PAGEBREAK

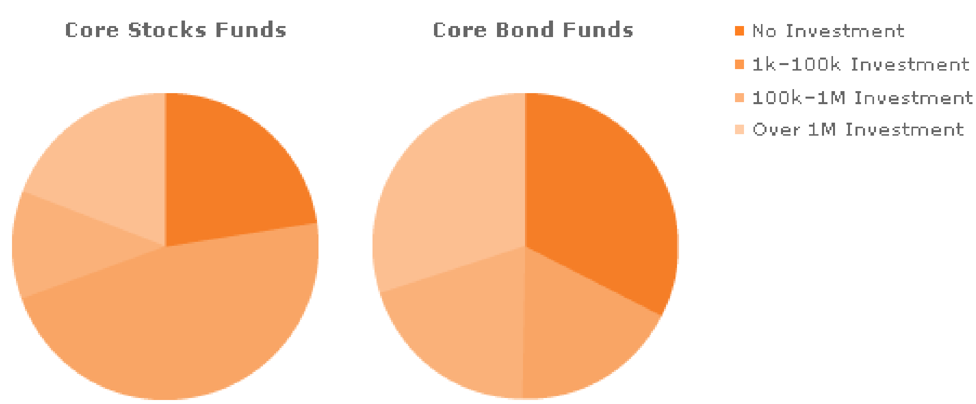
In the latest study, Morningstar took the most recent fund manager ownership data and looked at how it correlates to various other data points. This time we focused on core fund categories, excluding sector funds and similarly nondiversified groups.

Who Has Skin in the Game?

Back in 2008, 46% of U.S. stock funds and 65% of taxable-bond funds reported no manager ownership. The 2010 results were very similar, with 45% of core stock funds and

66% of core bond funds having no manager ownership. However, things look a little better if we measure the percentage of fund assets with manager ownership, rather than the number of funds. The following pie charts show the amount of total assets in each ownership range for core stock and core bond funds. For simplicity's sake, the seven bands are consolidated into four: zero; $1 to $100,000; $100,000 to $1 million; and more than $1 million.

Total Assets by Ownership Level



Source: Direct

While 45% of core stock funds have no manager investment, only 23% of core stock fund assets are in funds with no manager investment. And while only 13% of core stock funds have at least one manager with $1 million invested, 47% of core stock fund assets are in such funds. This reflects the fact that lots of small funds don't report any manager investment, while many of the biggest funds, such as American Funds Growth Fund of America AGTHX, have managers with substantial skin in the game.

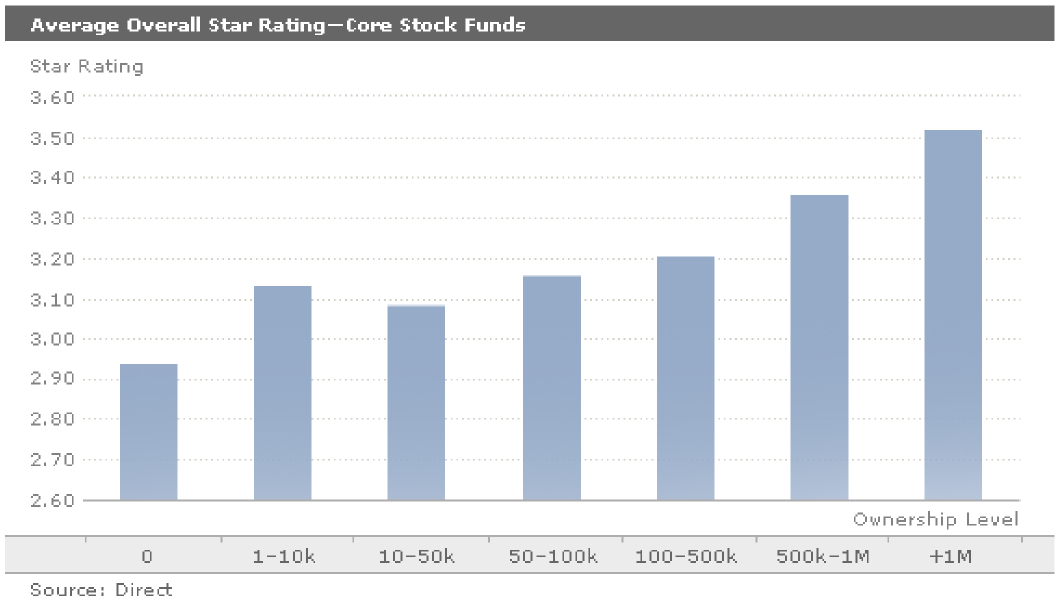
The pattern is similar with core bond funds. While 66% of these funds have no manager ownership, only 33% of core bond assets are in such funds. Only 3% of core bond funds have at least one manager with more than $1 million invested, but 30% of core bond assets are in such funds.

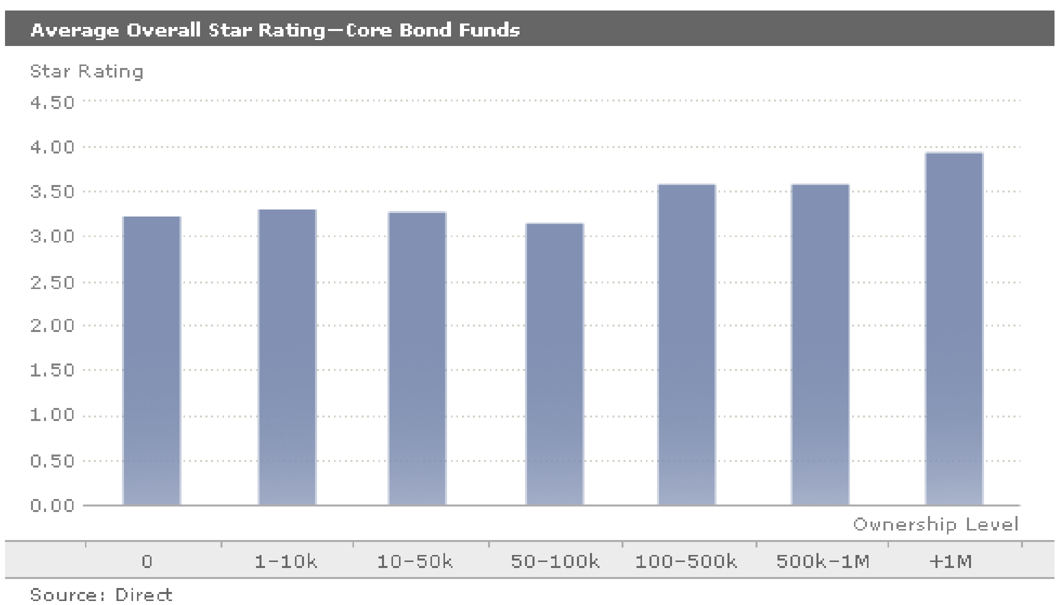
Owned Funds Have Outperformed

Morningstar also looked to see whether high manager investment is correlated with better fund performance.

For this purpose, we measured funds' performance in terms of category percentile rankings and star ratings rather than raw returns, which are difficult to compare across different fund categories. For example, the average three-year percentile ranking of core stock funds with zero manager ownership is 50, right around the category median, while those in the $1 million-plus band have an average three-year ranking of 38--significantly better than the median.

It's a similar story with the Morningstar Rating for funds, which measure a fund's risk-adjusted returns relative to its category. The charts below show the average overall star ratings for the funds in each of the seven manager ownership investment bands, for core stock funds and core bond funds.





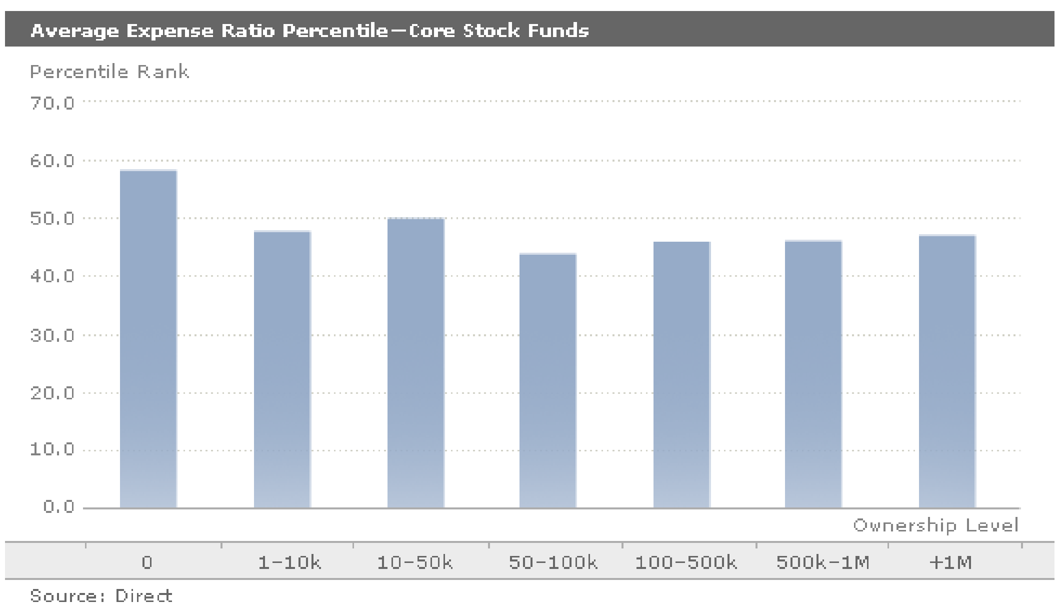
The chart for core stock funds is especially striking. Here, the average fund with no manager investment has 2.93 stars, and that number rises steadily until the group with ownership greater than $1 million, which has an average star rating of 3.51. Core bond funds show a similar trend: The average fund with no manager investment has 3.20 stars, and the average fund with more than $1 million in manager ownership has 3.90 stars.

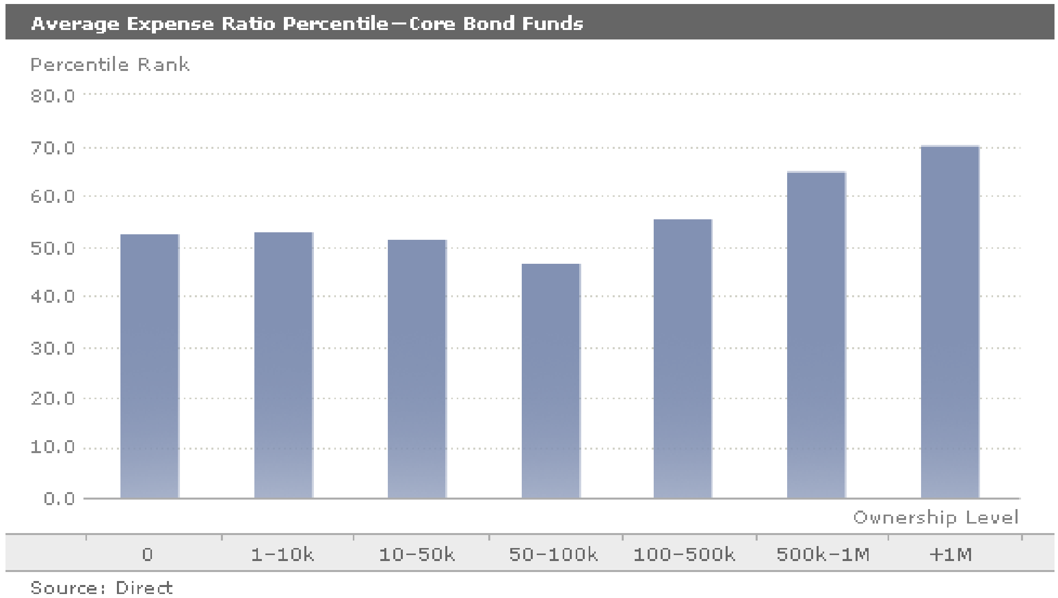
This data is compelling, but it's important to recognize that correlation isn't the same as causation. It may be the case that high manager investment contributes to better fund performance, but it also might be that managers invest more in funds that already have good track records. In the absence of fuller historical data, it's hard to determine cause and effect, and unfortunately the data doesn't go back far enough to provide meaningful conclusions.

Time to Build a Nest Egg

Interestingly, Morningstar also found a significant positive correlation between manager investment and manager tenure. Among core stock funds with no manager investment, the average manager tenure is 4.7 years, but among core stock funds whose managers have invested more than $1 million, the average tenure is 12.1 years. Here, too, it's tough to say anything about causation; longer-tenured managers tend to have more money invested in their funds, but this may be simply because they've had more time to invest.

Finally, Morningstar looked at the relationship between manager investment and fund costs, the idea being that cheaper funds are more likely to attract managers' dollars. In order to compare funds across categories, we looked not at raw expense ratios, but at the percentile rank of each fund within its broad category group, where a lower number represents a higher ranking (and thus a cheaper fund). The following charts show the average expense ratio percentile rankings for funds in each of the seven ownership bands for core stock and core bond funds.





The results are a little surprising. Among core stock funds, those with no manager investment are more expensive in relative terms than the other groups, but after that there's not a whole lot of difference among the various ownership bands. Among core bond funds, there's actually a modest negative correlation between manager investment and expenses; the most expensive group is the one with more than $1 million in manager ownership, and the least expensive is the $50,000 to $100,000 band. There's no obvious reason why this is so, but it's worth noting that there are only 25 core bond funds in the $1 million-plus group, and this small sample happens to include several relatively pricey funds. Regardless of the reason, it looks as though price is not a particularly important driver in determining how much money managers invest in their own funds.

Want to find out if your fund's manager has skin in the game? Morningstar.com users can enter their fund's ticker, go to the fund's main page, then click on the Filings tab in the upper right to find the fund's Statement of Additional Information, or SAI. This document, filed annually with the SEC, contains ownership data on each manager named to a fund. For subscribers to Morningstar Office and Direct, the manager ownership data associated with each fund is available in a spreadsheet view.

David Kathman and Kailin Liu collaborated on this study.

Adapted from an article published by MorningstarAdvisor.com on 01-11-11.

Disclosure for Morningstar article, "More Evidence Supports Manager Ownership"

For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.)

Fund Morningstar rankings and ratings discussed in this article were as of 12/31/10.