

Do Managers Eat Their Own Cooking?

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A key piece of the mutual fund puzzle has fallen into place.

A couple of years ago the SEC started requiring that funds disclose how much each fund manager invested in his or her fund. Right away I saw confirmation in my belief that manager ownership was a signal of managers' commitment to fundholders as well as their faith in the funds they ran.

While the trend was clear, I didn't have a way to quantify it until now. Morningstar has gathered manager ownership information about each and every U.S.-run mutual fund in its database. The data allow us to take a more comprehensive look at how much managers invest in their funds in different asset classes. This gives us a benchmark for judging whether a manager has greater conviction in his/her fund than his/her peers. Next month, I'll examine how manager ownership syncs up with other key mutual fund data.

I've also gathered data on all of the Morningstar 500 funds in one place so you can quickly find out not only how your funds' managers are doing but also the managers of funds that you are considering buying. To see the whole list, go to www.mfi.morningstar.com.

How Ownership Is Disclosed

The disclosure rules say that managers must disclose ownership in the following ranges: 0, \$1–\$10,000, \$10,001–\$50,000, \$50,001–\$100,000, \$100,001–\$500,000, \$500,001–\$1 million and over \$1 million. Each manager on a fund must disclose his/her investment, so you have multiple investment amounts for every fund with more than one manager. We looked at the largest amount that any manager in the fund had; second, we assigned a median to a manager's investment range and then averaged that. So, if one fund manager was between \$10,001 and \$50,000 and another was

between \$500,000 and \$1 million, the average of the midpoints is \$387,500.

A note on manager pay. At major fund companies, total compensation above \$1 million a year is common though the most junior of managers are likely below that. In fact, during the timing scandal it emerged that one of the Putnam managers who timed his own fund had taken in over \$14 million in pay that year. Thus, the \$1 million top level isn't that challenging a hurdle but it does indicate the manager really believes in his strategy.

Managers Hate Their Own Cooking

Looking at the data, the figures that jump off the page are those where no one invested a dime. At U.S.-stock funds, 47% report no manager ownership. And it gets worse from there. Fully 61% of foreign-stock funds have no ownership, 66% of taxable bond funds have no ownership, 71% of balanced funds put up goose eggs, and 80% of muni funds lack ownership.

There are really only two excuses for not owning a fund you run. First, if you run a single-state municipal-bond fund for a state other than the one you live in, it doesn't make sense to own that fund as you won't benefit from the tax breaks. Also, managers who are citizens of foreign countries have a good excuse if their country bars investment in U.S.-domiciled funds. A number of foreign-stock funds are run by foreign citizens and that may account for the 4 percentage point difference between U.S.-stock funds and international-stock funds.

For managers who run niche funds or run a lot of funds, there's good reason for them to be at the lower end of the ranges, but not at zero.

The number of managers showing no faith in their process is staggering. With the two exceptions I spelled out, I can't think of why anyone should invest in a fund that its own manager doesn't invest in. True, higher investment levels aren't a guarantee of success or an ethical manager but at least they show that managers believe in the funds and they pay some of the costs and taxes that the rest of shareholders do.

What Should You Demand?

I've argued investors should buy funds with expense ratios in the cheapest quintile of their category.

So, how much would a fund manager need to invest to be among the top 20% of his asset class? The answer varies.

Among domestic-equity funds, the top two investment levels account for 16% of funds and the third one is an additional 17%. So, that means if the manager with the highest investment in his/her fund has \$100,001 or more invested, the fund places in the top third of domestic equity funds. For core funds such as large-cap value, blend, and growth, I'd round that up to the \$500,000 level but accept something north of \$100,000 for sector and other niche funds.

Internationally, you have to go down to the \$100,001 to \$500,000 range to capture the top quintile, and that seems reasonable to me.

For balanced funds you have to go all the way down to the \$50,001 to \$100,000 bucket just to get the top quintile. This may be skewed a bit by target-date funds where managers run 10 or so funds with different target-date funds. So, I'd say give the target-date funds a pass on any ownership in your particular target-date fund but others in the balanced group such as moderate allocation should be expected to invest over \$100,000.

In taxable bonds, funds where the top investing manager has more than \$50,001 account for 18% of the group and that seems like a decent standard.

Unlike muni funds there really isn't an excuse for a taxable bond fund manager to have nothing in his fund.

Sadly, for munis just having \$5 in their fund takes muni managers to the top quintile. I'm not going to blame a Pennsylvania-based Vanguard manager for not investing in Vanguard California Long-Term Tax-Exempt, so consider manager investment in a single-state fund a plus but not a prerequisite. For national funds, I'd like to see some investment.

Looking at Our Picks and Pans

We're not the only ones who have more conviction in our Fund Analyst Picks than our Fund Analyst Pans. Assuming the midpoint of each range, we found an average investment of \$354,000 for our Fund Analyst Picks compared with \$52,000 for our average pan. That's a factor of nearly seven.

If we exclude areas where managers have good excuses, such as target-date, single-state muni, and index funds, the average pick investment pops up to \$431,000. That illustrates the conviction we look for as well as the alignment of interests with shareholders. Is it an accident that managers are reluctant to invest in the pans, which suffer from some combination of high costs, poor strategy, shaky management, and disappointing stewardship?

The median pick has an average of \$430,000 invested by each manager. It happens that that particular mutual fund is **American Funds Income Fund of America** AMECX. The fund has nine managers—meaning that you have something like \$3.6 million

Manager Investment Breakdown

Level of Ownership	Domestic Equity		Intl Equity		Balanced		Taxable Bond		Municipal Bond	
	# of Funds	%	# of Funds	%	# of Funds	%	# of Funds	%	# of Funds	%
≥ 1,000,000	349	12	70	9	38	5	31	3	4	1
500,001–1,000,000	130	4	18	2	12	2	7	1	5	1
100,001–500,000	498	17	98	13	77	11	86	9	18	3
50,001–100,000	211	7	41	6	29	4	61	6	14	3
10,001–50,000	265	9	44	6	38	5	99	10	25	4
1–10,000	92	2	21	3	11	2	44	5	46	8
0	1350	47	450	61	514	71	639	66	447	80
Total # of Funds	2895		742		719		967		559	

Data based on highest ownership level of any manager.

Funds Where All Managers Invest More Than \$1 Million

Allianz RCM Tech DRGTX	Davis New York Venture NYVTX	Oakmark OAKMX	Third Avenue International Value TAVIX
Artisan International ARTIX	Fidelity Dividend Growth FDGFX	Oakmark Global OAKGX	Third Avenue Real Estate TAREX
Artisan International Small Cap ARTJX	FPA Capital FPPTX	Oakmark Select OAKLX	Third Avenue Small Company TASCX
Artisan International Value ARTKX	Harbor Capital Appreciation HACAX	Oppenheimer Global OPPAX	Vanguard Health Care VGHGX
Aston/Montag & Caldwell Growth MCGFX	Harbor International HAINX	Royce Special RYSEX	Vanguard Wellesley Income VWINX
Bogle Small Cap Growth BOGLX	Mainstay ICAP International ICEUX	Selected American SLADX	Vanguard Wellington VWELX
Calamos Growth & Income CVTRX	Mainstay ICAP Select ICSLX	T. Rowe Price Equity Income PRFDX	Wasatch Small Cap Growth WAAEX
Clipper CFIMX	Northeast Investors NTHSX	T. Rowe Price Global PRGSX	Weitz Hickory WEHIX

invested and almost certainly more than that as two top out at more than \$1 million. Conversely, the median pan has \$0 invested.

Thirty-two of our picks could claim that all of their managers have at least \$1 million invested including our newest Fund Analyst Pick Wasatch Small Cap Growth where Jeff Cardon has more than \$1 million invested. See the table for details.

Among niche fund picks, there were some disappointments. The managers of **T. Rowe Price New Asia** PRASX and **Blackrock Global Resources** SSGRX don't own their funds.

Are Managers Following the Crowd?

Since funds with big inflows and outflows were the subject of last month's cover story, let's take a look at whether the managers share fund investors' convictions. At the 10 funds with the biggest inflows, investment by managers was quite heavy with two exceptions. **Fidelity 100 Index**'s FOHIX manager had no direct investment in the fund. However, that's acceptable as the fund can only be held indirectly through target date-funds. Michael Avery and Daniel Vrabic don't own shares of hot-selling **Ivy Asset Strategy** WASAX, but they do invest in the clone **Waddell & Reed Advisor Asset Strategy** UNASX.

The list of 10 most redeemed funds shows that most managers still have faith in their funds even if some shareholders don't. **Fidelity Growth & Income** FGRIX, **Fidelity Low-Priced Stock** FLPSX, **Dodge & Cox Stock** DODGX, American Funds **Washington Mutual** AWSHX, and **American Funds Investment**

Company of America AIVSX can claim at least one manager with more than \$1 million invested. Interestingly, **Schwab YieldPlus** SWYPX had one manager in the \$100,000 to \$500,000 range. That's quite a bit for an ultrashort fund and shows that management is suffering right along with shareholders. Only one manager at **Templeton Foreign** TEMPX had anything in the fund and that was in the \$1 to \$10,000 range. However, two of the fund's managers came on board in late 2007, so that figure should climb.

Conclusion

Manager investment is a great new tool to put to use when you pick funds, I'd go with the highest sum by any of the managers. I'm looking for that seal of approval and I'd be wary when it isn't there. In the coming months I will bring you more research on this new treasure trove of data, so stay tuned. ■■■

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