Journal of Economics and Business 87 (2016) 18–34

Contents lists available at ScienceDirect

Journal of Economics and Business

Managerial investment in mutual funds: Determinants and performance implications[☆]

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ARTICLE INFO

Article history:
Received 3 August 2015
Received in revised form 14 May 2016
Accepted 25 May 2016
Available online 28 June 2016

JEL classification:
G29
G32

Keywords:
Mutual funds
Managerial ownership
Fund performance
Team management

ABSTRACT

We examine the determinants of managerial investments in mutual funds and the subsequent impacts of these investments on fund performance. By using panel data we show that investment levels fluctuate within funds over time, contrary to the common assumption that cross-sectional data are representative. Managerial investments reflect personal portfolio considerations while also signaling incentive alignment with investors. The impact of managerial investment on performance varies by whether the fund is solo- or team-managed. Fund performance is higher for solo-managed funds and lower for team-managed funds when managers invest more. These results are consistent with the higher visibility of solo managers, and less extreme investment returns of team-managed funds. Our results suggest investors may not benefit from all managerial signals of incentive alignment as managerial investments also reflect personal portfolio considerations.

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1. Introduction

Since March 2005 the SEC has required that mutual funds disclose annually the level of portfolio managers' ownership in self-managed funds. Managerial investments may directly affect a fund's performance through incentive alignment or career concerns, leading to a reduction in agency costs.[1] When the SEC proposed this disclosure requirement, some fund managers argued that this information would be a noisy, non-informative signal that investors might have difficulty understanding. Although these disclosures began a decade ago, there have been few studies to date of the determinants of managerial ownership in self-managed funds and also the subsequent relationship between mutual fund performance and managerial ownership. Managers may invest in self-managed funds to signal incentive alignment with shareholders or to fulfill personal portfolio preferences. Managerial ownership in a self-managed fund may directly affect the fund's performance if managers with more skin in the game invest more astutely, consistent with a reduction in agency costs (e.g., Jensen & Meckling, 1976;

☆ We thank seminar participants at the 2015 AEA meetings, Wesleyan University, and Williams College for advice. We also thank Masami Imai, Manolis Kaparakis, Tanseli Savaser, Sherrill Shaffer, Elif Sisli Ciamarra, and anonymous referees for helpful comments; the Wesleyan University Quantitative Assistance Center for financial support; and Jeffrey Legunn for research assistance. All errors are our own.

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[1] We use the phrase "managerial investment" to capture the average level of investment per *individual* manager, not the total amount that may be invested by multiple managers in team-managed funds. This is consistent with Evans (2008) but is not the same as Khorana et al. (2007) and Fu and Wedge (2011) who use the phrase to capture total investments in a fund from all managers.

http://dx.doi.org/10.1016/j.jeconbus.2016.05.002
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Mahoney, 2004). This governance view was cited by the SEC in 2004 in proposing and implementing the required disclosure of managerial investments.

Mutual fund families generally have one of four sets of policies governing managerial investment (Braham, 2010). First, some fund families have a co-investment requirement or expectation. Second, employees may be prohibited from owning individual stocks or other mutual funds. Next, some larger funds pay bonuses, at least partially, in fund shares that vest over multiple years. Finally, other mutual funds have no rules governing such investments. Khorana, Servaes, and Wedge (2007) find that managerial investments reflect personal portfolio allocation decisions, and this is consistent with an absence of formal policies regarding managerial investments at many mutual funds.

If the SEC's hypothesis of long-term incentive alignment were correct, then managerial investment levels would generally be non-decreasing across time and there should be a positive relationship between fund performance and the level of managerial ownership. In this light, Khorana et al. (2007), and Evans (2008) use a single cross-section of managerial ownership data to find that fund performance is strongly positively related to ownership stakes. Similarly, a 2009 Morningstar study shows that managers with more than $1 million invested in their own funds beat 58% of peers, on average, over the previous five years while funds with no manager investment outperformed only 46% of their peers (Braham, 2010).

On the other hand, Kumlin and Puttonen (2009) reported no significant relationship between managerial ownership and mutual fund performance in Finland. Furthermore, when Kumlin and Puttonen controlled for portfolio manager ownership as a percentage of taxable wealth, they found a negative relationship between portfolio manager ownership and fund performance.[2] Kumlin and Puttonen produced the only published study that has used panel data on managerial ownership stakes and data on overall managerial wealth, and, is also one of the few studies on this topic to use non-U.S. data. In a related, complementary study Fahlenbrach and Stulz (2011) found that U.S. banks with CEOs whose incentives were better aligned with their shareholders achieved worse performance than their peers due perhaps to actual corporate performance that was below prior expectations. These studies both lay the groundwork for questioning whether skin in the game can align managerial and shareholder incentives over the long-term and highlight the need for using panel data on managerial ownership in such analysis.

We use panel data on managerial ownership of self-managed mutual funds to examine two intertwined questions previously examined by others using cross-sectional data. Khorana et al. (2007) and Evans (2008) used data on managerial ownership from the first year in which data was available, 2005, which was a year where managers did not know ex ante their ownership stakes would ever be disclosed. We use panel data from subsequent years, 2006–2009, as managers may have behaved differently if they knew ex ante that their ownership stakes would be publicly disclosed. First, we examine whether managerial investments are driven by personal preferences or by incentive alignment. Khorana et al. (2007) found that managerial investments are motivated by personal preferences even as 57% of the managers in their dataset did not invest in their funds. Second, we examine how managerial investments affect subsequent fund performance. That is, if managerial investments serve to align effectively managerial and investor concerns, then fund performance should be stronger when managers invest more. Khorana et al. (2007) and Evans (2008) both found evidence in favor of the incentive alignment story.

The SEC assumption that skin in the game matters to investors rests on the assumption that investors can identify the "skin". When a fund has one manager, this is straightforward. However, most funds are team managed and most managers oversee simultaneously multiple funds. When a fund has a team management structure, an individual manager may feel that their actions are less observable and thus will be rewarded less by their employer and investors (Massa, Reuter, & Zitzewitz, 2010). Accordingly, managers who are part of team structures may have reduced incentives to invest in their own fund perhaps because team-managed funds tend to have more diversified portfolios that follow less extreme investment styles, and the fund's performance tends to be less extreme (Bar, Kempf, & Ruenzi, 2011). Thus, even if an individual manager's investments signal an alignment of interests, it is possible that fund performance may not be systematically related to the level of average managerial investments. Thus, there may be a mismatch between the underlying theory that there is an alignment of managerial and shareholder interests at a specific fund and what is best for the manager as a personal investor.

We hand-collected a panel dataset detailing managerial ownership at nearly 400 mutual funds across 2006–2009. SEC-mandated disclosures of managerial investments began in 2005, and thus 2006 is the first year for which managers knew ex ante their investments would be publicly disclosed. Our sample ends in 2009 both to parallel the end of the financial crisis and to pre-date the round of fund mergers and delistings that began in 2010.[3] Thus, our results also provide insights into how effective managerial investments could be at aligning managerial and investor interests at a time of market turmoil, which is precisely when investors might most value such managerial signals.

The average total managerial investment stake in a fund in our dataset is valued at $756,000 with the average mutual fund holding $1.5 billion in assets and having 1.8 managers. This low average ratio of average total managerial investment to fund size (0.05%) suggests that an alignment of interest story as laid out by Khorana et al. (2007) and Evans (2008) may not fully explain why managers invest in their mutual funds, and thus complicates the interpretation of a mutual fund manager's decision to invest in a self-managed fund. Moreover, we focus on average *individual* managerial investment and

[2] In Finland, data on individuals' taxable income and wealth, as verified by the tax authority, are published annually.

[3] 3.7% of all funds listed in the mutual fund database delisted or merged in 2006; 2.0%, 2007; 0.7%, 2008; 2.1%, 2009; 19.9%, 2010; 19.5%, 2011; 3.7%, 2012; and 3.0% in 2013.

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