Review of Financial Economics 21 (2012) 69–81

Contents lists available at SciVerse ScienceDirect

Review of Financial Economics

journal homepage: www.elsevier.com/locate/rfe

Mutual fund corporate culture and performance

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ARTICLE INFO

Article history:
Received 1 June 2011
Received in revised form 8 December 2011
Accepted 28 February 2012
Available online 14 March 2012

Keywords:
Corporate culture
Mutual fund performance
Morningstar
Governance
Survivorship bias

ABSTRACT

In this paper we test if a mutual fund's own corporate culture predicts fund performance. To do this we use Morningstar's corporate culture ratings for mutual funds and then examine the ability of these corporate culture ratings to predict risk-adjusted performance of domestic equity funds over the period 2005–2010. Using methods that are robust to survivorship bias, we find there is little significant evidence that corporate culture predicts better fund performance. Indeed, we find that no individual component of the Morningstar stewardship rating including board quality, fees, manager incentives and regulatory issues is able to consistently predict fund performance.

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1. Introduction

On December 22, 2006, Deutsche Bank agreed to pay $208 million in order to end federal investigations into their late-trading and market-timing activities in their mutual fund accounts.[1] Amazingly, this was the 21st settlement with a mutual fund company made by the Office of the New York Attorney General over the three preceding years. The list of indicted fund companies included some of the most well-known firms in the country such as Alliance Capital, Bank of America, Bank One, Janus, Prudential, Putnam and Strong funds.[2]

To investors, the news that mutual funds were committing such abuses was a shock as fund companies were thought to be free of the abuses so common in other parts of the financial industry. Indeed, in March 2003, Paul G. Haaga, Jr., the chairman of the Investment Company Institute, summed up this belief by stating: “under the S.E.C.'s watchful eye, mutual funds have remained free of a major scandal for more than 60 years.”[3] That streak ended on September 3, 2003, when the late-trading and market-timing scandals were first revealed to the public by the New York Attorney General.

For the public, the impact of the crisis was severe. Since so many investors own mutual funds,[4] the scandal touched many more investors than did the earlier Enron and World.com scandals. In fact, Arthur Levitt, the former Securities and Exchange Commission chairman, called the mutual fund scandal “the worst scandal we've seen in 50 years.”[5] The public perception of mutual funds was greatly damaged as well. In a CNN/USA Today/Gallup poll that was taken in October 2003, a few weeks after the scandal was first announced, 26% of fund investors said they were less likely to invest in funds because of the scandals, and 71% of respondents said they would “definitely or probably” move their money if their mutual fund companies came under investigation.[6]

In light of these scandals there has been growing interest in fund governance by both practitioners and academics. Among practitioners maybe the single best example of the interest in mutual fund governance is that Morningstar, the well-known mutual fund data provider, created a mutual fund stewardship rating in August 2004 to complement its well-known star rating system. Unlike the star ratings, which focus only on past fund performance, the stewardship ratings examine five governance factors of the fund company itself: board quality, corporate culture, fees, manager incentives, and regulatory issues. The stewardship ratings essentially allow an

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[1] See “Deutsche Bank Settles Some Cases”, *Wall Street Journal*, December 22, 2006, page A1.

[2] The Morningstar Stewardship ratings, including the corporate culture ratings, were not published by Morningstar until August 2004. Hence, during the time of the scandals (the Sptizer complaint was issued in September 2003) these fund companies did not yet have a corporate culture rating. As of December 31, 2004, when most of these fund companies had a corporate culture rating, Alliance Capital, Janus, and Putnam were all rated as poor, and Strong was rated as very poor.

[3] See Gretchen Morgenstern, “Will Investors Stampede out of Mutual Funds? *New York Times*, November 9, 2003, page B1.

[4] As of 2009, 51% of U.S. households owned mutual funds according to the 2010 Investment Company Factbook (2009), Investment Company Institute, 50th edition, chapter 1.

[5] See Paul Krugman “Funds and Games”, *New York Times*, November 18, 2003, page A24.

[6] See Gretchen Morgenstern, “Will Investors Stampede out of Mutual Funds? *New York Times*, November 9, 2003, page B1.

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doi:10.1016/j.rfe.2012.03.003

investor to determine how well the fund company is taking care of its fiduciary responsibilities.

Academics have also shown interest in fund governance, particularly after the scandal. For example, a number of recent papers have investigated the quality of the board of directors at mutual and pension funds (e.g. Tufano and Sevick (1997), Ambachtsheer, Capelle, and Scheibelhut (1998), Del Guercio, Dann, and Partch (2003), Khorana, Tufano, and Wedge (2007), Cremers, Driessen, Maenhout, and Weinbaum (2009), Ding and Wermers (2009)). These papers have generally found that funds with better boards have better performance, lower fees, and are more likely to replace poorly performing managers. Another stream of research examines the proxy voting decisions of mutual funds. Chou, Ng, and Wang (2009) found that mutual funds with better governance tend to use their proxy votes to protect shareholder's rights as opposed to siding with management. Additionally they also found that better governed mutual funds are more likely to hold better governed firms in their portfolios. Finally, another branch of research has started to examine the predictive ability of the Morningstar stewardship ratings themselves. In an unpublished working paper Wellman and Zhou (2007) found some evidence that funds with better stewardship ratings have better risk-adjusted performance.

In this paper we examine another aspect of fund governance, corporate culture, which heretofore has not been explicitly examined in the literature. Specifically we examine how well a mutual fund's corporate culture predicts mutual fund performance. The reason we choose corporate culture is that it is the single fund feature that is most directly related to the overall governance of the fund family. Indeed, our belief is that corporate culture sets the tone for the entire operation of the fund and may influence the performance of the fund.

For example, a fund's corporate culture tells us whether the fund is sales driven or investor driven. That is, it indicates whether the fund always acts in the interest of the investors. The corporate culture of the fund also tells us about the fund's ability to attract and retain top employees. Funds with strong corporate cultures are generally able to keep top people from switching to other firms. They invest in their employees and nurture them. Conversely, funds with poor corporate cultures often have significant managerial turnover which presumably could affect the performance of the fund.

Our views that fund corporate culture is the seminal issue to understanding its governance is also shared by Morningstar. In 2007 Morningstar changed their methodology to make corporate culture the most important criterion in the stewardship rating. Hence, rather than making up just 20% of the stewardship rating, as was the case before 2007, a fund's corporate culture now comprises 40% of the stewardship rating, an amount double that of any other criterion used in determining the rating. Laura Lutton, a Morningstar analyst stated: "we got feedback from mutual fund companies that corporate culture sets the tone. For example, if a family focuses on its investors and lets that focus drive its corporate culture, then it also tends to have strong board oversight, fair fees, and few regulatory mishaps and earns good long-term returns for its shareholders."[7]

Using the corporate culture ratings from Morningstar, we investigate whether fund corporate culture predicts future mutual fund performance. In our study we use an out-of-sample approach in which we put ourselves in the shoes of an investor who makes a mutual fund choices on each of three dates (January 1, 2005, January 1, 2007, or January 1, 2009) and then holds the fund for 12 months, 24-months, or 60 months (for the sample starting on January 2005 only). We then measure performance using a battery of risk-adjusted performance metrics that are adjusted for survivorship bias.

The rest of this paper is organized as follows. Section 2 describes the related literature and also explains how fund corporate culture influences fund performance. Section 3 describes our data. Section 4 provides our methodology. Sections 5 and 6 explain our results and we conclude with Section 7.

2. Related literature

2.1. General research on the relationship between corporate culture and performance

The popular press has placed a great deal of attention on the idea that firms with strong corporate cultures have better performance than other firms. Each year Fortune magazine comes out with the "100 Best Companies to Work for list", which describes how these 100 firms benefit from highly motivated employees dedicated to common goals. Moreover, there are numerous references made about a company's specific corporate culture, such as the IBM Way or 3M Value, that speak to the advantages that these firms derive from their corporate culture.

Academic studies have also found that firms with strong corporate cultures have better firm performance. Denison (1984), Gordon and DiTomaso (1992), Kotter and Heskett (1992), and Sorensen (2002) all have found, across many different industries, that strong corporate culture is positively related to firm performance. These studies, when matched with qualitative studies by Peters and Waterman (1982), Deal and Kennedy (1982) and Collins and Porras (1994), further cement the notion that a strong corporate culture is crucial to a firm's long-run success.

As stated by Sorensen (2002), the reasons why a strong corporate culture improves firm performance are threefold. First, there is enhanced coordination and control within the firm. For example, strong corporate culture enhances agreement that certain behaviors are more appropriate than others. Hence, breaches of behavioral norms may be discovered and corrected more quickly than is the case when corporate culture is weak. Second, the strong culture improves goal alignment between the firm and its employees. Consequently, employees will understand and take the proper course of action when faced with unexpected situations. Third, and perhaps most importantly, a strong corporate culture produces increased employee effort and motivation, as employees feel they are recognized for their contributions and are involved in decision making. In essence, they work harder because they feel they are making a difference at the firm.

Of course, there are also arguments against having a strong corporate culture. Namely, it is very expensive to implement as employees must be developed, mentored and nurtured. Indeed, during the financial crisis of 2008–2009 several companies known for strong corporate culture had to severely cut back their policies as they were too expensive.[8]

Another limitation discussed by Sorensen (2002) is that during periods of crisis, when volatility is substantial, there is some evidence that firms with strong corporate cultures are not able to change quickly. When employees are committed to a certain way of doing things they may be less able to carry out the types of changes needed to adjust to high volatility. Indeed, Sorensen finds that as industry volatility increased, firms with stronger corporate cultures underperformed relative to other firms.

2.2. Definition of strong mutual fund culture and the possible consequences of this culture on fund performance

We define a mutual fund with a strong corporate culture as having two qualities. First, funds with strong cultures mentor their employees, reward performance and hard work, and listen to employee

[7] David J. Drucker, "Fiduciary Funds", *Research Magazine*, October 31, 2007.

[8] SAS for example had to cut a number of their benefits for employees during the recession of 2008–2009.

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