How Fund Managers Who Invest Elsewhere Exploit Their Clients

If you didn't have the data, you might reasonably assume that any fund manager worth his salt was heavily invested in his own fund. This ought to apply to an overwhelming percentage of all the actively managed funds out there. In fact, as a recent article in Barron's points out, it's the exception rather than the rule. Using data from Morningstar, they find that almost half the funds tracked were led by a manager with no money invested at all. This sorry bunch may think they're good, and their marketing materials presumably make the case, but by investing their own money elsewhere they tell you what they really think.

And of the 7,700 funds tracked by Morningstar, only 910 had a personal investment by the manager of at least $1 million. This isn't a high hurdle; less than this threshold either means the manager doesn't have $1 million to invest, a paucity of personal resources that should give any potential client pause, or chooses not to.

It's not just that it feels right to know your manager is invested alongside you. For the client, this is the only way to ensure alignment of interests and protect themselves from the principal-agent problem so prevalent in finance. If you're a fund manager only managing OPM (Other People's Money), your compensation is fully linked to the size of the fund you manage. The most reliable way to grow your fund is to outperform your competition. A seductively simple way to outperform is to take more risk than the others. Because if you take more risk in a rising market, you will assuredly do better than most and money, which chases performance, will follow. If the market goes down and you underperform, you

haven’t lost much because it’s only your clients that suffer the returns. And if performance is really bad, you can always start a different fund.

The money manager who’s invested elsewhere has a free option at the expense of his clients. He has far more to gain from outperforming than he has to lose from underperforming. For the investors, their risk is linear. Bad returns hurt, and good returns help.

The analysis of the Morningstar data supports other research which shows that active managers in aggregate take more risk than the overall market. They are biased towards stocks with more volatility than average, and as a consequence their actions underpin the Low Beta Anomaly, the tendency of low volatility stocks to outperform over the long run. This is because high volatility stocks draw more demand from active managers which raises their prices, thereby depressing future returns. An active manager owning low volatility stocks is failing to exploit the optionality that his role as agent provides at the expense of the principal (i.e. client). It’s one of the reasons we like low volatility stocks – because although they’re widely owned, they’re not widely owned by active managers. And we think that active managers under-invested in their own funds are likely to continue exploiting their advantage which will cause the low volatility bias to persist.

For the investor, it’s not a bad rule to simply eliminate from consideration any investment manager not personally and significantly invested in his own strategy. It makes intuitive sense but it also provides for an alignment of interests. Don’t let the uninvested take advantage of you.