Show Me the Money

The importance of co-investment

One of the most important characteristics to look for in a fund manager is whether their money is invested alongside their clients' money. Co-investment signifies conviction, alignment and commitment. Yet, it is often difficult to determine if, and to what extent, a manager has their own money invested in the same portfolio they're running for their clients.

This report examines the importance of co-investment and challenges the industry's lack of focus on the issue. In a supplementary document titled *Showing you the Money: Co-Investment at Steadyhand*, we provide details of the level of co-investment among our employees and fund managers.

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Introduction

If you're not a professional investor, one of the keys to making money in the stock market is to seek out those who are and piggyback on their knowledge, insights and experience. You want to find people who live and breathe investing. People who have a penchant for making money and who like to win. And you want to ride them for as long as you can.

But before you park your money with these professionals, you want to make sure they're invested alongside you. In other words, you want to be certain that they eat their own cooking.

The rationale for seeking managers who invest alongside you

Why is it relevant whether your money manager invests alongside, or *co-invests*, with you? It matters because when every dollar that you invest goes into the same ideas they're personally investing in, there's a clear alignment of interests. When they make money, you make money. But perhaps more importantly, when you lose money, they lose money. When this alignment isn't there, a manager may take on excessive risk or invest in businesses in which they don't have a high level of conviction.

Without their own money on the line, other factors can more heavily influence how a manager runs a portfolio. For instance, they may be more interested in mirroring the index for business reasons (so their performance doesn't deviate too much from the index) than they would in their own portfolio. If the manager didn't like a sector or some prominent stocks in the index, they wouldn't own them with their personal money. In a portfolio where the benchmark is a factor, they may own these stocks, sometimes making up a substantial part of the portfolio, and declare they are "underweighted".

Further, co-investment is an important attribute to look for in a manager because it's a good indication that they're passionate about their investment philosophy. If a manager is running a portfolio with none or little of their own money at stake, it may be a poor representation of how they feel they can best make money over the long term.

The practice of co-investment is particularly valued among sophisticated investors. In the hedge fund world, where a manager's personal investment in his or her own fund is known as "hurt money", this practice is seen as a better risk control than those techniques used by investment banks, according to the European Central Bank.[1] Many institutional investors also seek out managers who invest alongside their clients. David Swensen, the Chief Investment Officer of Yale University and a favorite mutual fund basher of ours, stresses the importance of co-investment in his book *Unconventional Success – A Fundamental Approach to Personal Investment*. In his words:

> "Investors might sensibly consider placing money with fund management companies that demonstrate high degrees of co-investment by the firm's portfolio managers. A manager's desire to take on the role of principal, expressed by significant side-by-side participation in fund

> performance, signals an unusual coincidence between the interests of investors and the incentives of fund managers."[2]

The practice is also applauded in the academic community. Louis Lowenstein, a Professor Emeritus at Columbia University, views co-investment as a critical factor in picking a fund manager. In his recent book, *The Investor's Dilemma: How Mutual Funds are Betraying Your Trust and What to do About it*, Lowenstein lists nine qualities to look for in a fund. Among them is co-investment. He opines, "If a manager won't invest in the fund, why should you? Any fund may lag for a while, but if the manager is hurting, too, I have confidence in the ultimate outcome."[3] Lowenstein also references an academic study titled *Portfolio Management Ownership and Fund Performance* which concludes that "managerial ownership has desirable incentive alignment attributes for mutual fund investors…and future risk-adjusted performance is positively related to managerial ownership."[4]

In short, when fund managers invest alongside their clients, investors can be assured they're getting the full benefit of the manager's skills, savvy and expertise.

Some disturbing numbers

It only seems logical that money managers would invest their own money in the same portfolios they're running for their clients, but sadly this is not always the case. The investment landscape has become increasingly complex. There are over 2,000 mutual funds in Canada, many of which are targeted at a specific trend or sector. A manager who runs a biotechnology fund, for example, may not have a lot of his own money tied up in the fund if he desires a more diversified portfolio. Moreover, many managers run more than one fund or mandate, so it's difficult for them to have a large portion of their own net worth invested in a specific fund. Or, quite simply, they may be running a mandate that they're just not that interested in.

A recent study conducted in the U.S. by mutual fund-research firm Morningstar looked at roughly 6,000 funds and found that nearly half of all domestic equity funds had no manager ownership.[5] The number was even higher for foreign stock funds. There are legitimate reasons why a manager may not own units in a fund they manage. As Morningstar points out, if a fund is run by a foreign citizen, the manager may be restricted from investing in it. As well, the manager may have his or her money invested in the same 'model portfolio', but in a non-pooled structure (i.e., they may own the securities in the model individually in a personal account). Even so, the numbers in the study are disturbing.

Morningstar's director of mutual fund research and the author of the report, Russell Kinnel, proclaims "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."

Mention of co-investment would seemingly be a selling point for fund companies, but few organizations make any reference to the practice. If a manager has a good track record and has much of his/her net worth invested in their fund, why not be public about it?

Understandably, a fund manager may not want to reveal the actual dollar amount of assets they have invested, but they could make known the percentage of their investment portfolio that is tied up in their fund.

How to determine whether your fund manager has skin in the game

There's no denying the merits of co-investment. So how can you tell if a money manager eats what they cook? Unfortunately it's not that easy to determine. Investors can turn to a fund's Annual Information Form (AIF) or Management Report of Fund Performance (MRFP) to help determine the level of ownership of fund units by large unitholders and insiders. If a single unitholder owns more than 10% of the outstanding units of a fund, this information must be disclosed in the fund's AIF.

Similarly, in the MRFP, fund companies are required to disclose the percentage of fund units that are owned in aggregate by its affiliates, subsidiaries, officers and directors. However, the aggregate amount is not broken down by individual, so this measure doesn't go far in showing how much the fund manager has invested in his or her fund. And that's assuming they're an officer or director of the company, which may not be the case. In summary, unless a fund manager owns more than 10% of the outstanding units of the fund they manage, their level of ownership cannot be determined by scouring the regulatory documents.

Aside from the above measures, which may or may not provide an indication of the level of co-investment, there are some steps investors can take to determine whether their fund manager is investing alongside them:

1. Try asking the manager or a representative from his or her company. Call their toll free number or send them an email. You may not get far with some managers or organizations, but you could be surprised with the response you get from more service-oriented shops and those that cater to higher net worth individuals.
2. Look into the number of funds the manager runs, and their tenure at the helm. If they manage or co-manage several funds (or model portfolios) with different mandates, their wealth can't be concentrated in all of them. GlobeInvestor Gold, the Globe and Mail's premium mutual fund research website (www.globeinvestorgold.com), offers a tool that allows investors to generate a report that shows all of the funds that a manager runs. The same tool shows how long they have managed the fund. This is important because it will provide an indication of whether they have built an established track record and reputation with respect to a specific mandate. Long-standing, focused managers are more likely to have their own money invested alongside their clients than those who jump from ship to ship and are willing to manage to a broad range of funds.

3. Consider the manager's role in running the fund. Are they the senior individual and trigger puller? Or is the fund managed by a larger team with responsibilities spread among multiple individuals and no one person calling the shots? There's nothing wrong with having plenty of horsepower, but it's key to have a lead manager and decision maker who is accountable for the fund. When one individual is largely in charge of and responsible for running a fund, the greater the likelihood that they will have their own wealth at stake.

While the above considerations are useful indicators and precursors of co-investment, at the end of the day, the only way to determine if a manager invests alongside their clients is to hear it from them directly, be it in their marketing or reporting materials, or straight from the horse's mouth.

Taking the high road

There are a handful of firms that choose to take the road less traveled and make their position on co-investment readily available. We were inspired by *Tweedy, Browne*, a New York-based money manager. In their marketing materials, the firm makes front and center the 'Commitment of the Advisor'. They report the amount of assets that the firm's Managing Directors, employees, retired principals and their families have invested in their funds. As of March 31, 2008, this amounted to $670.5 million.

Southeastern Asset Management is another U.S. firm that highlights co-investment. The firm manages the Longleaf Partners Funds, which at the end of 2007 had roughly $18.5 billion under management (spread across three funds). The firm's leading Governing Principle is "We will treat your investment in Longleaf as if it were our own." They note in their marketing materials that their employees and affiliates are collectively the largest shareholders in their funds. A little digging reveals that this group owns just under $1 billion, or roughly 5% of the firm's mutual fund assets.

Other firms that emphasize the importance of co-investment here at home include *Burgundy Asset Management*, *Mawer Investment Management*, and *ABC Funds* (Irwin Michael).

There are other firms, including Steadyhand, that are highly committed to the funds they manage, as illustrated by their level of co-investment (for details on co-investment at Steadyhand, refer to the supplementary article, *Showing you the Money: Co-investment at Steadyhand*). Yet, by and large, reporting on co-investment seems to be the exception rather than the norm, especially when it comes to concrete numbers. Moreover, the issue seems to generate little attention from some of the larger fund manufacturers. And with the exception of a few investment reporters and financial bloggers who continue to beat the drum on the issue, it rarely makes the business page.

Until fund managers are required to more prominently disclose this information or until investors start to speak up on the issue, this will likely remain the case as, sadly, it seems that most managers don't want you to know this information.

Conclusion

There are a number of attributes to look for in a winning fund manager. Are they experienced? Do they have a successful track record? Do they have a well-defined investment philosophy and approach? Are they willing to go their own way? Do they have the capacity and flexibility to pursue opportunities in all areas of the market? And, of course, do they eat their own cooking? All of these ingredients are important, but it is the latter that creates the best alignment of interest between investor and manager.

So when you're researching a fund manager, don't forget to ask *what's for dinner*.

Notes

[1] Hutchings, William. "ECB Praises Hedge Fund 'Hurt Money.'" *Dow Jones Wealth-Bulletin*. June 10, 2008.

[2] Swensen, David, *Unconventional Success: A Fundamental Approach to Personal Investment*, New York: Free Press, 2005. p.296.

[3] Lowenstein, Louis, *The Investor's Dilemma: How Mutual Funds are Betraying Your Trust and What to do About it*, New Jersey: John Wiley & Sons, Inc., 2008. p.183.

[4] Khorana, Ajay (Georgia Institute of Technology), Servaes, Henri (London Business School), and Wedge, Lei (University of South Florida), *Portfolio Manager Ownership and Fund Performance*, Working Paper, August 10, 2006.

[5] Kinnel, Russel. "Managers' Investment Secrets Revealed." *www.morningstar.com*. June 16, 2008.

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