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Management team structure and mutual fund performance

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ABSTRACT

We investigate the relationship between performance and portfolio management team structure of open-end mutual funds during 1997–2004. We first analyze differences in performance and risk taking between single-manager and multiple-manager mutual funds and find that the latter underperform the single-manager funds in terms of risk-adjusted returns during the 2001–2004 bear market. This underperformance is more evident among growth-oriented funds. There are no differences observed in the 1997–2000 bull market. Not all multiple-manager funds, however, are managed by pure teams. When we compare the performance of single-manager and pure-team funds we do not find any differences in performance. The underperformance of multiple-manager funds documented in previous studies comes from multiple-manager funds that employ many investment advisors and, therefore, their exact management structure is unknown. We also document differences in management structure reporting between Morningstar and CRSP.

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1. Introduction

The U.S. mutual fund industry has grown dramatically in the past decade. From $2.8 trillion in 1995, assets under management rose to a record-breaking $8.1 trillion in 2004 (ICI, 2005a). As the scale of the mutual fund industry has changed so have the funds themselves. For example, funds have introduced additional share classes to attract more investors and developed new channels to better reach the investment public. Moreover, the architecture of the portfolio management system has evolved with

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teams of managers replacing single managers as the dominant decision-making unit.[1] During this period and thereafter, mutual funds actively promoted the potential benefits of team management to its current and potential clients. By way of illustration, according to its Web site, "[the] Brazos Funds view the team-based approach as an important component in creating less risk for clients and increases their long-run returns."

Many studies, especially in the management and psychology literature, have examined the role and performance of teams. After reviewing more than 100 studies on team performance in a variety of circumstances, Stock (2004) reports that almost all of them find that teams behave differently than individuals but that these differences do not necessarily translate to superior performance no matter how measured. In the context of portfolio management, advantages of teams include being able to diversify style and judgment (Sharpe, 1981) and having a broader range of specialized skills and knowledge and abilities to process larger amounts of information (Hill, 1982; Herrenkohl, 2004). Disadvantages include the presence of free riders (Holmstrom, 1982; Rasmusen, 1987) and delays in decision making (Sah and Stiglitz, 1988). The role of risk is ambiguous. Barry and Starks (1984) suggest that overall teams may reduce risk taking, but others (Janis, 1982; Herrenkohl, 2004) contend that teams may actually increase risk because shared risk makes the risk borne by individuals seem less.

Nevertheless, limited research has been done concerning the notion that the team is the superior fund management structure, and the empirical evidence that has been reported provides little or no support for this contention. For instance, Prather and Middleton (2002) find that there is no difference in the performance of team-manager and single-manager funds, while Chen et al. (2004) and Bär et al. (2005) document that team-manager funds do not perform as well as their single-manager counterparts. Massa et al. (2006) provide evidence that team underperformance is correlated with the anonymity of the managers, and Qiu (2003) shows that single-manager funds are more aggressive and tend to adjust their risk exposure more than team-managed funds. In a more recent paper, Han et al. (2008) find evidence suggesting a positive relation between fund performance and team management.

All of the abovementioned studies characterize funds that list multiple portfolio managers as team-manager funds. This characterization, however, may be overly simplistic. Many times funds assign the management of their portfolio to more than one investment advisor and these advisors may be internal of external to the family. Carnahan (2004), for example, reports that Vanguard has contracts with 24 outside management companies for one-third of its funds. Thus, the team-manager category used in the previously cited studies contains (1) one investment advisor with multiple managers, (2) multiple investment advisors each with multiple managers, and (3) multiple investment advisors each with a single manager. Moreover, the single-manager designation is comprised of (1) one investment advisor with a single manager and (2) multiple investment advisors with a single manager.

Even these distinctions are fuzzy representations of the decision-making structure. To illustrate, consider the following possibilities. First, co-managers who belong to the same advisory company may share the same pool of analysts and communicate with each other, and even though a consensus must be reached, individual members may be held accountable for specific recommendations. Thus, it is difficult to determine whether their investment decisions are independent of each other. Second whether the advisor is external or internal to the firm may make a difference because, according to Chen et al. (2004), externally advised funds are more likely to be closed down for poor performance than comparable internally run funds. The risk of closure may influence investment decisions. Finally, in the case of multiple advisors, their relative contribution to performance is unclear. This is because usually there is one major advisor who hires one or more sub-advisors. Kuhnen (2004) reports that about one-third of all mutual funds are managed by more than one advisory firm and that it is often the sub-advisor(s) that is responsible for the day-to-day management of the fund. This gives rise to

[1] In one sense all funds are team managed. This is because many analysts and support staff work together in collecting and analyzing data. The distinction between single-manager and multiple-manager funds refers to whether a single individual or multiple individuals make the final transaction decisions.

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