The Importance of Eating Your Own Cooking

Imagine yourself in Paris right after the Second World War. There was a collective sigh of relief at being back in a peaceful democratic society, but life was not all wine and roses. There were food shortages all over Europe, as basic infrastructure and transportation services were re-started or re-built.

Many restaurants in Paris faced food restrictions. Patrons suspected that restaurateurs, with their array of connections within the food industry, could dodge those restrictions and get a tasty meal for themselves at home, while serving the gristle and scraps to their customers in the restaurant.

To counteract this perception, it was commonplace at the time to see signs above restaurant kitchens saying that the proprietor ate regularly at the establishment. Restaurant proprietors that "ate their own cooking" made a compelling case that their customers could be assured of being served high-quality meals, too.

Thankfully, we have no such problems these days in the restaurants of the developed world. However, we believe there is a similar crisis in the investment community. You would think that, of all the industries today, the field of investments is the foremost one in which potential customers would want to see a sign above the "kitchen door" proclaiming that the managers "eat their own cooking." After all, if these managers are willing to put their customer's hard-earned money at risk, shouldn’t they be willing to put their own money at risk in the same fashion? Why should someone trust me with their money, if I don’t even trust myself?

Mutual fund managers know their funds better than anyone else. They have studied extensively all their holdings, spending hours meeting with companies and analyzing financial statements. In other words, they have seen "how the sausage gets made." Furthermore, they also usually have a deep knowledge of the strengths and weaknesses of their competitors, so they know whether another competing fund may be better or worse than their own.

No Thanks, I’ll Go to the Restaurant Down the Street

Up until recently, it was nearly impossible to know whether and how much mutual fund managers invested in the funds that they manage. Now, though, we can very easily make this determination, thanks to a recent SEC ruling that requires funds to disclose how much each fund manager invests in his or her fund. While the disclosure is not ideal, providing the disclosure in bands of dollar values instead of percentages of net worth, it is still worthwhile. The bands are divided as follows: $1 to $10,000; $10,001 to $50,000; $50,001 to $100,000; $100,001 to $500,000; $500,001 to $1 million; and over $1 million.

According to Morningstar, the preeminent mutual fund rating firm based in Chicago, a stunning 47% of U.S. equity funds report no manager ownership at all. In other words, these managers not only don't eat the majority of their meals in their own restaurant—*they never have a single meal there!*

And the U.S. Equity category is actually one of the better ones of the pack: 61% of foreign-stock funds, 66% of taxable bond funds, 71% of balanced funds, and 80% of municipal bond funds lack any ownership by their own managers. The table below shows the details for manager investment levels for U.S. equity funds (that is, funds that invest primarily in stocks) and balanced funds (funds that invest in both stocks and bonds).

	U.S. Equity Funds		**Balanced Funds**	
Dollars invested	# of funds	%	# of funds	%
$0	1,350	47	514	71
$1 - $10,000	92	2	11	2
$10,001 - $50,000	265	9	38	5
$50,001 - $100,000	211	7	29	4
$100,001 - $500,000	498	17	77	11
$500,001 - $1,000,000	130	4	12	2
$1,000,000 or greater	349	12	38	5

Source: Morningstar

To be fair, there are some instances where it is understandable if the fund manager does not invest in his or her own fund. For example, if a fund manager runs a single-state municipal bond fund for a state other than the one he lives in, it wouldn't make sense for him to own that fund as he wouldn't benefit from the tax breaks. Or, perhaps the fund manager is a foreign national and his country has restrictions on investing in U.S. funds.

Nevertheless, these results are pretty dismal, and they certainly do not offer mutual fund customers a vote of confidence. Based on these numbers, it seems to us that most mutual funds might as well have a big sign above their kitchen door saying, "We don't eat this food ourselves. Eat at your own risk."

I'll Have What He's Having

We can hear some of you saying, "I understand your point, and it kind of makes sense, but do you actually have data that proves that funds where managers invest alongside clients are actually better?" Morningstar anticipated this question, so it has data on that too.

Morningstar looked at manager investment levels from 2009, and then tracked five-year performance from that point forward. They assigned a "success rate" for each fund category based on the percentage of funds which not only survived but outperformed their category peers over the five-year period. This is exactly the sort of data that will give us an idea of whether returns are better for funds with high manager investment levels.

The tables below show the results for U.S equity funds, balanced funds, and all funds. Balanced funds are funds that invest in both equity and bonds. The "all funds" category tracks all mutual funds, including those that invest solely in international equities or in bonds.

U.S. Equity Funds

Dollars invested	Success Rate (%)
$0	28.99
$1 - $10,000	28.74
$10,001 - $50,000	29.65
$50,001 - $100,000	33.52
$100,001 - $500,000	36.52
$500,001 - $1,000,000	31.86
$1,000,000 or greater	39.08

Balanced Funds

Dollars invested	Success Rate (%)
$0	31.65
$1 - $10,000	21.43
$10,001 - $50,000	52.63
$50,001 - $100,000	76.92
$100,001 - $500,000	50.00
$500,001 - $1,000,000	64.29
$1,000,000 or greater	84.62

All Funds

Dollars invested	Success Rate (%)
$0	34.85
$1 - $10,000	36.24
$10,001 - $50,000	35.52
$50,001 - $100,000	43.25
$100,001 - $500,000	42.55
$500,001 - $1,000,000	40.31
$1,000,000 or greater	46.74

Source: Morningstar

While the numbers don't march up the chart in lock-step, the data shows a pretty consistent pattern of better performance being earned the higher you go up the scale of manager investment levels. Managers investing no money at all in their funds had a paltry 35% success rate in the All Funds category, whereas those with more than $1 million had a 47% success rate. And while that 47% success rate might not seem all that great, it is actually quite good when you take into account that about one third of the funds were merged away or liquidated during the period covered by the study. Balanced funds show the most contrast in performance between the categories, with a 32% success rate on the bottom rung versus 85% on the top.

Conclusion

Just as you would avoid a restaurant where the owner doesn't eat the food, you should avoid fund managers or investment advisors that don't follow their own investment advice. Next time you are looking to hire an investment adviser or thinking about buying a mutual fund, first inquire about whether the manager invests alongside his clients. It could be the difference between tasty returns and stale performance.

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