

I&T interviews Bellwether about the power of 'skin in the game' - the alignment of interest that exists when Investment Managers have their own money invested in the Funds they manage.



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Managers find the taste of their own cooking is sweet

Catherine James

A recent researcher's report found a correlation between managed funds in which the investment professionals put their own money alongside that of the punters, and ratings upgrades for those funds. It was no coincidence, as CATHERINE JAMES reports.

A chief investment officer was discussing the numerous funds offered by his company with a somewhat lethargic audience. He began to describe one product with the comment "I particularly like this fund - I've invested in it myself". The impact was visible. The audience sat up, more alert, more interested.

If knowledge is power, inside knowledge is particularly so.

An investor is understandably encouraged to put money in a fund if he knows the person managing it - an insider, so to speak - has a personal investment weighing in the balance as well.

And investors aren't the only ones reassured by a portfolio manager's capital tied up in the fund.

Fund research and ratings house Morningstar recently surveyed international equity managers. Its report highlights an interesting correlation between funds managers "who eat their own cooking" and the ratings upgrades for these very funds.

Morningstar head of research Anthony Serhan says a portfolio manager investing in his or her own fund is a bit of sideline information.

The core of the review still revolves around the quality of the people and their ability to implement the fund's strategy and processes, he says.

"But I'll be honest in saying that if we're reviewing a manager and they say they've got a substantial amount of their money inside [the fund], you do take a bit of extra comfort from it," Serhan says.

"It's a bit like when you go and review a boutique. The fact that the portfolio manager owns a chunk of the firm, it doesn't automatically mean they're a good manager, but it gives you some comfort about the period for which they're going to stay with that operation."

Self-investment helps get gatekeeper tick

Morningstar suggests managers who put personal capital in their own fund demonstrate a conviction in the success of the fund that is difficult to match.

"After all, if a fund manager does not invest some of their own money into the fund they manage, then why should you?" the report says.

Anecdotally, consultants and clients frequently ask whether a manager has their personal capital in a fund. In Australia there

is no requirement to disclose it, unlike in the United States where legislation requires fund managers of publicly available mutual funds to disclose the level of personal investment they hold in the fund they manage.

It's a practice unlikely to be enforced in Australia in the short term - certainly there's been little mention of it from the regulators. But funds managers are putting in place, if they have not already done so, the means to facilitate - short of mandating - staff investment in the funds.

Melbourne-based boutique manager Bellwether Partners has a policy for all staff to have some "skin in the game", whether they are investment personnel or not.

"There is policy, or there is an expectation, which is transparent to any party who is looking at putting funds with us, that every staff member of this business also has an investment in our funds," chief executive Bruce Bell says.

Bellwether has eight staff, four of which make decisions on investment strategy. The total amount held by staff as a percentage of total funds under management is not high, Bell says, but the important thing is that they are in there.

"It doesn't have to be a lot - I would certainly discourage a staff member putting all their available funds in - but I think it helps for people to take a real interest in, for example, what happens with the unit price each month. It's something of theirs which is in there," he says.

While Bellwether is pitched at institutional investors, staff are brought into the fund under Section 101 2E of the Corporations Act 2001. This section of the Act allows for up to 20 small-scale offerings of a managed investment in a 12 month period with a different set of investment requirements for both the fund and the investors.

For example, Bell says, it allows staff to invest in the fund without meeting the minimum investment amount.

Bell believes there is an argument for more disclosure from Australia's fund managers who hold an amount of their fund above a certain threshold.

"You could debate what that threshold is," he says.

"But I think it's important to know, because although I don't think a professional manager would manage it differently if the bulk of the money was theirs compared to if the bulk was a large number of external people, it could have some implications for the risk appetite of the manager."

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Mitigating risk is a high priority for Herschel Asset Management chairman Saxon Nicholls, who views staff investing personal capital in Herschel funds as a good business practice. Four million dollars of Herschel's \$622 million in funds under management belongs to key staff, including Nicholls.

"We think that's important in terms of aligning interest with the client and in terms of mitigating agency risk," Nicholls says.

Like Bell, he points to a reduction in excessive risk-taking if a manager's own money is on the line.

"If someone has a big go at something in the portfolio and it doesn't work out, there's an argument people can change roles relatively easily and leave someone else to clean up. At the end of the day the client gets stuck with it. By having [personal] money in there at risk, you're carrying the same risk, ignoring portfolio diversification effects, as the underlying client," he says.

"And that's one of the reasons why, for example if you look at hedge funds, it's so important to know if the managers have capital invested in their funds. I can't think of one credible hedge fund where the manager doesn't have a lot of their own money tied up in it."

Not just a boutique phenomenon

Some large funds managers, such as global institution Franklin Templeton, have a remuneration structure in place to ensure portfolio managers get some personal investment into the funds they manage.

One third of any bonus paid to the manager is automatically placed into some company shares and the fund of that manager. The other two-thirds is paid as cash without strings attached.

Portfolio manager of Templeton global equities, Peter Wilmshurst, chooses to put most of the two-thirds of his remaining bonus into his funds anyway. He manages over \$1 million of his own money in two retail funds of the nine portfolios he oversees.

He says it's important to him to align his interests with those of the investors.

"The closest alignment is co-investing on the same terms and basis as your investors. Performance fees have some pros and cons. Some managers even own the management firm themselves – that is a form of alignment. But the only way you can say you will make the same dollar as the client is if you're a co-investor in the fund," he says.

And co-investing is not just a marketing platform, Wilmshurst says.

"It's a genuine commitment on my behalf and others if they do the same. There's an element of [marketing power] in it, but it's marketing with substance if you like. It's not tokenism."

Wilmshurst isn't sure mandated disclosure on a manager's personal holdings would achieve anything, but says as an investor he would definitely be putting the question to the manager anyway.

It's not legislation but the questioning from clients that effectively makes disclosure mandatory, Nicholls says.

"The clients will ask, and if you don't tell them they're not going to give you the money. They want to know," he says.

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