KIM: Invest with managers who eat their own cooking

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Did you wash the car you rented on Spring Break? I didn't because I don't own it. I know I'm returning it at the end of the week, so don't care if it's dirty. In other words, I have no skin in the game.

Contrast this with my own car, which I wash regularly and will go to great lengths to avoid parking even in the vicinity of another car. I always want it to look as nice as the day I drove it off the lot. You get the picture.

The same analogy can be made with investing and investment managers. It's logical you want to invest with a manager who has a *significant* amount invested alongside you. Why? The manager's financial interests are aligned with yours. In fact, the higher the manager's investment, the more closely your interests are aligned.

Managers who "eat their own cooking" sit at the same table and eat the same meal as their investors. When the "cooking" is good, the manager benefits along with the investor. Similarly, when the "cooking" is not so good, both get indigestion.

Since 2005, the SEC requires each mutual fund to report how much the portfolio manager has invested in the fund. This information is found in the fund's Statement of Additional Information (SAI) and is broken down by seven ranges: $0, $1-$10,000, $10,000-$50,000, $50,000-$100,000, $100,000-$500,000, $500,000-$1 million and more than $1 million.

This information on manager ownership would be more useful if it distinguished amounts over $1 million and/or gave specific dollar amounts, but Morningstar has found the data still has predictive power.

It may surprise you just how few managers "walk the talk" of sharing their investors' financial interests. The reason this isn't just an interesting bit of investment trivia is Morningstar found a strong *correlation* between ***manager ownership*** and ***investment performance***.

In a recently published study, Russ Kinnel, Morningstar's Director of Manager Research, looked at manager investment levels from 2009 and tracked five-year performance going forward. Unbelievably to us, ***54% of funds had zero manager investment*** at the start of the period. After grouping funds by the seven manager investment ranges, Kinnel calculated what percentage survived the entire period and outperformed their category peers (i.e. the "success rate").

Not surprisingly, funds in which managers invested nothing had the lowest success rate and those in which managers had more than $1 million invested had the highest success rate. Looking at U.S. Equity funds, funds with no investment had a "dismal" 29% success rate versus 39% for the top group. In other words, your chance for success was 1/3 greater investing in a fund in which the manager invested more than $1 million.

We realize correlation isn't the same as cause-and-effect. Still, Kinnel writes, "those with high investment levels likely believe strongly in the strategy and people in place." On the other hand, "those who view their fund as simply a product to be sold may not be as likely to invest in a meaningful way."

The next time somebody is pitching an investment product as good for you, ask how much they will have invested alongside you. You may be surprised at the answer. If the answer is little or none, that should be a bright red flag.

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