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Why Fund Managers Risk Too Much

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Many investors are passive and accepting of poor fund management. When they should make a fuss, they rarely do - even when things go horribly wrong, as they did between 2000 and 2003 during the dotcom crash. But when investors keep their mouths shut about bad fund management, this opens up the potential for fund managers to take advantage them. In this article, we'll show you why you should play an active role in understanding and evaluating your portfolio, even if it has been performing well.

Investors Lured by Last Year's Winners

A March 2004 study at the University of Cologne in Germany, "Family Matters: The Performance Flow Relationship in the Mutual Fund Industry", demonstrates the prevalence of the unfortunate but common process of investing in last year's winners. According to the study, despite the warnings against using the previous year's performance as a predictor of future success, investors remain impressed by past gains, and continue to base their investment decision on this data.

This means that in order to attract new investors each year, fund managers need to show good results from the year before. This often leads managers to take on above-average risk, which can be fine in good times, but it can also be disastrous in a bear market, as this strategy can go horribly wrong when the market turns for the worse.

When evaluating a fund, therefore, it is important that investors remember the adage that "past performances does not dictate future performance."

Fund Managers Propelled by Investor Behavior

Because investors tend to be reluctant to switch funds and/or managers - whether because of up-front fees or just plain apathy - fund managers are able to take undue risks with existing investors in order to attract new ones. In other words, fund managers are not punished appropriately for gambling with their clients' money because most investors remain faithful to a fund when it underperforms.

In these cases, investors lose out heavily because they do not get what they wanted or expected in terms of risk. One of the most basic principles of fair play in the industry is that people should never lose money through taking risks they did not agree to. Nevertheless, this is exactly what tends to happen in the mutual fund industry when gaining new investors takes precedence over protecting current fund holders' interests.

The process can also work in reverse, causing successful managers becoming too cautious. For example, once a manager has a strong client base, he may become defensive and focus on matching the benchmark or index. For investors who are counting on active management and exploiting current market opportunities, this isn't the attitude they want in a manager.

Common Problem

How likely is all this to happen? These problems are serious in the U.S., where risky business is particularly beneficial to fund managers. Stefan Ruenzi of the Center for Financial Research in Cologne found clear evidence that bad funds are not appropriately punished by outflows of money. His research indicates that funds in the top 20% during one year pick up 10% more business than funds in the second 20%. Below that, performance does not seem to make much difference.

When top-performing funds rake in considerably more new business, it is tempting for fund managers to beat the index by taking on a greater amount of risk. This is not always a bad thing for investors in a fund: by taking on more risk the fund will likely perform much better than the index when the overall market is trending upwards. Of course, the problem is that the fund will also do proportionally worse than the index in a bear market.

Far too many fund managers rely on indexes and try to beat them, but what should really matter to investors is whether their fund manager is staying within the bounds of the fund's risk profile (and possibly having some form of explicit loss control). Getting a couple of percentage points more in good times is not much of a consolation if the gains of the last five to 10 years get wiped out then the market takes a turn for the worse.

Vying to Beat the Index Seldom Pays

Investors should also bear in mind that one of the best-kept secrets in the industry is that few funds succeed in beating the index consistently over time. For this reason, investors are generally better off with products that do not claim to do anything other than match the index, so-called "trackers".

Alternatively, if this does not appeal to you, find a fund that is deliberately contrarian and does not worry about the index at all. Anything in between could turn out to be a bad and expensive compromise, both in terms of fees and potential losses.

Learn the Level of Risk

To avoid getting trapped in an underperforming mutual fund, investors also need to check out the risk of specific funds through sites such as Morningstar and Feri Trust. These internet services provide information on the risk profiles of funds and even give risk rankings. Alternatively, investors should not be afraid to ask their banks, brokers and advisors exactly how (relatively) risky various investments are. They should also request meaningful feedback as to whether any gamble is really worthwhile in terms of their risk preferences and personal circumstances.

In addition, the Center for Financial Research stresses that it is important for investors to know how fund managers are paid. If this depends on how much business they bring in, all the above dangers will apply. Find out how your fund manager is paid and rewarded for success as well as how this success is defined.

Most managers are measured by returns in relation to an index (an average of a large number of shares) or a group of similar funds. What is stated less often is how much money a fund managed to attract in a given period. Even more rare is the information that may matter most: H*ow did the fund do, not only when return is taken into account, but risk as well?*

Both the market and firms reward managers for good returns in good times far more than they punish for losses in bad times. This contributes to the problem of fund managers taking on more risk than may be appropriate. Few managers are paid for keeping to the right level of risk despite the fact that during times of market volatility, this may be the only way to prevent losses that investors were never really willing to chance. As a result, investors who request medium- or low-risk investments frequently end up with medium-high or truly aggressive portfolios.

Conclusion

The Center for Financial Research suggests that in the future, some funds may start paying their managers based not only on a fund's returns, but also on the level of risk required to achieve them. Recent research, however, suggests that that day may be a long time coming. Therefore, investors must try to familiarize themselves with the risk profiles of their portfolios and ensure that they match the level of risk that they are willing to take on.

Alexander Kempf und Stefan Ruenzi: "Family Matters: The Performance Flow Relationship in the Mutual Fund Industry", CFR-Working Paper 2004-05 (http://www.cfr-cologne.de/downloads/workingpaper/cfr-04-05.pdf).