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New studies suggest that mutual funds with more than one portfolio manager tend to perform better

By Jim Middlemiss | April 2014

Mutual fund portfolio managers who work as part of a team are less likely to use deceptive tactics such as window dressing or portfolio pumping. In addition, their funds perform better, attract more investment dollars and are cheaper, according to two recent Canadian studies.

"Teams cheat less than individuals in a mutual fund setting," says finance professor Saurin Patel. "We show that team management significantly inhibits a [portfolio]manager's drive to deceive.

"By increasing the number of team members, cheating actually goes down by as much as 50%," adds Patel, who teaches at the Richard Ivey School of Business at the University of Western Ontario in London, Ont. He conducted his studies with Sergei Sarkissian, a finance professor at McGill University in Montreal.

The two studies, *Deception and Managerial Structure: a Joint Study of Portfolio Pumping and Window Dressing Practices* and *To Group or not to Group? Evidence from Mutual Funds*, examine the impact that portfolio-management teams have on mutual fund investing.

The first study, Patel says, was set up to examine whether team-based organizations deterred people from engaging in unethical or deceptive behaviour.

In the second study, the focus was on the impact that the group dynamic had on performance and productivity.

The researchers looked at the trading and performance data for U.S. equity mutual funds for the period of Jan. 2, 1992, to Dec. 31, 2010, in four categories: aggressive growth, growth, growth and income, and equity income.

Patel and Sarkissian looked for indications of portfolio pumping - illegal activity in which portfolio managers artificially inflate their yearend or quarterly performance by placing large orders on existing holdings.

The researchers also looked for window dressing, in which portfolio managers buy or sell stocks prior to public disclosures to give the impression that winners are being held in the portfolio.

The study found "strong evidence" of portfolio pumping over the sample period. Further, the "largest extent of portfolio pumping occurs among the worst-performing, single-managed funds."

However, the study found, portfolio pumping "diminishes with team size." For example, among aggressive growth funds, according to the study report: "Strength of portfolio pumping for funds with five or more managers is 35% lower than [for] single-managed funds."

Regarding window dressing, the study found that team-managed funds tended to sell fewer of their "extreme" losing stocks or buy fewer "extreme" winning stocks than single-manager funds. The selling intensity of bad stocks was most prevalent among single-manager funds.

Patel says the incentive for people to cheat in a team environment is less because there is greater social pressure and peer monitoring. Also, there are reduced benefits from cheating because any gains earned would be spread across the team, as opposed to benefiting one individual. Those reasons, he says, reduce the incentive for an individual portfolio manager to cheat.

In the second study on performance, Patel and Sarkissian found that team-managed funds had higher risk-adjusted

returns than did funds overseen by a single portfolio manager.

The researchers tested for performance using data from Morningstar Direct rather than information from the Centre for Research in Securities Prices, the usual database used by academics. The same four categories of U.S. equity funds were examined - aggressive growth, growth, growth and income, and equity income - for the period of 1992 and 2010.

The researchers found that team-managed funds outperformed single-manager funds in every category except aggressive growth, for which there was no impact.

Patel speculates that this is because aggressive growth funds deal with "soft, not easily available information about stocks," in which case a single manager is better equipped to oversee the fund.

Teams added an average of 37 to 46 basis points (bps) to fund performance. In the case of growth and growth and income, the positive impact of team management averaged 47 to 102 bps.

Funds overseen by three portfolio managers performed best, adding 59 to 65 bps annually vs single-manager funds. Three-manager funds also outperformed funds with two portfolio managers and those with four or more.

Patel and Sarkissian also tested to see if location had an impact on performance, and found that portfolio managers located in financial centres gain an average of 60 to 72 bps annually.

Patel attributes this to better information: "In a big financial centre, teams will actually be more effective in collecting information through various social and business networks."

This study also found that homogeneous (in terms of age and education) teams outperformed heterogeneous teams. Says Patel: "Managers with large differences in incentives and career options, stemming from differences in their educational background and age, are unlikely to collaborate well on such vaguely defined issues as fund portfolio composition and trading activity."

The study also found that team-managed funds had 5.5% lower annual turnover rates, which led to costs that were 2.5% lower than single-manager funds. According to Patel, the lower turnover rate "implies less aggressive trading within groups of portfolio managers and, therefore, provides additional support that teams lead to less extreme behaviour."

Team-managed funds also resulted in 4.5% net asset growth per year over their single-manager peers.

These studies could easily be replicated for Canadian mutual funds, says Patel, who thinks similar findings would result.

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