OPINION

Canada should require managers to disclose their investments

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In my previous article entitled "Why performance fees are a scam" I discussed why performance fees are both harmful and unnecessary. I concluded that a better alignment of interests could be achieved by having fund managers invest in their own funds; also known as co-investment. Unfortunately, most fund companies don't disclose the investing habits of their managers. And there is no requirement in Canada for them to do so. It's high time our regulators changed that.
First, let's be clear. Co-investment is really important information. It is the simplest and most effective method of aligning the interests of a fund manager with those of investors. After all, what more incentive could a fund manager need to perform well than having her own money on the line?

According to research by investment research firm Morningstar, there is very good evidence that in the United States the more money a manager has invested in the funds he runs, the better those funds perform. Funds that are run by managers with no co-investment perform meaningfully worse. It isn't hard to figure out why.

Sadly, the United States is the only country in the world that requires co-investment disclosure from its fund managers. U.S. fund companies are legally required to detail the dollar amount (within a range) a fund manager has invested in each fund that he manages. In every other country across the globe, investors are largely left in the dark.

I say "largely" left in the dark because a small number of Canadian fund companies will disclose some co-investment information if you ask for it. However, few investors or advisers think to ask and the information provided is generally vague and rarely communicated in writing. For instance, a firm might make a general verbal statement like, "many of our fund managers invest in the funds they run." This tells us nothing about the significance of that investment or exactly which of the firm's funds are run by managers with high levels of co-investment.

Even better, some firms make it a standard practice to pay at least a portion of a manager's bonus in fund shares on a vesting schedule. This guarantees at least some degree of co-investment as long as the fund shares remain unvested. But again, it's rare that a firm will disclose even approximate dollar figures.

It is worth mentioning that a small minority of fund companies publicly disclose co-investment information directly on their website for all to see. To my knowledge that list includes one firm, Steadyhand Investment Funds.

Unfortunately, a much larger number of firms do not volunteer this information and refuse to disclose it even when asked.

This represents a farcical double-standard. I speak with fund managers regularly who tell me that before they buy stock in a company, they look to see whether its executives are also owners of the company they run. Many fund managers simply won't invest in a company where the management team doesn't have skin in the game. But these same fund managers will then refuse to disclose their own investment in the funds they run.

In this regard, mutual fund investors are treated like second-class citizens. Stock investors have access to this vital information. It's a matter of public record whether managers of publicly traded companies hold stock in their firm. So why shouldn't fund investors receive the same treatment?

One reason for this disparity is that stock investors know how important this information is and they demand it. Since stock investors (such as pension funds and mutual funds) typically control large amounts of money, they can exert considerable influence. By contrast, investors in mutual funds often don't think to ask for it and individually no single investor controls enough money to have any real bargaining power anyway.

This is why the regulators need to mandate this disclosure. It's valuable information and investors aren't likely to get it without the regulator's help.

Many firms claim that this disclosure would compromise the personal privacy of their portfolio managers. True. But tough luck. Positions of great responsibility demand the highest level of transparency and scrutiny. Fund managers are responsible for managing the savings of our nation's citizens. The stakes are high enough to warrant this invasion of their privacy.

Furthermore, there's plenty of precedent here. Executives of publicly traded companies are required to disclose this information and south of the border this information is required of U.S. fund managers already. So what's the problem?

Reticent firms raise other objections in an attempt to muddy the waters. For instance, some argue that it isn't reasonable to expect all fund managers to invest heavily in their funds. For instance, the manager of a gold fund or an emerging markets fund likely won't want to have more than a small percentage of their portfolio invested in a fund like this; no matter how confident they are in their fund.

This is true. However, it doesn't prevent these managers from investing in other funds they run or other funds offered by their firm. Furthermore, these instances represent the minority of cases. Declining to disclose co-investment information on these grounds would be throwing the baby out with the bathwater.

Hopefully, one day regulators will mandate the disclosure of co-investment information. Failing that, it falls on us to begin demanding this information. It would be nice to see more firms voluntarily disclose it for the simple reason that it's useful information to the investors they are in the business of serving. Knowing whether your fund manager has his or her own skin in the game tells you a lot about the incentives they have. After all, as my former colleague at Morningstar Don Phillips liked to say: "No one washes a rental car."

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