When it Comes to Fund Management, Two Heads Really are Better than One

By Robert Huebscher
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Team-based management got a big endorsement in October of last year, when Fidelity Investments announced it was embracing a team-oriented approach to fund management. Team management is widely employed throughout the fund management industry, with 919 of 2,171 (42%) of funds reporting more than one manager. That includes American Funds' Growth Fund of America, the largest mutual fund with $178 billion in assets, which boasts 10 portfolio managers and more than 40 analysts, according to a Reuters report.

Academic studies have shown that team-managed funds enjoy a marketing advantage, attracting more assets than their single-manager counterparts. But the same studies have shown that team-managed funds perform no better than single-manager funds. A new study, "Horses for courses: Fund managers and organizational structures," sheds light on this apparent anomaly. Team management may indeed be the more effective structure for mutual funds, even though these funds will not attract the highest-performing star managers.

The study has important implications for advisors. Team-based management is a superior structure and leads to better performance. Advisors selecting single-manager funds need to pay special attention to the skill set of the manager.

The study's authors are Yufeng Han of Tulane University, Thomas Noe of Oxford, and Michael Rebello of the University of Texas at Dallas. We spoke with Professor Noe on September 6, 2008.

Comparing Performance in Team- versus Single-Manager Structures

Noe and his co-authors began with the hypothesis that a single-manager structure offers a critical advantage to skilled fund managers, allowing them to follow a management style that better reflects their personal abilities. By contrast, in a team management structure, an individual manager's abilities are clouded by those of their co-managers.

But this opportunity for skilled managers to display their abilities carries a cost. The study shows that single-managed funds tend to have more eccentric portfolio holdings when compared to peer group averages based on investment style.

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Noe and his coauthors show that team management results in superior performance when measured across the fund universe. Superiority is evident through a difference in alpha of 873 basis points, using the Fama-French three factor model. But, consistent with prior studies, this performance advantage disappears when investment style is controlled for. Approximately 60% of team-managed funds fail to achieve the expected level of style-adjusted performance, which has led many in the investment industry to criticize the team-based approach.

Team-managed funds exhibit a tilt toward stocks with higher capitalization, growth (low book-to-market ratio), and momentum, resulting in a slightly lower beta, as compared to single-manager funds. This finding indicates greater conformity in investment style among team-managed funds, whose holdings are significantly closer to peer group averages based on their investment style.

The distribution of single- and team-management structures across the nine style boxes is shown below.

(Note: S=small; M=medium; L=large; G=growth; B=blend; V=value)

Endogenous Choice

The most interesting findings come when Noe and his co-authors further analyze performance results by investment style.

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The authors looked at the issue of endogenous choice, wherein a variable displays misleading results because the experiment masks the interaction of the variable with other factors. Noe offers the following example: Suppose red wine is hazardous to your health, but health fanatics (who are, on average, healthier) think red wine is beneficial and thus drink a lot of it. If the wine's harmful effects are minor but health fanatics are significantly better off than the population average, then a cross-sectional study would find a health benefit from drinking red wine, even though drinking has adverse health consequences.

Economists would say that because drinking red wine is an endogenous choice, the statistical relation between red wine consumption and health might be the product of selection bias.

In this study, the endogenous choice is the decision a fund manager makes between joining a team or managing solo. Thus, it is possible that some unobserved variable--management ability is the obvious candidate--affects the manager's choice. Any negative correlation that arises between team management and performance may not be directly causal—it may instead reflect the fact that certain types of managers are prone to join a management team.

When endogenous choice is properly analyzed, 70% of team-managed funds surpass expectations given fund characteristics. Team-managed funds outperform because the eccentricities of single-manager funds' portfolio holdings introduce a costly drag on performance.

Team-managed funds exhibit inferior stock-picking ability, as well as more sluggish response to new information (i.e., single-manager funds tend to adjust holdings more quickly in response to the release of public information, such as analyst recommendations). But these two factors are not sufficient to overcome the performance drag introduced by eccentric holdings.

The study used data from 2,171 mutual funds (consolidating across share classes) from 1993-2002 which had either a single- or team-management structure during that period. There were 1,758 funds that changed management structure during that period, and these were excluded from the study. The authors provide evidence that this exclusion did not bias their results.

Implications for Advisors

The study reveals a dichotomy: on average, team-managed funds under-perform, but when the endogenous selection of team management is considered, team-managed funds actually do better. The best and brightest managers select into individual management, but this selection effect does not lead to a performance advantage. Team-managed funds still outperform because they

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follow more conventional strategies, relying on factors such as large cap, growth, and momentum.

Noe says the best way to interpret the results is through an analogy to basketball. Team-based management is like a highly structured basketball offense, where each play is carefully scripted. Single-manager funds are like unstructured offenses, where each play is run on an ad-hoc basis. The best basketball players will choose to play on a team that runs an unstructured offense, because this allows them to showcase their skills. But, in the world of mutual funds, the structured offense wins more games.

Lest you think the analogy to basketball in far-fetched, remember the 2004 U.S. men's Olympic basketball team. It had far and away the most talented players, but found itself losing to countries playing more fundamentally-sound, disciplined basketball.

"There should not be a uniformly negative view of team management, as shown by earlier research," says Noe, adding that "team-managed funds are going to get a more generic management style, but it will have performance advantages, because there are fewer unnecessary deviations from benchmarks." Individually managed funds might perform better, Noe says, but advisors should be careful when selecting them. "If you don't have good managers, such as a player like Julius Erving on your basketball team, you may be better off with a more disciplined approach," he said.

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