

Mutual Fund Incubation

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Research Questions

What is the role of incubation in fund initiation?

- How can incubated funds be identified?
- How prevalent is this practice?
- What is the impact on performance, risk, flows?
- Which families incubate?

Results

- Incubated funds:
 - 23% of new domestic equity funds are incubated
 - Outperform by 3.5% risk-adjusted during incubation
 - No difference in performance after incubation
 - Attract higher flows post-incubation
- Fund Families who incubate:
 - Larger families with an active focus
 - Primarily broker distributed
 - Incubated previously
 - Strategically use incubation to shore up fund offerings

Outline

- An Introduction to Incubation
 - The broker dilemma
 - Regulation
 - Examples - public & private incubation
- Results
 - Performance/Risk
 - Investment flows
 - Determinants of incubation
 - Impact on fund inferences/incubation filters
- Conclusion

The Broker Dilemma

One day a broker emails your Aunt Hilda

- She mentions impressive credentials
- She offers free advice to demonstrate her ability
- Over 6 weeks she makes 6 correct predictions:
 - Week 1: IBM will move higher
 - Week 2: GM will drop
 - Et cetera
- The 7th week she emails with another prediction...
...she wants you to buy stock in a little known but publicly traded company called ILINK

What does Aunt Hilda do?

The Broker Dilemma (2)

- The 1st week she emailed 32,000
 - She tells 16,000 that IBM will go up (Group 1)
 - She tells 16,000 that IBM will go down (Group 2)
- The 2nd week she emails 16,000 (Group 1)
 - She tells 8,000 that GM will go up (Group 3)
 - She tells 8,000 that GM will go down (Group 4)
- Aunt Hilda is one of the lucky few (500) remaining
- The broker owns shares of thinly traded ILINK...
when Hilda buys, pushing up the price, the broker sells
- This scam is a variation on the pump and dump
- The SEC made it illegal...why?

Mutual Fund Incubation

Do fund families actually incubate?

- Public Fund Incubation
 - Start multiple funds with a small amount of money
 - Register the funds and file the relevant SEC documents
 - Do not advertise the funds (Morningstar, advisors, etc.)
 - After the funds have established a track record, advertise the funds with good returns to the public and shut down the others
- Private Fund Incubation
 - Advisors manage both mutual funds and separate accounts
 - Convert unregistered separate accounts to a mutual fund
 - Only the best performing unregistered accounts are converted

Public Incubation Regulation

“You ask whether a mutual fund sponsor can establish a number of lightly capitalized **private pools** for the purpose of generating performance track records. In the situation you describe, the sponsor...would select the pools with the best returns and take them public, touting their excellent past performance....The hypothetical you raise is one that the Division term the ‘incubator fund’ problem. The Division has consistently, for close to thirty years, expressed severe reservations about these funds...These concerns underlie the Division’s longstanding position that...incubator fund performance should not be included in a mutual fund’s prospectus in the absence of extremely clear disclosure explaining the sponsor’s purpose in establishing the incubator fund.”

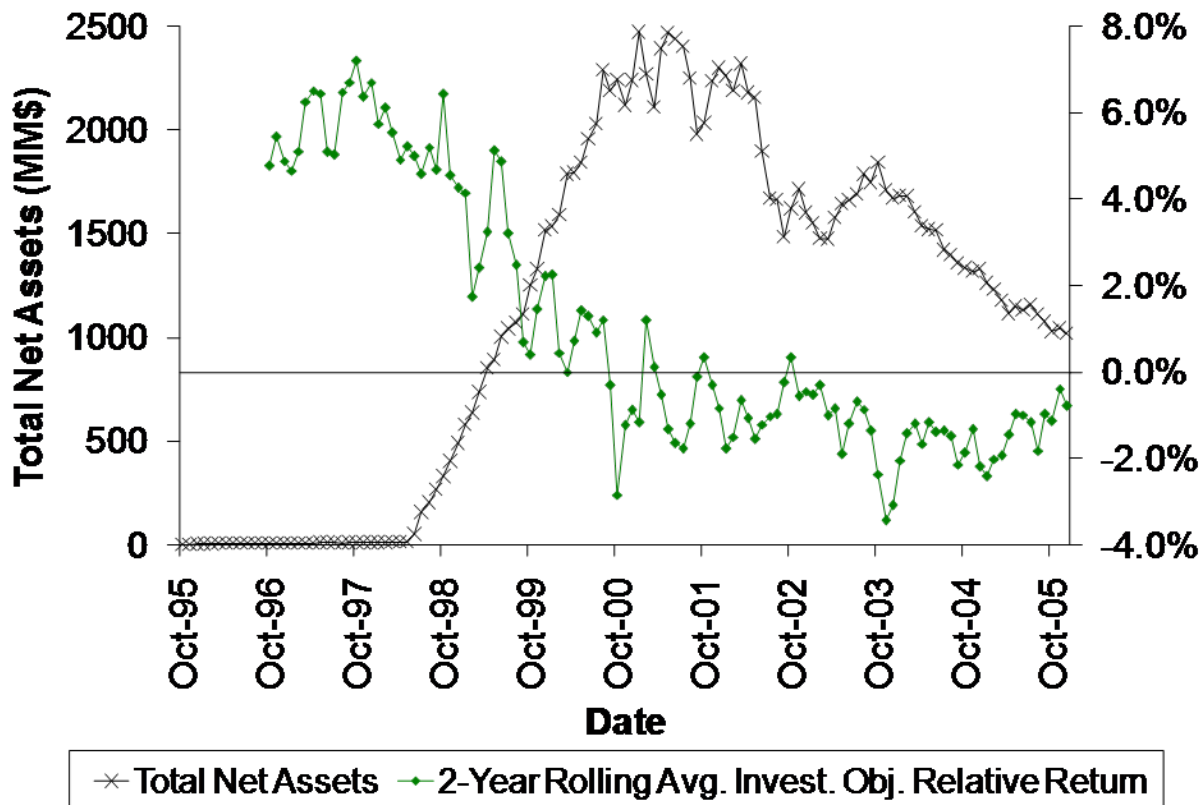
-Jack W. Murphy
SEC Chief Counsel

Private Incubation Regulation

- MassMutual Institutional No-Action Letter (9/28/95)
 - SEC response to MassMutual
 - MassMutual asked about “predecessor performance”
 - Funds can use unregistered account performance to advertise a new fund if (Pierce (1998)):
 - The adviser remains the same
 - Management practices remain the same
 - Investment policies remain the same
 - Unregistered account was not created to generate a track record

Public Incubation: Putnam Research Fund

Putnam Research Fund – Performance vs. Size



Putnam Research Fund: When was it incubated?

- Ticker creation date (PNRAX) for the fund was July 13th, 1998...
...inception date for the fund was October 1995.
- Statement of Additional Info. discloses principal shareholders

STATEMENT OF ADDITIONAL INFORMATION ("SAI") October 2, 1995

SHARE OWNERSHIP

On August 31, 1995, the officers and Trustees of the Trust as a group owned 3.44% of the outstanding shares of Putnam Balanced Fund, 7.27% of the outstanding shares of Putnam Basic Value Fund, 3.67% of the outstanding shares of Putnam Global Utilities Fund, 6.56% of the outstanding shares of Putnam Real Estate Opportunities Fund and to the knowledge of the Trust no person owned of record or beneficially 5% or more of the shares of any fund of the Trust, except that Putnam Investments, Inc. owned of record and beneficially 100% of Putnam American Renaissance Fund, 95.30% of Putnam Balanced Fund, 84.90% of Putnam Basic Value Fund, 96.00% of Putnam Global Utilities Fund, 91.50% of Putnam Real Estate Opportunities Fund and 100% of Putnam Research Fund

Putnam Research Fund: When was it added to Morningstar?

Morningstar Principia Pro - [Untitled]

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Mutual Funds

Mutual Funds Universe
Data updated through 03-31-1999

Primary Rank
▲ Fund Name

Secondary Rank

Fund Name	Morningstar Category	Prospectus Objective	Tot Ret 12 Mo	Tot Ret Annlzd 3 Yr	Mstar Rating	Mstar Rating 3 Yr	Fund Incept Date
8484 Putnam Research A	Large Blend	Growth	19.04	28.79	★★★★★	5	1995-10
8485 Putnam Research B	Large Blend	Growth	-	-	-	-	1998-06
8486 Putnam Research M	Large Blend	Growth	-	-	-	-	1998-06

8487 Morningstar Principia for Mutual Funds

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8490 March 1999 Additions

8491 Putnam Research A

8492 Putnam Research B

8493 Putnam Research M

8494

Private Incubation: Nicholas Applegate

Statement of Additional Information August 2, 1996

“The following table sets forth historical performance information for the Core Growth...Portfolios and the following predecessor investment partnerships and pooled trust which were operated by the Investment Adviser prior to the organization of such Portfolios: Core Growth Portfolio -- includes performance information for Whitehall Partners, a California limited partnership the assets of which were transferred to the Core Growth Fund on April 19, 1993...”

“The Investment Adviser has advised the Trust that such partnerships and pooled trusts were operated in substantially the same manner as such Portfolios...”

New Fund Performance

- Incubated funds outperform during incubation
 - Control sample – non-incub. domestic equity funds
 - 4-factor alpha – 4.2% vs. 0.68%
 - Inv. obj. relative return – 3.5% vs. 0.97%
 - Total return – 17.3% vs. 7.5%
- Post-incubation, no performance difference
 - No statistically significant difference
 - 4-factor alpha – 0.72% vs. 0.68%
 - Inv. obj. relative return – 1.9% vs. 0.97%
 - Total return – 4.3% vs. 7.5%

Aggregate Fund Returns

	Total Obs.	% Obs. Incub.	Bias Estimate		
			4-Fctr. Alpha	EW Avg.	VW Avg.
1996	7433	39.28%	1.33%	1.48%	0.18%
1997	10023	30.14%	0.66%	0.95%	-0.02%
1998	12967	25.22%	1.20%	0.81%	-0.44%
1999	15101	20.15%	0.94%	0.41%	-0.17%
2000	16939	17.25%	1.04%	0.83%	0.27%
2001	18370	11.73%	0.36%	0.28%	0.08%
2002	18993	10.02%	0.16%	0.20%	0.04%
2003	18984	7.36%	0.08%	-0.04%	0.05%
2004	18970	7.03%	0.02%	0.00%	0.00%
2005	18230	7.04%	-0.04%	-0.08%	-0.02%
Overall	156010	14.90%	0.43%	0.84%	0.11%
p-Value			0.001	0.002	0.709

Incubated Fund Risk Measures

Incubated funds are riskier...but not by much

- Incubated funds vs. non-incubated funds
 - Total risk - 6.45% vs. 5.97%
 - Active risk – 2.33% vs. 2.16%
- Incubated funds - during incubation vs. post-incubation
 - Total risk - 6.45% vs. 5.93%
 - Active risk – 2.33% vs. 2.11%

Why aren't they taking bigger bets in incubation?

Is Incubation A Test Of Managers?

Arguments against:

- Outperformance disappears post-incubation
- Incubating families have shorter manager tenure
- Incubation decision influenced by competitive factors:
 - Funds selection based on total return not alpha
 - Selection also based on investment objective flows

Arguments in favor:

- Examples - Putnam Research
- Large family, active management focus

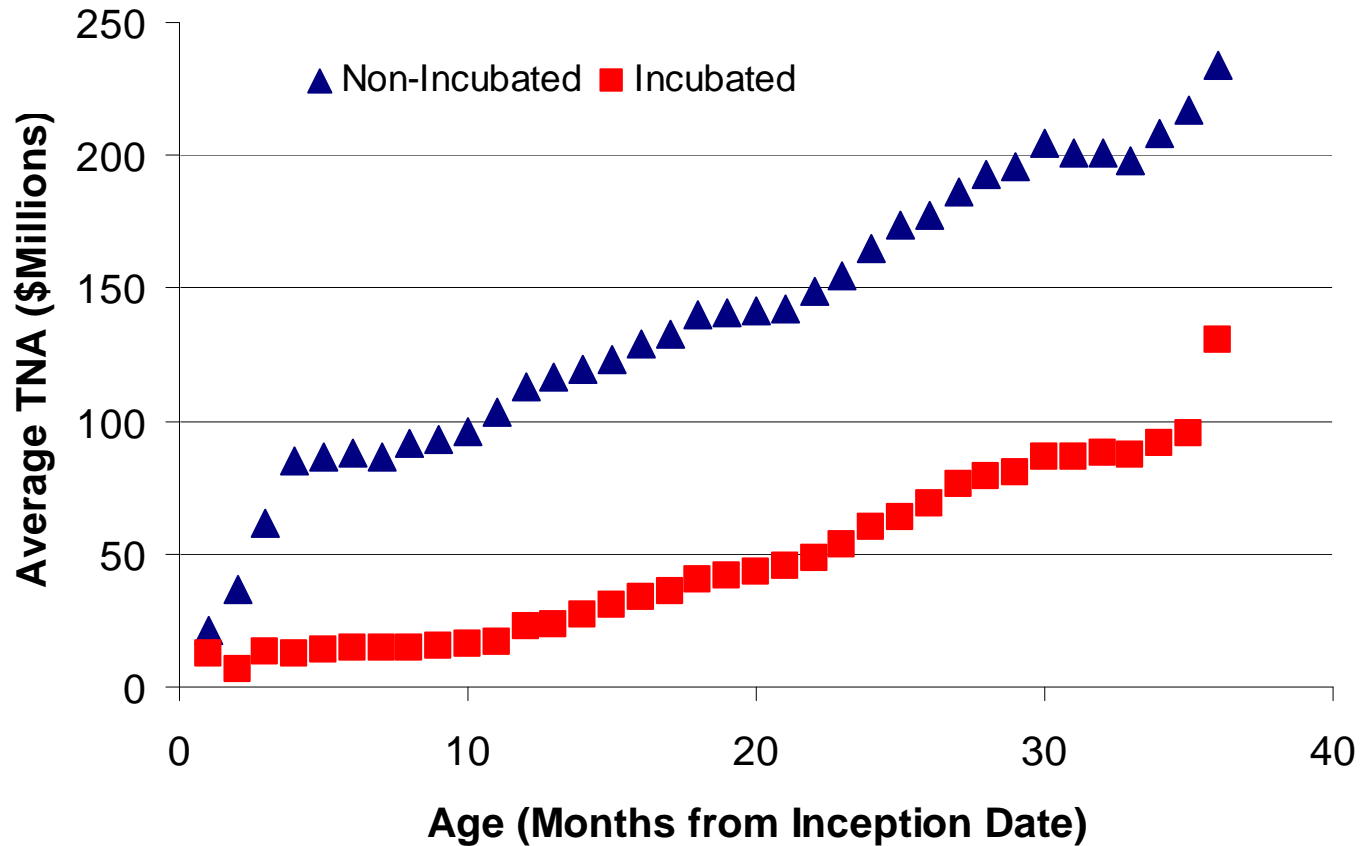
Incubation and Fund Flows

- Incubated funds attract higher flows:
 - Net dollar flow rank - 53rd vs. 48th percentile
 - On average, about \$9 million more a year
- Higher flows are due to:
 - Fund performance since inception
 - Investment objective of the fund
 - Past fund flows
- Are these inflows sticky?

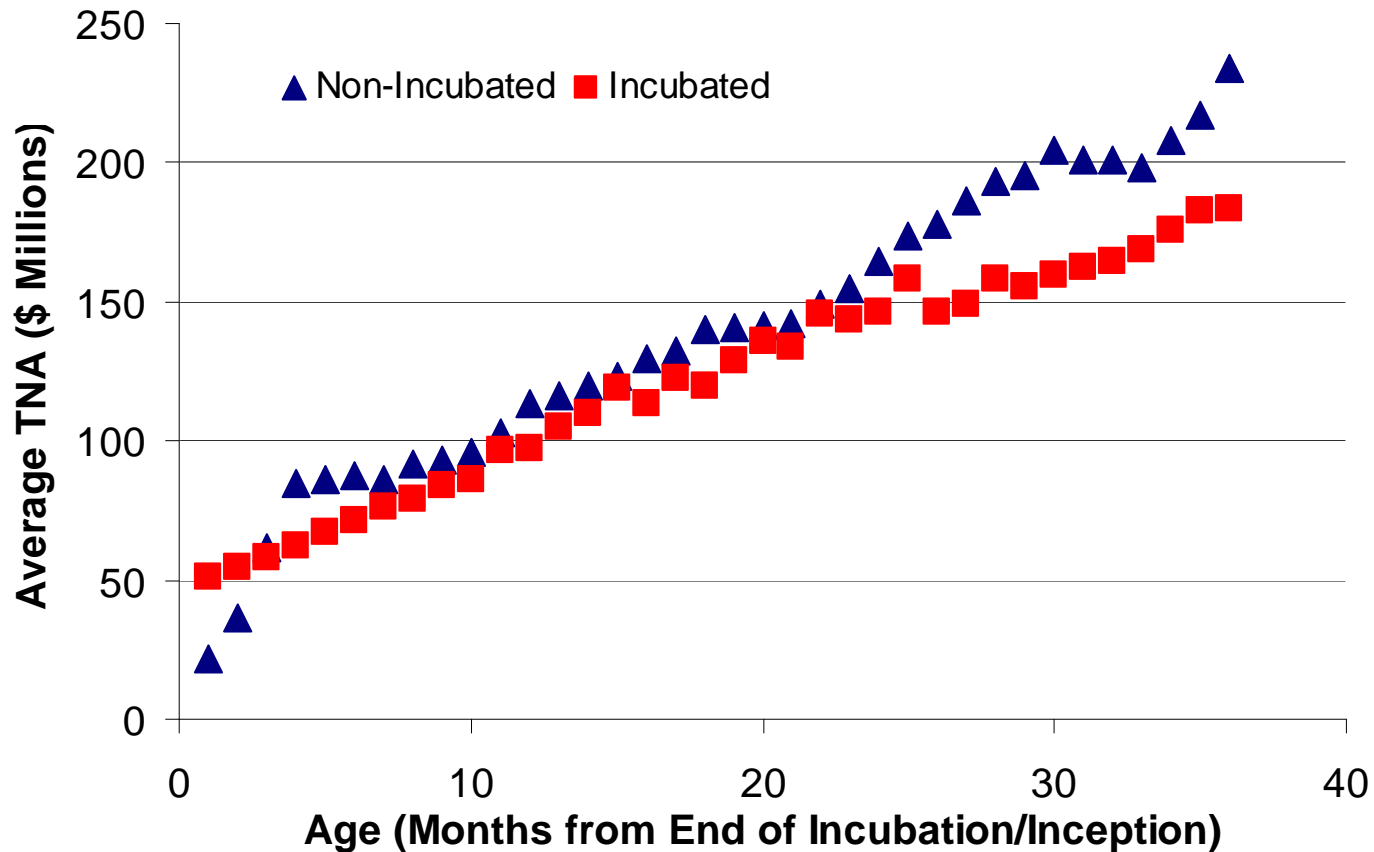
Which Families Incubate?

- Families that incubate:
 - Large families
 - Broker distributed
 - More institutional money (private incubation)
 - Incubate consistently
- Funds incubated where
 - Investment objective flows high
 - Current family offerings performing poorly
 - Current family inflows poor relative to invest. obj.
 - Lower fund proliferation/fee competition

Flow, Size, Performance Inferences



Flow, Size, Performance Inferences (2)



Incubation Filters

- Ticker creation date filter
 - Clear indication of public availability
 - Not available before 1999
- Age filter (remove first 3 years of performance)
 - Easily implementable over entire sample period
 - Also removes valid observations
- Total net Assets filter (remove funds below \$25 million)
 - Most commonly applied filter
 - Does not remove bias – private incub./good performance
 - Removes non-incubated funds with bad performance

Conclusions

- Incubation is prevalent – 23% of new domestic equity funds
- Incubation increases performance
 - Incubation period outperformance:
 - 3.5% (4-factor alpha)
 - 2.6% (Inv. obj. relative return)
 - Post-incubation, no difference in returns
- Investor flows respond to incubated fund performance
- Large, broker-sold, families incubate strategically
- Incubation affects performance/size/flow inferences...
...and can easily be controlled for