Mutual Fund Incubation and the Role of the Securities and Exchange Commission

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ABSTRACT. A mutual fund family incubates a fund when it creates a privately subsidized fund not available to the general investing public. It destroys unsuccessful incubator funds. The few successful funds will report higher incubation returns than the market return in advertisements intended to attract money from individual investors. This practice is currently allowed by the SEC. The evidence is that incubation returns are not a good predictor of subsequent fund performance and likely serve to mislead unsuspecting investors.

KEY WORDS: mutual funds, incubation, Securities and Exchange Commission

There are over 20,000 mutual funds to choose from. In the U.S., there are now more mutual funds investing in stocks than there are companies listed on the New York Stock Exchange (NYSE), the American Stock Exchange (Amex), and Nasdaq combined. Deciding which mutual fund to invest in can be a daunting task for an individual investor.

The typical U.S. equity mutual fund pools money from many different investors to purchase shares of publicly traded companies. Managers of mutual funds receive fees from investors in return for running the fund. Mutual funds may have different investment styles, such as growth, value, small-cap, or large-cap (see Brown and Goetzmann (1997) for a discussion of mutual fund style categories).

The common starting point in selecting a new fund is examination of the fund’s past return relative to the market return as reported in the prospectus. Mutual fund company advertisements often focus entirely on past performance over the market to entice investors. Research by Warther (1995) and others has shown that investor cash flows to funds are directly tied to their past relative performance. Mutual funds with abnormally good performance see money flow their way; underperforming funds often see money outflows as investors follow managers with “hot hands.”

Mutual fund families may experiment with different trading strategies or investment managers before they offer a product to the investing public. Funds not open to investment by the general public are called incubator funds. Unsuccessful funds in terms of realized returns relative to the market are not offered to the general public, but rather are eliminated by the mutual fund family (see Evans, 2004). The poor realized returns and strategies are generally unreported. Well-performing incubator funds are opened up to the general public, which is often attracted by new investment strategies and outstanding past performance.

A hypothetical example can demonstrate the potential misuse of incubator returns. Suppose we allocate $50,000 to 100 different kindergarten students for each to create an investment portfolio (similar to an incubator fund). The students are asked to randomly select about 10 publicly traded stocks to form the investment portfolio.
Over 3-month, 6-month, or 1-year investment windows, the average return for the kindergartener-run portfolios would not be expected to beat the returns of a major stock market index. Just by luck though, a few of these children might do quite well in terms of realized portfolio returns relative to the market. Now, since the children selected the names of the companies randomly, we would not expect those few successful portfolios to continue to outperform the stock market going forward.

We do not expect past performance to predict future performance in mutual funds either. With millions of investors scouring the stock market for profit opportunities, it may be difficult for a mutual fund manager to consistently find bargains. Carhart (1997) and others show that performance persistence is not detectable in mutual funds.

The same principle applies for incubated mutual funds. It has to do with self-selection. If only the successful funds are offered to the public, while the randomly unsuccessful funds are destroyed, why would the past performance of incubator funds be a good predictor of subsequent return performance?

The protector of individual investors is the Securities and Exchange Commission (SEC). Its primary mission is to “protect investors and maintain the integrity of the securities markets.” The SEC states on its website that “only through the steady flow of timely, comprehensive and accurate information can people make sound investment decisions.”

In the case of incubator funds, are the reported returns biased? Is the past performance of incubator funds a reasonable proxy for their return once a fund is opened to investing by the public?

We will show that the past performance of incubator funds is indeed a poor proxy for the returns that the general public receives once a fund is opened up to investors. Results for a unique sample of 95 U.S. equity mutual funds during 2000–2003 indicate that incubator funds have higher returns than the Center for Research in Security Prices (CRSP) value-weighted NYSE/Amex/Nasdaq stock market return for various periods before a fund entered the Morningstar fund database. Value-weighted returns are created by multiplying and summing each firm’s stock return by its proportional weight in the index. Thus, larger capitalization (stock price multiplied by shares outstanding) firms have a bigger proportional weight in the CRSP value-weighted Index.

Table I reports the number of mutual funds in the sample. The last two columns report the percentage of entering funds that are internet funds and large-capitalization blend funds.

Each January of 2000–2003, we examine Morningstar for new domestic equity mutual fund listings. Morningstar is a widely used independent research provider of mutual funds; it serves over 4 million investors and 140,000 professional advisors. All the added mutual funds have some incubator returns. As an example, all of the 14 mutual funds entering the Morningstar database in January 2000 had a monthly return for December 1999.

The back-filled or incubator returns occur when monthly returns are entered into the Morningstar system before the fund was opened to the general public. These are the returns that occurred when the fund was a privately held incubator fund.

Interestingly, the number of back-filled returns varies greatly. While five funds report only one back-filled monthly return, one fund (Stonebridge Aggressive Growth) reports 167 months of incubated returns (almost 14 years).

Not surprisingly, as the stock market reached new heights propelled in part by the gigantic returns of internet companies, internet funds were introduced to meet investor demand. In 2000 (Nasdaq hit its record high in March 2000), over 14% of all equity funds added were internet funds. As the internet bubble burst, the number of new internet funds had

<table>
<thead>
<tr>
<th>Calendar year</th>
<th>Number of funds</th>
<th>% Internet fund</th>
<th>% Large-cap blend fund</th>
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</thead>
<tbody>
<tr>
<td>2000</td>
<td>14</td>
<td>14.3</td>
<td>0.0</td>
</tr>
<tr>
<td>2001</td>
<td>29</td>
<td>6.9</td>
<td>17.2</td>
</tr>
<tr>
<td>2002</td>
<td>34</td>
<td>2.9</td>
<td>26.5</td>
</tr>
<tr>
<td>2003</td>
<td>18</td>
<td>0.0</td>
<td>33.3</td>
</tr>
<tr>
<td>Total</td>
<td>95</td>
<td>5.3</td>
<td>21.1</td>
</tr>
</tbody>
</table>

Each January, 2000–2003, funds that initially appear in Morningstar’s database are included in the sample (only U.S. equity mutual funds). All funds have at least 1 month of back-filled returns before entering the Morningstar database.