

How Corporate Governance Affects Mutual Fund Performance

By Alan Lavine

Want better mutual fund performance for clients? Check out Morningstar's "Stewardship" grades, which rate funds on five components: regulatory issues, board quality, management incentives, fees, and corporate culture.

Mutual funds with good Stewardship grades tend to outperform funds with poor Stewardship grades, according to a working paper by Northeastern University finance professors David P. Boyd and Mustafa Yilmaz. In their paper, "Stewardship as a Factor in the Financial Performance of Mutual Funds," Boyd and Yilmaz say Stewardship grades are a statistically significant component affecting stock fund returns.

Morningstar Inc., Chicago, began assigning Stewardship grades in 2004, following an investigation of mutual fund improper trad-

ing activities by former New York Attorney General Eliot Spitzer. Under Morningstar's Stewardship rating system, a mutual fund earns 2.0 points for an excellent score on each component. Funds with a "good" component get a score of 1.5; 1.0 point is awarded to funds with a fair score, and so on for "poor" and "very poor" ratings.

The component scores are added up. Funds with 9 to 10 points are rated "A"; funds with 7 to 8.5 points are rated "B"; 5-6.5 is a "C"; 3-4.5 points is a "D"; and anything less is an "F."

By looking at the correlation between Stewardship grades and performance of 860 stock funds and 264 bond fund returns over three years ending in 2005, the researchers found these results (which are statistically significant):

- On average, a 1 point increase in the Stewardship rating would result in a 0.8 percent increase in the annual average return of a fund.

- Stewardship was a slightly greater contribution factor in growth and value funds returns, compared with blended fund returns.

- Stewardship was not a significant variable in explaining the return on bond funds. Probable reason: Equity funds exhibit greater variability in returns than bond funds.

This working paper is the first in-depth study on the relationship of Morningstar's Stewardship grades and fund performance, and it confirms a shorter study, published in *Financial Advisor* magazine, that found that for the single year 2004, a higher Stewardship grade correlated with better performance by growth stock fund.

The results also track with findings about pension funds done by Keith Ambachtsheer, Ronald Capelle, and Tom Scheibelhut. They found that pension funds that improved their organizational structures, decision-making processes, resources, and clarity of goals, exhibited improved fund performance. That report, "Improving Pension Fund Performance," was published in the *Financial Analysts Journal* in November/December 1998. ■

Alan Lavine writes about mutual funds and investing.