Fund Spy

Capital Group Stays at the Top Through Hard Work

By Janet Yang, CFA | 10-01-15 | 06:00 AM | Email Article

Morningstar recently issued a new Stewardship Grade for American Funds, a subsidiary of Capital Group. The firm's overall grade--which considers corporate culture, fund board quality, fund manager incentives, fees, and regulatory history--is an A. What follows is Morningstar's analysis of the firm's corporate culture, for which American Funds receives an A. This text, as well as analytical text on the other four Stewardship Grade criteria, is available to subscribers of Morningstar's software for advisors and institutions: Morningstar Advisor Workstation(SM), Morningstar Office (SM), and Morningstar Direct(SM).

Capital Group and its subsidiaries, including American Funds, remain among the industry's strongest stewards of investors' capital. With more than $1.4 trillion in assets under management, over 7,000 employees, and a history that goes back longer than eight decades, Capital Group long ago showed itself to be an enduring franchise. Reaching that apex required continual evolution, including the creation of the firm's multimanager system six decades ago. The development continues today, as the firm finds its footing in a changing fixed-income environment and a market more skeptical of active management. Through it all, keeping focused on investing, generating strong long-term results, and committing to financial advisors has made the company one of the world's largest asset managers, and it earns the firm a Corporate Culture grade of A.

It helps that investors have remained firmly at the helm of this privately held company. Longtime portfolio managers such as Tim Armour, Rob Lovelace, and Darcy Kopcho constitute the majority of the firm's seven-person management committee. Armour, already the committee's chair, became chairman of Capital Group in July 2015 following the unexpected passing of Jim Rothenberg. With the other committee members, he'll continue to set the firm's overall business direction, which mirrors the patient and long-term approach that has long been the hallmark of the firm's investment offerings. There's little chance that Armour's recent appointment will change that cultural tenor.

The firm pioneered the use of multimanager investing in the 1950s, and the system has since become inextricably tied to the firm's identity. The current structure allows sometimes a dozen or more managers, and usually analysts as well, to independently manage slices of a fund's portfolio. This generally results in well-diversified funds that are less volatile than their respective peers, helping investors to stay in them through all sorts of market environments. (Financial advisors, through whom the company gathers most of its assets, can also play an important role here.)

The multimanager system also has its advantages when transitioning portfolio managers on and off funds. Easing managers onto small slices of funds means that investors won't experience the jarring change in investment process that sometimes occurs with single-manager funds. In addition, managers have usually already

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the 12 equity funds with at least a decade of history, all outpace their respective peer group medians, and seven rank in their groups' top quartile.

Such strong results stem from an incentive plan that emphasizes the longer term by using one-, four-, and eight-year returns. In a market that is increasingly sensitive to short-term fluctuations, the firm's longer-term incentive structure allows managers to avoid a myopic view of the market and provides a real competitive advantage. That level of patience has fueled the firm's equity fund performance and is entwined with the firm's low personnel turnover and level-headed culture.

Working to Better Its Bond Business
The firm's defining features haven't translated as readily to success in its fixed-income offerings. As bond markets have evolved during the past decade to become more interconnected and reliant on macro considerations, the firm's multimanager format and traditional focus on bottom-up, fundamental credit research have held it back. Though low personnel turnover has benefited investors overall, the resultant insularity may have hindered the fixed-income team as its members appeared somewhat cloistered from a rapidly changing fixed-income market.

To Capital Group's credit, it has been addressing some of its weaker areas during the past few years, including taking the uncharacteristic step of hiring experienced outsiders at various levels and functions to provide much-needed perspective. One such hire was Pasi Hamalainen, formerly a portfolio manager with PIMCO. He was instrumental in helping the firm make major strides to catch up with competitors, particularly in portfolio risk monitoring. Hamalainen unexpectedly passed away in January 2014 at the age of 46, but he left his mark: Capital Group seemed to have recognized the value of an outsider's perspective and hired Mike Gitlin, formerly head of T. Rowe Price's bond business, in 2015 to lead the firm's fixed-income unit. The role is a first for Capital Group, which previously led all of its investment units by committee, and it underscores how much the firm is willing to change. Other hires include those on the risk monitoring side and an experienced high-yield manager, an area in which the firm continues to add analyst resources.

Since 2008 when its bond offerings stumbled during the credit crisis, Capital Group has gradually been instituting tighter controls in areas that can greatly influence bond fund performance, such as duration or sector positioning. In trying to balance the tension between top-down directives and manager independence, the firm has been using a few new tactics, including formalizing the idea-sharing process, making managers more aware of one another's portfolios, and using analyst and sector portfolios as signaling tools for how diversified managers should consider positioning their investments.

The changes further the firm's relatively newfound goal for its fixed-income offerings to act as buffers to choppy equity markets rather than as sources of meaningful growth. It's a reasonable tack that similar large and respected firms, such as Vanguard, also take. The modest goal seems achievable, and the firm's low expenses can particularly help in this aim. Strong performance in August 2015's volatile market was an important victory for funds such as American Funds Bond Fund of America (ABNDX) and American Funds Intermediate Bond Fund of America (AIBAX).

three distinct and largely independent entities has been one of the ways that Capital Group has maneuvered around its size. For instance, since the three groups (Capital International, Capital Research Global Investors, and Capital World Investors) are separate legal entities that report their holdings separately, they avoid triggering certain rules pertaining to large shareholders.

The large size of many of its funds still practically prevents the firm from accessing the smaller-cap areas of the markets. Still, combining the equity teams' disaggregation with the modular nature of the firm's multimanager system, Capital Group's equity teams have delivered strong results even in the face of naysayers (which include Morningstar) calling for the firm to close its larger funds.

There's no doubt that Capital Group has seen its share of changes during the past few years. And while the firm's fixed-income evolution remains an open question, there's reason for optimism. Overall, the firm remains a shining example of a strong investment culture.

This article is the Corporate Culture portion of the Morningstar Stewardship Grade for funds for this fund family. Visit our corporate website to see Morningstar's Stewardship Grade methodology.

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