Why the size of your fund matters

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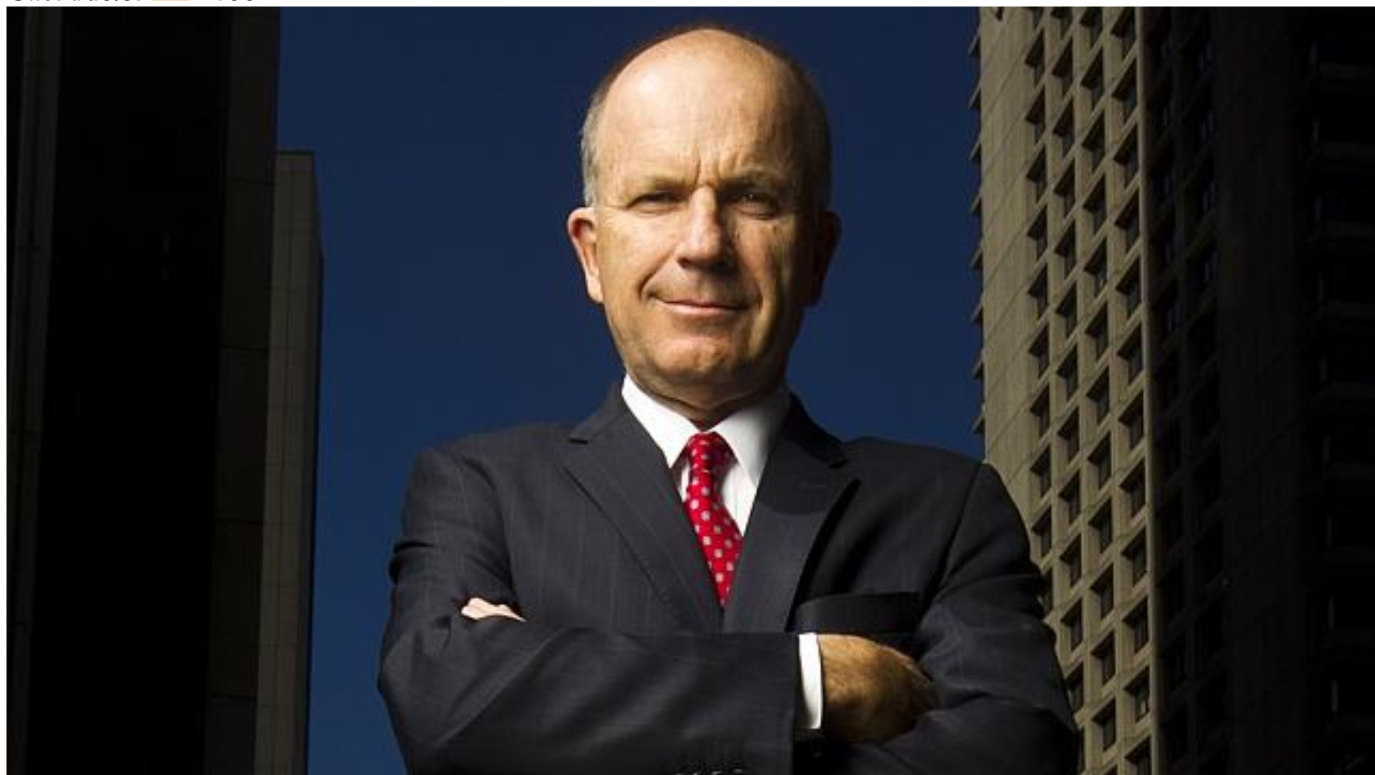

David Paradice admits feeling the headwinds stiffen as his $1.8 billion flagship small cap fund is rubbing up against the uppermost limits of its capacity. **Photo: Nic Walker**

Matthew Smith

Popular managed funds are becoming victims of their own success as - mandated superannuation flows and investor support sees some swell to unwieldy proportions.

It seems bigger is not always better when it comes to managed fund performance, with some of Australia's best-known stock-pickers choosing to close doors to new money in order to maintain impressive returns.

While most investors are comforted by the astronomical size of some funds, few would realise the potential drawbacks of the rock-star status some fund managers have attained.

There is growing body of academic research that suggests that next to stock-picking, a fund's size has the biggest impact on its ability to out-perform, which should prompt unit holders to rethink their allocations and ask if their money could be put to better use elsewhere.

Matthew Ross, head of portfolio strategy and quantitative research at Goldman Sachs, says that scale can bring its own problems.

"The assumption that bigger is better needs to be looked at," he said.

"If you look at the fund managers with the best returns they are generally those that are more nimble."

Managers with muscle

Largest managers of Australian equities by FUM*

Manager	FUM
AMP Capital	$28bn
MLC	$28bn
Colonial First State	$23bn
Perpetual Investments	$22bn
State Street Global Advisors	$18bn

Largest managers of small cap equities by FUM

Manager	FUM
Ausbil Investment Mgmt	$844m
Pengana Capital	$626m
BT Investments	$576m
Eley Griffiths	$497m
Colonial First State	$418m

* Funds under management. Only money managed in retail unit trusts. Excludes institutional and private mandates.

SOURCE: RAINMAKER

Academics and asset consultants who regularly consider the matter place the ability of a fund to capitalise on opportunities among the top criteria for recommending a fund.

While the stock-picking ability of a fund's top portfolio manager will always be the No. 1 consideration, even the most talented fund manager will encounter difficulties when piloting a fund the size of an oil tanker.

The fund capacity issue places managers in an interesting conundrum: on the one hand, the more money a fund takes in, the more it makes.

However, should a fund become too large, managers can be forced into taking positions when they would prefer to be on the sidelines.

Specialist small-cap managers that get too big for instance are forced to invest in larger companies; large cap managers with massive amounts of FUM become conservative because the bigger they are the quicker they end up diluting their best ideas by investing in a greater number of stocks.

Turning down new money

In April 2013 closely watched fund manager John Sevior closed his flagship Australian Share Fund to new money less than six months after opening in an effort to preserve the integrity of the investment strategy.

While there are rules of thumb as to how big a manager can get before performance risk creeps in, there are no hard and fast rules for investors who want to know if a manager is too big for its market.

Most professional investors are aware if their fund accounts for more than 1 per cent of the capitalisation of the market they are investing in, they are at risk of sabotaging their own returns.

That said, a manager's style will dictate where capacity impacts returns, for instance a manager who naturally buys out of favour stocks can afford to grow their funds larger than "momentum" or "growth" managers who are more likely to buy companies in higher demand. Asset class and size of the end investment certainly dictates how big a manager can be without putting performance at risk.

"For managers who have surpassed reasonable capacity levels, it's a hard issue to come to grips with," says Mercer's David Scobie, who has conducted extensive research on the topic.

"Every extra dollar that comes in the door will add to revenue they've reached a certain threshold. The question managers have to ask themselves is this: will that extra dollar impinge your ability to get performance?" Scobie says.

Highly regarded small cap fund manager David Paradice, who founded Paradice Investment Management, admits to asking himself this question or a question like it most days.

With $1.8 billion in his flagship fund, Paradice's fund is understood to be the largest small cap fund in Australia.

The fund – which was closed to new money in 2002 – has an enviable track record of annualised returns close to 18 per cent since inception.

Approaching capacity

In Australia's $180 billion small caps universe, however, the fund is rubbing up against the uppermost limits of its capacity.

Paradice admits to feeling the headwinds stiffen as the fund has grown.

Paradice told Smart Investor he's worked hard to keep the fund's returns up. Since 2007 he says he's handed back as much as $400 million to avoid jeopardising performance, with the most recent episode taking place in 2010.

He's taken other measures to manage his capacity issue – he's carved out a small fund within the small caps fund designed to pay distributions to the broader fund like a stock would.

Within this component Paradice manages a separate portfolio with 30 to 40 micro-cap stocks.

Despite going to these considerable lengths, Paradice admits to being "forced up the market cap scale"; investing in larger companies because positions in smaller companies are too difficult to execute and manage.

Paradice will invest at least 2 per cent of the value of his fund in any given stock in order for it to be meaningful to the overall performance of the portfolio; he will invest as much as 10 per cent in a high conviction position.

He says he is reviewing the fund's position and considering options relating to capacity. "Yes it does get harder to get those returns the bigger you get. We could have grown it a lot bigger but we have always focused on reducing FUM and driving performance," he says.

While small cap managers are the most susceptible to overcapacity, all managers are susceptible to the issue, says Fraser Murray, Frontier Advisors senior consultant and head of equities research.

Indeed, Murray says he believes there are some managers in the market who have “probably gone too far”.

“The push for more assets usually comes from the sales and marketing departments that will continually find reasons why the product should be grown further, not from the managers themselves,” Murray says.

Boutique firms

Boutique firms are less prone to talking on more assets than they should because the managers themselves are in charge of the business and they tend to be more attuned to reputation, he adds.

The biggest impediment managers have as they get larger is their ability to enter and exit positions efficiently.

Smaller stocks will have insufficient liquidity for larger managers to trade into at reasonable levels, while managers can get stuck in a falling stock because of their inability to unwind relatively large positions quickly.

Beyond the constraints excessive FUM can place on a manager’s ability to transact, mindset can also play a role in performance eluding large managers, says Ron Bird, director of the Paul Woolley Centre, University of Technology, Sydney.

Bird has co-written an unpublished paper that explores the respective attributes of diversified versus concentrated strategies.

He says larger managers can end up diluting their best ideas by spreading capital across a greater number of stocks.

“Even without the liquidity issue, larger managers can be prone to diluting their best ideas,” Bird says.

However, consultants and experts are adamant investors should be careful not to take a broad-brush approach to judging whether a manager is too large and therefore constrained in its ability to outperfom. Some managers like to trade quickly in and out of positions, making them more sensitive to capacity issues, while other managers are happy to build or unwind positions over time.

“Being a value manager helps,” says Perpetual Investments head of equities and senior portfolio manager Matt Williams.

Ability to move quickly

Perpetual is among the largest funds in the market and is recognised by experts for managing its capacity concerns well.

Perpetual manages execution issues that can come with funds of a certain size by being prepared to move quickly when a liquidity event reveals itself, according to Williams.

“If we feel that a stock we like is reaching price, we will seek out liquidity or often liquidity will come to us,” Williams describes.

Liquidity can present itself any number of ways such as a company disclosure like a profit warning, a large shareholder selling down or a macro-economic event.

Conversely, Willams says its Perpetual’s size that ultimately enables the manager to take advantages of such opportunities and trade in an opportunistic fashion because the large team of investment analysts are constantly crunching the numbers.

“If something is happening to a company we’re not in, we’ve done all the work and we can act quickly,” he says.

Williams also says Perpetual has been proactive managing its funds under management and is “quite selectively” taking new money into its Australian equities strategy, mainly from existing investors.

Soft and hard closes

Funds managers will often use phases such as “soft close” and “hard close” when discussing their management of capacity issues.

A soft close taken at face value means that a firm will not take on money from new clients but will generally accept flows from existing clients.

A true “hard close” will place much more stringent constraints on taking FUM but, Mercer’s Scobie says, fund closes can sometimes be a “bit fuzzy”.

“Managers handing back money is a rarity. Even a hard close is rare. Soft closes are a lot more common but the rules on a soft closure can vary from manager to manager,” Scobie says.

Investors want to avoid going into a situation where a fund, which produced strong returns in the past, might now be facing a new challenge because their assets under management have changed, says Myer Family Company investment director, Miles Collins.

“For managers who have demonstrated a good track record managing large cap equities on a global basis then this could be less of a concern. But if [a manager’s] returns are dependent on selecting small and certainly micro cap opportunities, or the stocks they invest in are large but have small free floats, then it makes it more difficult for them to produce those returns,” he says. The Myer Family Company, which takes a bespoke multi-manager approach to investing client assets, regularly meets with managers in an early stage of development and the firm currently backs a limited number of these funds.

Investing with smaller managers has its limitations too; Collins says smaller start-up managers need a track record from another recognised funds management organisation to be considered for investment.

He says the best managers to invest with are the ones who have already gone through process of being frustrated with managing big pools of capital and are now more interested in the intellectual process of out performing having already created their own wealth.

“Rather than get caught up straight away in the past performance of a star funds manager, its worth taking a step back and thinking about what kind of opportunities you are looking to get into and what kind of liquidity that requires,” Collins says.

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