global matters weekly

momentum

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Size Matters

by James Klempster, CFA

There's no two ways about it: size matters. We live in a society that admires big - The Angel of the North, the Great Wall - yet we also revere the precision of small - the microprocessor, automatic watches. When it comes to disadvantages, both large and small also can be found wanting. Needless to say, in the world of fund management things are equally nuanced. Plenty of academic literature has been devoted to whether fund manager scale is an explanatory factor for outperformance. Rather than rake over those nebulous arguments again here, the purpose of this article is to discuss why capacity management is – from a very practical perspective – absolutely essential if fund managers want to have a decent chance of delivering on their chosen investor outcomes.

> *"capacity management is – from a very practical perspective – absolutely essential"*

First, let's focus on the conflict that is present, to a greater or lesser degree, in every fund management firm. There are three ways most fund managers are able to improve their profitability, namely managing costs, pushing up ad valorem fees or having a greater pot of money on which to charge a fee. Of the three, our cost base is the part of our business model over which we have the most control. Increasing total expense ratios would be perceived as swimming against the tide in most instances and so, for most fund management firms, the surest route to being more profitable is to increase assets under management without a proportionate increase in costs.

> *"Unfortunately there is no single answer to this conundrum, each potential investment needs to be judged on its merits"*

That is fair enough but as potential investors with these businesses we need to assess assets under management (AUM) with a level of judiciousness that would make Goldilocks proud: not too big, not too small, but just right. This applies not only at a firm level but at a strategy level too. Unfortunately there is no single answer to this conundrum, each potential investment needs to be judged on its merits based on the asset class, the fund manager's style, the research requirements and, crucially, the capacity for them in the markets in which they operate.
Some funds are just too small. There are a number of issues that this can cause for example, funds hitting minimum fixed fee levels with service providers, such as administrators, which push up TERs; also if a fund is too small to deal in appropriate ticket sizes, they will struggle to trade effectively. Another example is the commercial reality of small funds being unlikely to move the dial in terms of a firm's revenue line which means it is either a cost drain for a large firm or serious headache for a smaller one.

> *"It is also worth looking back through a manager's past to see whether their portfolios – and results – of yesteryear could be replicated with today's AUM"*

Most discussions on capacity focus on the opposite problem; that of being too big. The old adage of super tankers being difficult to steer is true and also applies to fund management but, again, its validity depends on the type of investment you are contemplating. Some gargantuan funds have no issues with liquidity because their chosen markets are so deep and utterly liquid. When assessing this risk, one must look at a manager's AUM and compare it to the market in question. It is also instructive to look at the proportion of a company's securities that they own; large shareholdings are harder to sell, especially when the going gets tough. It is also worth looking back through a manager's past to see whether their portfolios – and results – of yesteryear could be replicated with today's AUM or whether success in asset growth comes at the cost of nimbleness and potential alpha.

> *"Firms that do the right thing and close a fund to subscriptions while their size remains in a sweet spot are to be commended"*

Generally speaking, we are most comfortable with firms that have a clearly stated policy on closing their fund due to asset growth and as they grow we continue to assess the appropriateness of this figure. Firms that do the right thing and close a fund to subscriptions while their size remains in a sweet spot are to be commended. Curtailing asset growth means the pool the manager has to use remains fit for purpose and can be deployed effectively to benefit existing investors first and foremost. These firms take the view that investment houses prosper in the long run thanks to performance so they prioritise having assets that are 'just right' for their market.

Market Focus

- Several countries ease lockdown restrictions from today
- Risk assets continued to recover last week
- Brent crude rallied 17.1% last week to $31.0 a barrel
- Gold rose 0.1% to $1702.7 an ounce

US

- President Trump says he will be able to report this week on whether he is satisfied with China fulfilling phase one of the trade deal, adding that the country is purchasing a lot of U.S. farm products. However, the situation remains volatile
- The main technology index moved into positive territory for the year to date last Friday and came within 7% of February's all-time high. Technology shares also bolstered the main US index with a particularly strong showing for Apple
- US payrolls dropped by 20.5 million in April giving an unemployment rate of 14.7%, the highest since the Great Depression of the 1930s. On the positive side, most are expected to be eventually re-hired
- US Treasuries returned -0.3% last week. Looking forwards, the futures market has moved to price in negative rates from next year in the US

Europe

- European equities rose amid optimism of an easing in lockdown measures, finishing the week up 0.5%
- The EU unveiled state-aid rules in a bid to help nations take equity stakes in, or provide subordinated loans to, companies though they also imposed a swathe of curbs to protect taxpayers
- The European Commission has threatened to sue Germany after the latter questioned the legality of the ECB's 5-year, €2.7 trillion bond-buying program

UK

- The UK is set to ease parts of its nationwide lockdown from today. PM Boris Johnson announced the 'first careful steps' towards restarting the economy, setting out a 'conditional plan' for getting people back to work. The Scottish, Welsh and Northern Irish governments announced a more limited easing of restrictions
- The government will extend their furlough scheme to help businesses retain workers on the payroll until the end of September, though reportedly at a reduced rate of 60% down from 80% of capped monthly earnings
- The Bank of England left monetary policy unchanged, but predicted that GDP would fall 14% in 2020 before rebounding in 2021
- UK equities ended the week up 3.1%

Rest of the World/Asia

- The Japanese yen strengthened to its mid-March high against the US dollar and a 3.5 year high versus the euro last Thursday. The currency is typically seen as a safe-haven asset
- China's return to a new normality continued apace with all provinces downgrading their threat levels for COVID-19 to level 2 or lower
- A strong positive surprise for China's export figures in April was announced. Merchandise exports saw a 3.5% increase (year-on-year in USD terms) when the consensus was for a double-digit decline
- South Korea is experiencing a new wave of COVID-19 infections linked to a nightclub in Seoul

Past performance is not indicative of future returns.
Source: Bloomberg, returns in local currency unless otherwise stated.

		Cumulative returns			
Asset Class / Region	**Currency**	**Week ending 08 May**	**Month to date**	**YTD 2020**	**12 months**
Developed Markets Equities					
United States	USD	3.5%	0.6%	-8.9%	3.2%
United Kingdom	GBP	3.1%	0.7%	-20.8%	-15.9%
Continental Europe	EUR	0.5%	0.4%	-15.6%	-6.5%
Japan	JPY	1.9%	-0.4%	-14.2%	-4.8%
Asia Pacific (ex Japan)	USD	0.0%	-1.5%	-14.2%	-7.7%
Australia	AUD	2.8%	-2.3%	-18.3%	-10.4%
Global	USD	2.9%	0.5%	-12.0%	-1.5%
Emerging Markets Equities					
Emerging Europe	USD	0.4%	-1.2%	-30.8%	-14.3%
Emerging Asia	USD	-0.5%	-1.2%	-11.7%	-4.2%
Emerging Latin America	USD	-0.9%	-2.7%	-43.8%	-38.1%
BRICs	USD	-0.1%	-1.3%	-15.8%	-7.7%
China	USD	1.4%	0.0%	-4.5%	1.9%
MENA countries	USD	-4.5%	-4.5%	-22.3%	-23.2%
South Africa	USD	4.0%	1.3%	-31.8%	-32.9%
India	USD	-6.5%	-6.5%	-28.0%	-23.8%
Global emerging markets	USD	-0.5%	-1.4%	-17.8%	-11.0%
Bonds					
US Treasuries	USD	-0.3%	-0.4%	9.0%	14.4%
US Treasuries (inflation protected)	USD	0.2%	-0.1%	4.8%	10.4%
US Corporate (investment grade)	USD	-1.0%	-1.4%	0.0%	8.4%
US High Yield	USD	0.8%	0.6%	-8.1%	-3.3%
UK Gilts	GBP	0.6%	0.1%	10.6%	16.0%
UK Corporate (investment grade)	GBP	0.1%	-0.2%	0.6%	6.6%
Euro Government Bonds	EUR	-0.7%	-0.7%	0.3%	4.2%
Euro Corporate (investment grade)	EUR	-0.5%	-0.5%	-3.1%	-1.0%
Euro High Yield	EUR	-0.7%	-0.7%	-10.3%	-5.7%
Japanese Government	JPY	-0.3%	-0.3%	-0.4%	0.2%
Australian Government	AUD	0.0%	0.1%	4.0%	7.5%
Global Government Bonds	USD	-0.6%	-0.6%	3.5%	7.9%
Global Bonds	USD	-0.6%	-0.6%	1.4%	6.0%
Global Convertible Bonds	USD	2.9%	2.1%	-1.4%	3.8%
Emerging Market Bonds	USD	1.5%	1.2%	-6.7%	-0.5%

Source: Bloomberg. Past performance is not indicative of future returns.

		Cumulative returns			
Asset Class / Region	**Currency**	**Week ending 08 May**	**Month to date**	**YTD 2020**	**12 months**
Property					
US Property Securities	USD	1.9%	-1.8%	-22.7%	-16.0%
Australian Property Securities	AUD	5.0%	-1.2%	-26.8%	-23.8%
Asia Property Securities	USD	0.1%	-0.8%	-17.9%	-14.7%
Global Property Securities	USD	1.3%	-1.1%	-23.0%	-15.5%
Currencies					
Euro	USD	-1.3%	-0.8%	-3.4%	-3.1%
UK Pound Sterling	USD	-0.7%	-1.3%	-6.3%	-4.5%
Japanese Yen	USD	0.2%	0.3%	1.9%	3.3%
Australian Dollar	USD	1.8%	0.2%	-6.9%	-6.6%
South African Rand	USD	2.7%	0.9%	-23.7%	-21.5%
Swiss Franc	USD	-1.0%	-0.4%	-0.4%	5.1%
Chinese Yuan	USD	-0.2%	-0.2%	-1.6%	-4.1%
Commodities & Alternatives					
Commodities	USD	5.9%	4.7%	-33.5%	-31.0%
Agricultural Commodities	USD	1.0%	0.9%	-13.0%	-6.8%
Oil	USD	17.1%	22.6%	-53.1%	-56.0%
Gold	USD	0.1%	0.9%	11.8%	33.0%
Hedge funds	USD	-0.1%	-0.1%	-4.3%	1.1%

Source: Bloomberg. Past performance is not indicative of future returns.

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