

Small is Beautiful

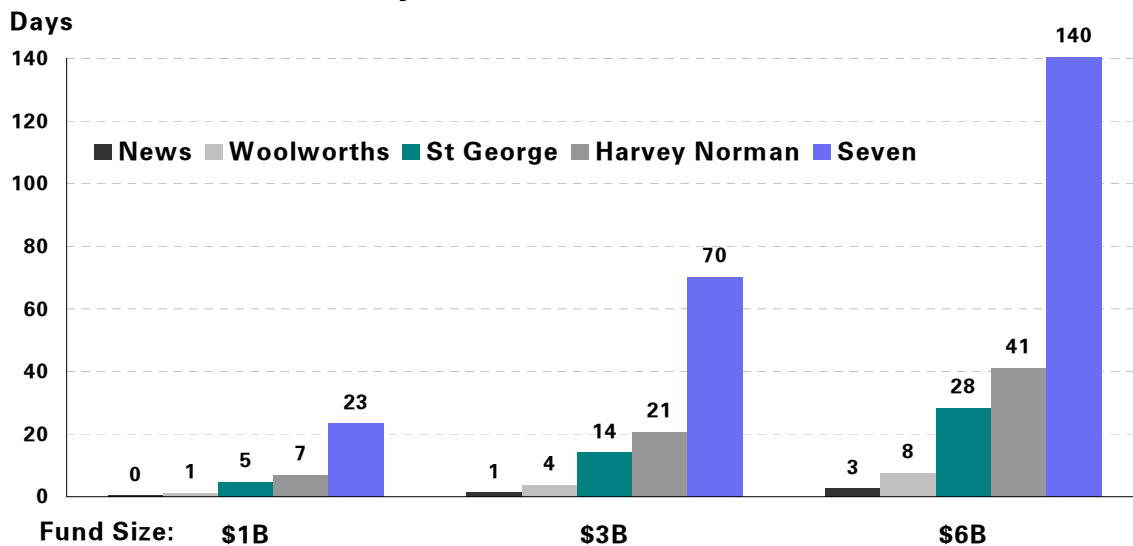
Investment managers with smaller funds under management have a clear performance advantage relative to larger counterparts in Australian equities.

The influence of size on performance has often been considered by comparing the returns of different size cohorts of investment managers. The problem with this approach is that other factors, such as style, skill and luck muddy the comparison. A large manager might do well, because it is legitimately skillful, or because its style is in favour, or because it has a good run of luck. Some small managers may perform poorly for the reverse reasons. So with enough contradictions, this analysis is inconclusive. Some managers report performance on select portfolios that represent only a minor proportion of total funds dedicated to an investment process, so the size of funds shown in performance surveys can also be misleading.

A more direct way of looking at the influence of size on performance is to create a model of the investment management process, and to simulate investment performance over time. With this approach style and skill can be held constant so that size becomes the only major variable accounting for variations in performance. Using a carefully structured analysis along these lines, recently published in the *Journal of Portfolio Management*¹, we have demonstrated how increases in funds under management ultimately lead to lower value added in Australian equity management.

As funds grow it takes longer to trade positions. The chart below shows how long it takes to trade 1% of a fund for a range of stocks across different fund sizes. The estimates assume the manager tries to avoid market impact.

Days to Trade 1% of Funds



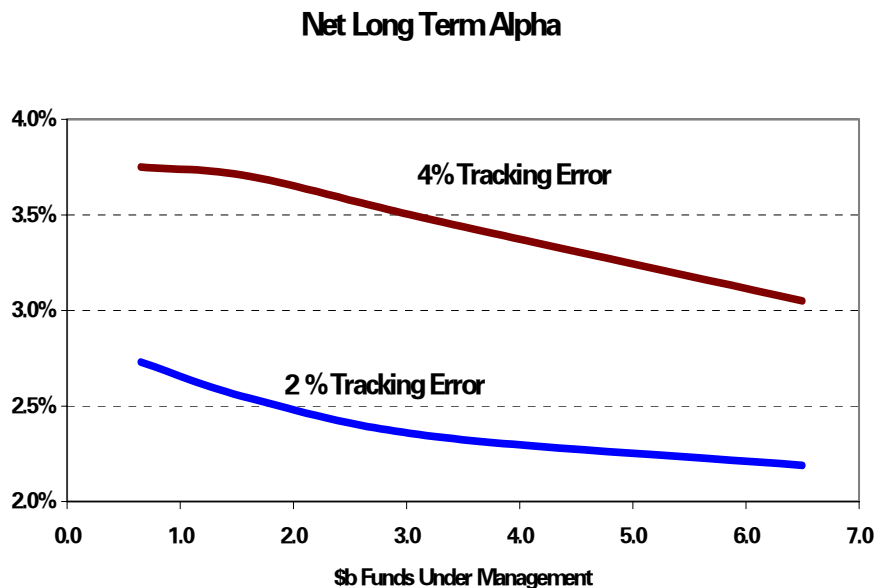
¹Beckers, Stan and Greg Vaughan. "Small is beautiful" *The Journal of Portfolio Management*, Summer 2001, pp9-17

Because the trades of large managers take time to implement, in the process they inevitably contribute to price momentum, as freely available stock liquidity in a stock is exhausted. This creates exploitable opportunities for smaller managers.

Active equity management involves adjusting a portfolio's active positions to reflect changes in the relative attraction of individual stocks. In gauging how attractive a stock is, managers commonly consider characteristics such as value, momentum in prices, and revisions to earnings forecasts. These various characteristics evolve at different speeds, with value slow to change for example, and earnings revisions changing relatively quickly. Where the pace of portfolio adjustment is retarded due to large funds under management, a manager will be less able to exploit fast moving characteristics, and rely increasingly on slow moving characteristics. Not surprisingly, as funds under management grow, managers move increasingly towards the value and large cap end of the style spectrum, by necessity.

Smaller managers can freely determine the optimal mix of positive stock characteristics that define style, and also the appropriate level of turnover to exploit those characteristics. If a smaller manager decides a fast moving characteristic, such as earnings revisions, is attractive, that can be reflected in the portfolio, even though it necessitates a higher turnover level. A small manager is more able to be genuinely style neutral, rather than having to rely on only slow moving stock characteristics.

A common misunderstanding about the effect of size on performance is that size is only an issue beyond some specific limit. In fact size is detrimental to performance from even the early stages of funds growth. The chart below shows how performance declines as funds under management increase.



Biasing manager selection towards smaller managers is one of the easiest ways for funds to improve investment performance.