

OLDMUTUAL

FUND SIZE AND PERFORMANCE: WHAT CAN WE LEARN?

Collin Nefdt | November 2022



CORPORATE CONSULTANTS

DO GREAT THINGS EVERY DAY

Old Mutual Corporate Consultants is a division of Fairbairn Consult FSP 9328, a member of the Old Mutual Group. Fairbairn Consult is a licensed FSP.

Many studies have been conducted on the topic of fund size and performance. A recent Morningstar study¹ of more than 2 300 mutual funds, across various asset classes in Europe showed that, on average, the bigger the fund the better its performance. Such studies have provided mixed results over the years. The financial

media highlights the spectacular returns occasionally achieved by certain smaller funds, and this may create a false impression that smaller funds perform better. Either way, it is interesting to see what the research shows for actively managed, diversified equity funds in South Africa.

MANY FACTORS CAN INFLUENCE FUND PERFORMANCE. CERTAIN FACTORS ARE MORE ROBUST THAN OTHERS, MAKING THEM MORE RELIABLE PREDICTORS OF FUTURE PERFORMANCE.

Based on recent findings, fees are the most important factor in terms of relative performance. Fund size has often been mentioned and researched alongside factors such as manager tenure, turnover, concentration and active share. At a stock performance level, there is evidence of a small-cap premium, but no such premium is found with smaller equity funds (note the distinction between small-cap equity funds versus smaller equity funds). There is the argument that equity markets in different regions may produce differing results as these different regions (or their stock markets) are at different stages in their development and evolution.

The study conducted for this research excludes funds that are not prone to “size effects” such as traditional passive funds, factor funds with passive implementation (i.e., smart beta), funds of funds and multimanager funds. Furthermore, one must remember that fund size is not static and that changes in performance that correspond to a change in size - which in turn is often a result of flows linked to strong or weak lagged relative performance - are noteworthy. Successful smaller funds attract investor attention and assets and become larger funds and vice versa. Furthermore, funds offered by established fund managers and financial services conglomerates alongside strong distribution networks can become large funds without spectacular returns, whereas smaller providers can remain small, even with strong track records, and often take longer to attract widespread investor attention.

It is a feature of the investment industry that equity funds attract flows and become large because of exceptional past performance. Investors are predisposed to strong past performance but are also prone to “performance chasing” that all too often culminates in fund performance deteriorating after reaching a certain

critical mass. Persistent outperformance is the holy grail of active equity management, but relative performance is often mean reverting. The BOE Growth Fund is a classic example within the local diversified equity market of a fund generating spectacular returns only for performance to deteriorate as investors flood the fund with assets. In the U.S., the Fidelity Magellan Fund is a classic case of fund size impacting relative performance. Under the management of the legendary portfolio manager Peter Lynch, the fund produced magnificent results. Heavily promoted by Fidelity it became their flagship fund and assets ballooned. Within 18 months of the Magellan Fund becoming available to the public - it was an incubator fund prior to this - assets rose to thirty times the previous size². This no doubt impacted its investment freedom. Shortly after Lynch's departure, the fund performance (while not falling away completely) became distinctly average and index-like and many of the later investors did not receive the spectacular active returns that had been earned by the smaller version. Many commentators put this down to “asset bloat” which limited the fund's universe to larger and larger stocks and reduced the impact of smaller cap stocks, which had been one of the keys to the fund's success in earlier years.



1) Morningstar busts myth that smaller funds outperform, J Colvin, August 2022

2) Fidelity Magellan and the Paradox of Skill, Morningstar's John Rekenhaller, Jan 13, 2022

What has the research on fund size and performance shown?

Some examples of research are as follows:

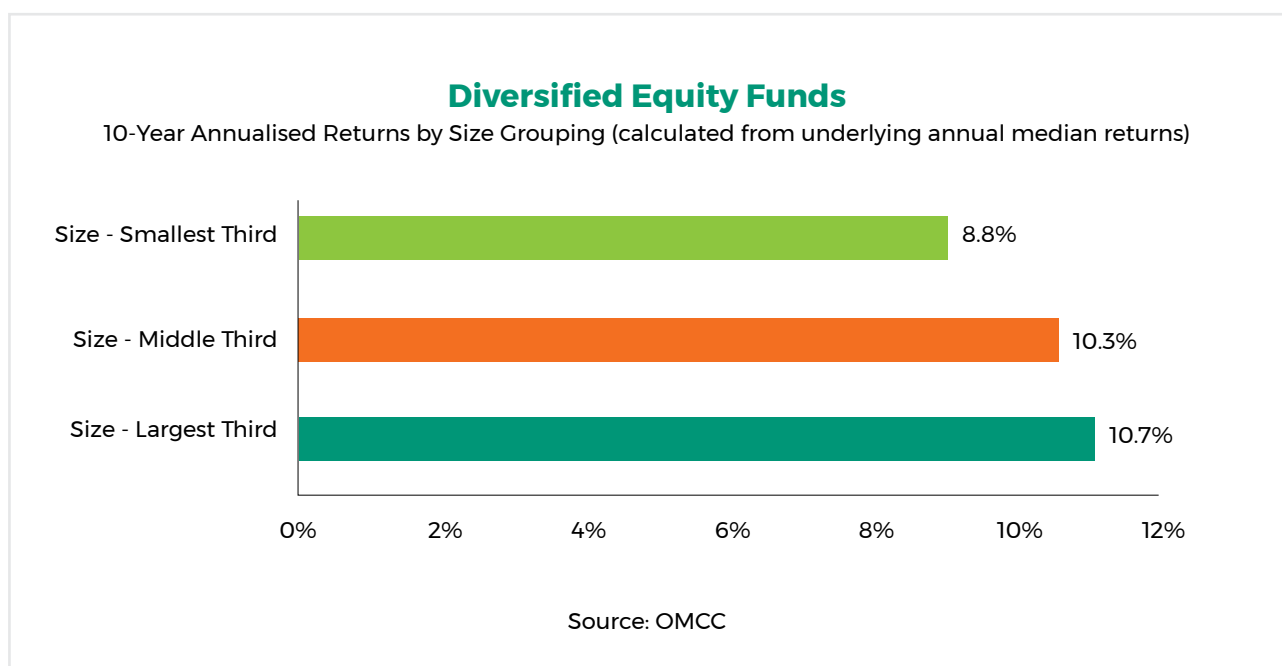
- 1 In the research undertaken for the report titled “Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization”³, it was found that fund size erodes performance. The exercise was undertaken for diversified equity mutual funds in the United States from 1962 to 1999.
- 2 The paper “How Does Size Affect Mutual Fund Performance? Evidence from Mutual Fund Trades”⁴ found that smaller funds performed better because small funds enjoyed an advantage of access to the full universe of stocks.
- 3 The research titled “Size Doesn’t Matter: Diseconomies of Scale in the Mutual Fund Industry”⁵ found little evidence that fund size affects performance.
- 4 A recent Morningstar study of European funds¹ found that bigger funds typically outperformed, and this was due to lower fees. This study also raised the prospect that different regions can provide different findings on this issue.
- 5 A study of fund size and performance undertaken for Indian funds (Impact on Fund Performance: An Empirical Evidence from Selected Indian Mutual Fund Companies⁶) provides a useful perspective. The study considered five fund characteristics: fund size, fund flow, expense ratio, portfolio turnover rate and fund age using a cross-sectional multiple regression approach. The study concluded that fund performance is significantly related to the size of the fund and the new money flowing into the fund every year.

One must also remember that a mutual fund may not represent all the assets in a particular strategy under management of a fund manager and that a small fund may be part of a much larger asset base for the specific strategy. Given this background, what can we learn from the size and performance of local diversified equity funds over the past 10 years?

As mentioned, the full universe of diversified equity funds was reduced by eliminating funds with strategies

not deemed to be impacted by size, leaving a dataset of actively managed equity funds. Annual returns were used and funds with less than 3 data points were removed. In total, ninety funds were analysed. Funds were sorted into thirds by size on an annual basis and median and average returns were calculated and linked for the 10-year period ended 31 December 2021.

The annualized returns for the 10 years for each size category are:

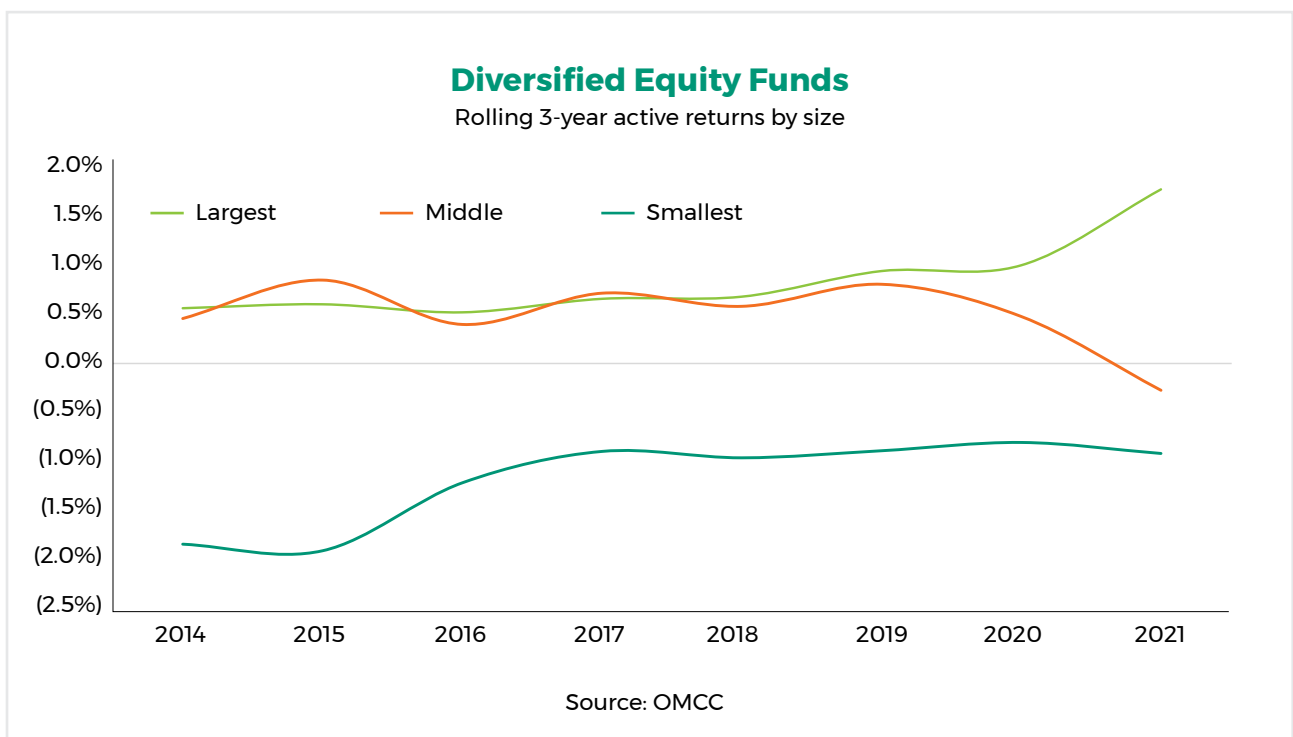


3) Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization, J Chen, H Hong, M Huang, and J Kubik, 2004
4) How Does Size Affect Mutual Fund Performance? Evidence from Mutual Fund Trades, JA. Busse, T Chordia, L Jiang, Y Tang, June 2014
5) Size Doesn't Matter: Diseconomies of Scale in the Mutual Fund Industry Revisited, B Phillips, K Pukthuanthong, and P. Raghavendra Rau, December 2017
6) Fund Size & its Impact on Fund Performance: An Empirical Evidence from Selected Indian Mutual Fund Companies, Prof. B. Ramesh, 2014



The research showed meaningful underperformance by the smallest third of funds. The largest and middle-size segments produced similar performance. An important aspect of the research is that fund size is not static and a large percentage of the funds under consideration moved at least once between the size segments. Outperforming small funds can quickly become medium-sized and vice versa. Assets flow to outperformers and away from underperformers and this process seems to have greater intensity with smaller fund managers and providers. Larger managers, in general, have greater portfolio management resources and marketing budgets to create investor awareness. Having a proven and established brand is valuable as intermediaries and capital allocators (such as multimangers) actively

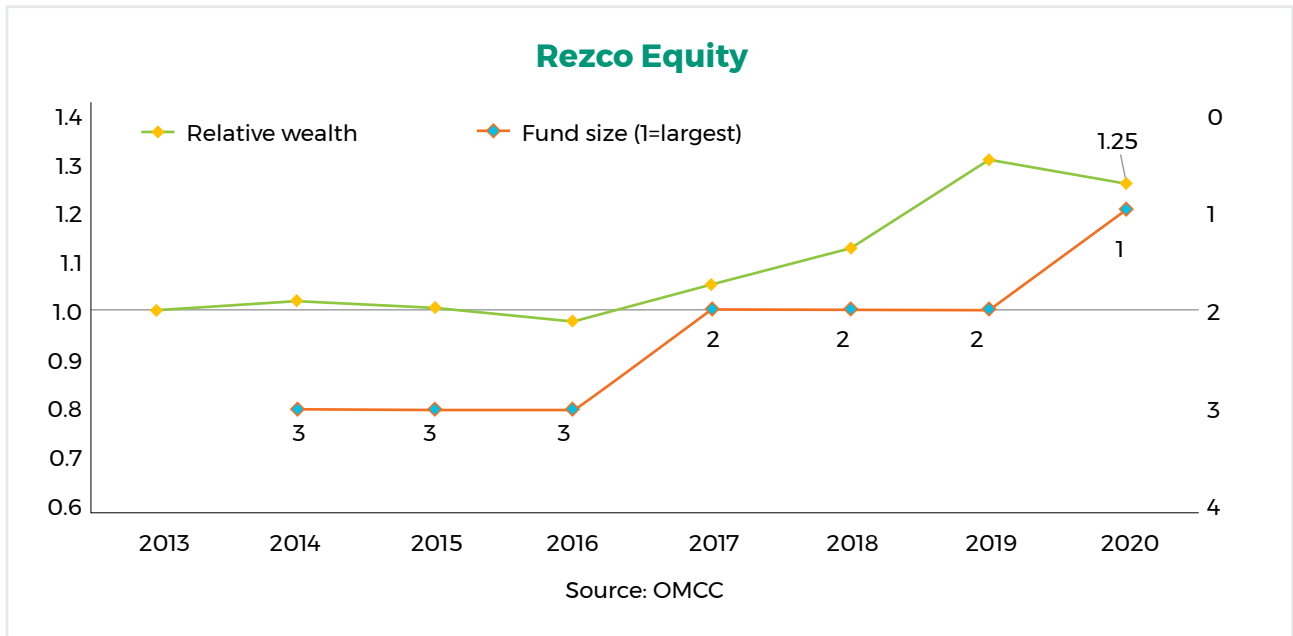
seek out top-quality brands. There is a view that smaller managers must work harder to develop a profile and as a result, over the research period in question, there is only one genuine example of a small fund graduating into a large fund. Of the funds terminated, only one was not a small fund, and the fund in question was part of a rationalisation of investment options by a large fund provider. Many of the fund terminations are related to firms that were either acquired or that closed. A local investment industry veteran also mentioned that to achieve a strong performance track record and hence grow assets, portfolio managers can become too short-term oriented and trade too aggressively whereas they would probably be better served to take a more patient approach.



When looking at rolling 3-year active returns (relative to the average of the fund universe) we see that the smaller fund underperformance was consistent. Middle and large-sized funds performed similarly with only a deviation in the final 3-year period, where large funds increased their advantage and middle-sized funds underperformed in line with small funds.

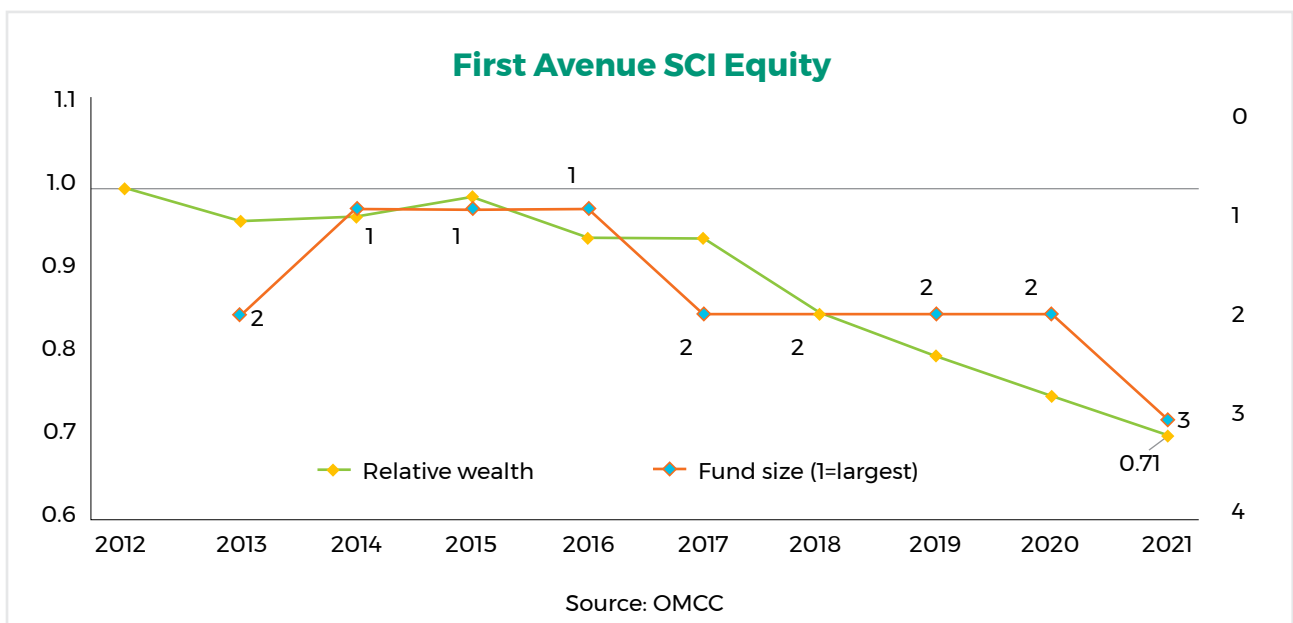
Analysing results by size categories is instructive it

is also useful to look at individual funds. The Rezco Equity Fund was formed in March 2014 and has progressed through the size levels and by end of 2021 was a large fund by the approach used in this research - current assets are just under R1.3 billion. The Fund has grown based on a strong track record and since inception - relative to the average diversified equity fund - has added 25% in relative wealth. This kind of outperformance is likely to attract flows.



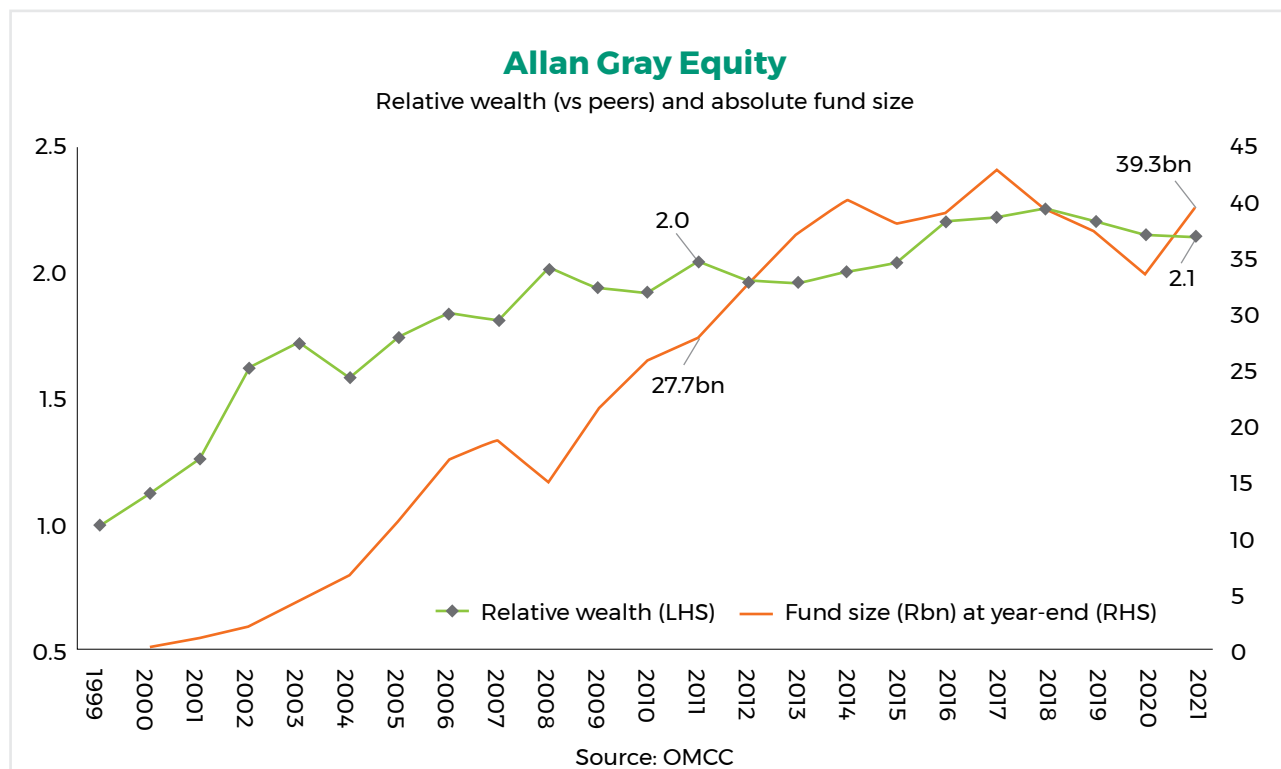
A fund that has moved in the opposite direction, in terms of size, is the First Avenue SCI Equity Fund. The fund quickly achieved a decent size after forming in 2011 but, following a prolonged period of underperformance, the assets have plummeted and the Fund is classified, by this research, as small. Recent past performance plays a vital role in current fund size plus funds that consistently languish at the bottom of

the return tables are going to be prone to outflows. The reality is that flows will follow strong recent performance, and this puts a premium on developing a patient and informed client base who do not relentlessly chase performance and destroy wealth in the process. However, even the most patient investors will reach a point where they lose faith in a manager who has not delivered over a meaningful period.



The diversified equity universe used for this research only has one fund greater than R30 billion in assets and this is the Allan Gray Equity fund – the current fund size is not far off R40 billion. The Fund has an excellent performance track record, but the relative performance profile has dropped off over the past 12 years. As a much smaller fund, it produced spectacular results, from its formation in 1998 through to 2011. In fact, at this point, it had created twice the wealth (on a lump sum investment) of the average diversified equity fund. While the fund’s relative performance profile has been stable in recent years it has struggled to produce

the stellar results of the earlier years. Hence, while asset bloat has put the brakes on performance it has not hurt to any degree. Investors looking for a core actively managed diversified equity offering are likely to be well served by the Allan Gray Equity Fund, but they may have to consider an alternative fund for meaningful alpha. It seems that it was around the R15 billion mark in assets that the relative performance started to taper off. Allan Gray runs a very focused local equity strategy and their considerable institutional local equity assets are managed on a similar basis i.e., overall strategy assets are much larger than the equity unit trust assets.



In the highly competitive unit trust industry diversified equity category a negative small fund premium exists based on this research over the past 10 years. While “small” has the potential to be beneficial in terms of access to the smaller capitalisation spectrum of stocks and greater nimbleness, it also does have disadvantages. Smaller funds tend to be slightly more expensive than the remainder of the diversified equity fund universe, but this explains only a small portion of the relative underperformance. Investment business imperatives and pressure to produce a strong track record in the early years in order to attract flows and turn small funds into larger, more profitable funds, must not be underestimated. This pressure could

result in unhealthy short-termism, leading to higher turnover and trading costs. At a basic level of analysis, the quality of some smaller fund managers will not match the high-quality firms such as M&G, Coronation, Ninety One, and Allan Gray. Established fund managers could be more patient with new funds and focus on letting the track record develop naturally as opposed to fast-tracking it. The underperformance of smaller equity funds should not mean that one does not select from this segment but that one should do more homework to ensure that long-term investing fundamentals are in place and override business imperatives. Turnover and active share information can be useful metrics in this regard.

