momentum

The art and science of capacity management

Andrew Smith & Jernej Bukovec

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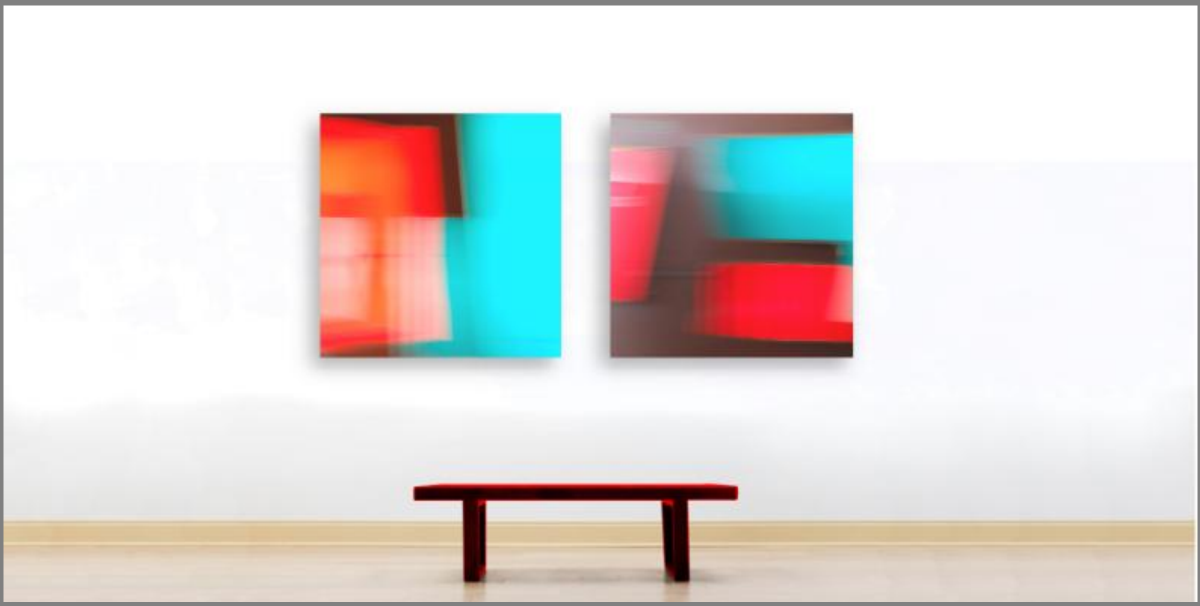

1. Capacity analysis

Regarding capacity analysis we believe that there are two key aspects to consider:

1. Why is capacity critical?

2. Why is capacity difficult to determine?

Why is capacity critical?

As a portfolio manager, having the freedom to implement your investment philosophy is a critical ingredient to generating strong outperformance. Irrespective of how skilled a manager is or how hard they work, if their universe of potential investments to select from is reduced or it takes them longer to trade in and out of their portfolio holdings they will be at a disadvantage. They may still outperform, but they will need to first overcome this handicap they face against more nimble peers.

Would you expect the top-ranked golfer to win a tournament against another top ten player if they had to use a heavier ball or had to play with only a limited selection of clubs? Probably not. They may beat a top 100 player, but not another skilled practitioner. In most investment asset classes, a skilled manager research team should be able to uncover a number of great managers so don't need to invest with those that start every day at a disadvantage.

A greater universe of potential investments to select from should enable better performance. Consequently, with lower assets under management in any given strategy, managers are more likely to be able to implement their best ideas at the appropriate weighting in their portfolios. Many managers will tell you that their universe is large enough and they always select their best ideas. However, it is worth asking them if screening for stocks above $5bn is in the clients' best interests or is actually better for the manager's P&L as they can run more assets in the strategy.

Notwithstanding the negative impact of having a smaller universe, having the liquidity to build up or dispose of positions in investments without affecting the price is clearly another advantage of having smaller assets.

Managers with large assets are likely to take longer to build up their desired weights in stocks. During this extended period there is an increased chance that other investors will recognise the opportunity and the price will appreciate before the manager can get their desired position size.

Having the ability to trade out of winners or losers and move on is also important. For example, if an equity manager owns 10% of a company (which is more than possible for larger strategies with holdings in smaller companies) and they decide that they no longer want to own the stock, they may find it difficult to sell at a price they're comfortable with, especially given that often the reasons they want to unwind the position may be simultaneously reducing the enthusiasm of other investors. Thus the sale of a large position can take time, causing an opportunity cost, or worse could negatively impact client performance if the manager's actions cause the share price to decline.

Such illiquid positions can end up taking up a disproportionate amount of an investment team's time. They may have to employ atypical and time consuming methods in an attempt to realise value, such as taking a seat on the Board or engaging with other strategic investors. Clearly this can add value, and is an important aspect of some investment managers' processes; but the key is to understand the difference between teams who expect to take this approach ex ante, and teams who are forced into doing so as a result of their oversized stake in a business being unsalable via normal methods.

Despite the clear disadvantages, it is worth noting that some managers will claim advantages of having enormous assets in their strategy. The most common is management access. However, we meet with a lot of investment management firms from around the world, some large and some very small managers. Many of the smaller managers once worked within a big firm, and it is extremely rare to find a manager who is not surprised by the level of management access that they continue to receive, even with significantly smaller firm or strategy assets.

Why is capacity difficult to determine?

Due to the liquidity of the underlying investments, capacity varies significantly across asset classes. For example, Global government bonds and UK smaller companies have differing levels of liquidity, so managers operating in these asset classes will have different levels of capacity.

Even within an asset class, capacity is impacted by each manager's individual strategy. For example, a high turnover growth strategy operating within the same universe as a buy-and-hold contrarian value strategy is likely to have a lower capacity, due to the extra liquidity required by the manager to implement their philosophy.

Furthermore, each manager's level of concentration impacts their capacity. Put simply, a manager who has a more diversified portfolio can generally manage more assets.

As a result of the above, there is no easy way out on this topic; no magic formula or number exists. Therefore, we believe that the most effective way to assess capacity is to understand a manager's asset class and their individual style of investment as best we can before we invest. Combining this with our experience, we can establish what we believe is an appropriate capacity for each individual strategy, and then seek to divest from managers as they approach this level. Our strong preference, however, is to invest with managers who have a pre-defined strategy regarding capacity that broadly agrees with our own analysis. Typically, this involves using managers with a commitment to close their strategies to new clients when they become too large.

Many successful managers who have built up a high level of assets under management will argue that capacity is not a problem for them, at least “not yet”. They could even evidence this by pointing out that, for example, they don’t own more than 5% of the free float of any of their existing holdings and could sell any holding within a week. However, this belies the fact that they may have (intentionally or unintentionally) migrated up the market cap spectrum as assets in their strategy have increased. From our research perspective, the key question we ask is: could they replicate their portfolios from the past (when they started building their track record and had lower assets under management) with today’s level of assets? The answer is often a resounding ‘no’ since it would result in them owning excessively large stakes in certain smaller companies that made meaningfully positive contributions to their past performance. Where this is the case we need to take this into account since it implies they would be unable to replicate past performance with current assets, and therefore the performance track record is less relevant.

2. Summary

As a portfolio manager having the freedom to implement your investment philosophy is a critical ingredient to generating strong outperformance.

If a manager’s universe of potential investments to select from is reduced or it takes them longer to trade in and out of their portfolio holdings they will be at a disadvantage compared to smaller more nimble peers.

Capacity analysis is one important ingredient in our detailed manager research process. However, there is no easy way to determine manager capacity. Therefore, we believe that the most effective way to assess capacity is to understand a manager's asset class and their individual style of investment as best we can before we invest. We then focus on managers who have a pre-defined strategy regarding capacity that broadly agrees with our own analysis.

For more information, please contact:

Natalie Mucrone
Marketing natalie.@momentumgim.com
Tel: +44 (0)207 618 1802

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