#MONEY

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Size matters in fund management, and it doesn't help: James Saft

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(Reuters) - (James Saft is a Reuters columnist. The opinions expressed are his own)

Size does matter in fund management, and if you are an investor it is not helpful.

While the idea that it is harder to perform well managing a larger fund than a smaller one makes intuitive sense, up until now the results from the academic literature have been inconclusive.

Most industries experience so-called diseconomies of scale, the point at which producing a given unit of output for a given firm rises. In the case of funds, the issue isn't so much of the price of managing the money but whether it can be done as successfully, with as much alpha, or market outperformance.

After all, size is difficult for fund managers; not only does more money deployed tend to make the market move against you as you try to build a position in a stock, but there are theoretically only so many good investment opportunities and fewer and fewer as your requirements for the size of an investment rise.

A new study of U.S. active equity fund managers, borrowing techniques from development economics, purports to show that economies of scale in fund management show diminishing returns.

"We find strong evidence for decreasing returns to scale at the individual fund level," Campbell Harvey of Duke University and Yan Liu of Texas A&M University write in a study released in late June. (here)

"We also present evidence for decreasing returns to scale at the industry level, although its economic significance is much smaller."

This is a finding with wide implications, not only for investors but for the fund management industry. For investors the implication is that they should be more careful, and perhaps parsimonious, in allocating to the largest funds. For fund companies, fighting a difficult battle as they see billions of outflows into passive instruments like ETFs, the realization that there are diseconomies of scale will be deeply unsettling to the largest funds, which benefit from brand recognition and marketing advantages.

For an average fund in the study, which covered the years 1991 to 2011, a doubling in size relative to the size of the industry over one year would shave 20 basis points off of their annual alpha.

A Business Which Gets Harder and Harder

What is true for funds is true for the active fund management industry as a whole, the study finds.

"We also find a significant impact of industry size, consistent with earlier research. We estimate that a 1 percent increase in industry size (at the monthly level) implies a 5-basis-point drop in alpha (per annum) for the average fund," the authors write.

The impact of industry size, relative to the size of the market, first improves and then gets worse. This the authors attribute both to the impact of new capital flowing in and the “profitability of investment ideas deteriorating through time.”

This, on its face, accords pretty well with Credit Suisse strategist Michael Mauboussin’s “Paradox of Skill”, which posits that the average skill level in the investment industry is rising over time, as poor managers get fired, but that this leaves a tougher set of opponents and less low-hanging investment fruit for those still in the game. Think of a poker game in which the lousy players bust out early in the night. By about midnight, if you are still playing, you are facing a tougher table.

Such may be the position of the investment industry, and in some ways, of those most successful at it, whose funds have grown too large to be easy to wield.

Mauboussin, building on work by Peter Bernstein from the 1990s, showed in earlier research that statistical measures of outperformance by large capitalization mutual funds in the United States have been declining steadily for almost five decades, with the standard deviation of excess return now less than half what it was in the late 1960s.

During the 20 years of the Campbell and Liu study the number of funds increased from about 400 to nearly 1,500 and they moved from owning about 4 percent of market capitalization to nearly 16 percent.

Unsurprisingly, the study finds that funds which show themselves less liable to perform more poorly tend to attract a disproportionately large amount of money, perhaps as investors seek to get in on what seems a good thing in a fund with which they are familiar.

While these funds are relatively less vulnerable to diseconomies of scale and decreasing alpha, they still are vulnerable, meaning that the additional and large flow of funds only hurts future performance.

To be sure, size is surely a good thing for operators of mutual funds.

For the rest of us, there is more reason to be skeptical and wary.

Editing by James Dalgleish