A deeper dive into the question of investment capacity

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As transparency in the broader investment industry gradually increases, largely assisted by regulation such as MiFID II in Europe, investors today have ever greater visibility of the various costs involved in managing their assets. Such improved investor awareness, amongst other things, now allows our clients to consider a broader range of costs when discussing capacity with their investment managers.

In our view, the investment capacity of any active strategy is an extremely important subject as it is directly linked to an investment manager's ability to deliver a high quality service to its customers. It also often acts as a very effective gauge for clients seeking to establish whether their investment service provider is primarily driven by its own business interests (i.e. asset gathering, revenue maximisation) or by client and investment considerations.

However, estimating and defining capacity is not straightforward. It also, importantly, should not be limited to simply the liquidity of a portfolio, or the explicit and implicit costs of transacting.

Given our organisation's keen focus on delivering high quality investment services for our clients, it should come as no surprise that we think and talk about capacity a lot. In this article we will share our thoughts on this issue and give some insight into how we view and approach the subject.

What is investment capacity?

The best definition we could come up with is that it is a **perceived maximum level of assets that could be managed in an investment strategy without a material negative impact on the strategy's ability to provide outperformance (alpha) for its investors**.

In financial literature this definition is referred to as a "threshold capacity" as it implies that there is a particular minimum level of alpha below which the customers of an investment provider should not be tolerating any further reduction of alpha potential. In other words capacity relates directly to an implicit contract between the asset manager and its customers. There are a few other definitions used within our industry, including those that try to estimate a maximum amount of wealth that could be created (i.e. trying to solve for a maximum product of alpha and AUM) or the one that defines capacity as a maximum AUM at which the net excess return of an investment approach is reduced to zero. We will ignore those for the purposes of this article as the one we focus on is the only client-centric one and therefore, in our minds, the only one that matters.

How is alpha affected by increasing AUM?

If we focus on alpha potential, then the first important step is to assess how that alpha might be affected by the growth of assets, growth of business and passage of time. In our view there are quite a few potential threats. When discussing capacity we will use the example of public equity markets, but most of the issues we identify should apply to other asset classes.

Here we consider what we believe to be the eight key investment strategy specific issues (for the sake of this exercise we will ignore how alpha could be eroded through time as a result of, say, a genuine loss of competitive advantage).

Transaction costs, both explicit and implicit.

Moving a larger amount of money in and out of a stock has a clear, albeit non-linear, relationship with the costs. The direct transaction and spread costs are relatively well known and easily observable. The implicit costs, or what some people call market impact, are less so. This is where we think the size really matters. Holding a stake in a company that is greater than an average daily volume of trading in that stock means that one has to take caution when transacting. Investment managers normally try to minimise the impact on the price by limiting their trading to a certain percentage of daily volume in the hope that they will go unnoticed by the broader market. A persistent seller or a buyer is likely to

receive a disadvantageous price as his/her counterparty becomes aware of the interest and direction of travel. For example, if one tries to build a position in a stock and requires several days of consistent buying in order to do it, the price on the later days could be higher as a result of the action itself (the stock would “run away” from a buyer). This would lead to a higher average price for a new portfolio position which would, all other things being equal, lead to a smaller upside.

There are numerous ways of minimising one’s impact on the price and access to a sophisticated, well-resourced dealing function could be crucial here. Also, investment manager style and capital allocation techniques could be important considerations. Investors that tend to buy and sell securities in a contrarian fashion tend to have smaller implicit costs as they are more likely to buy when the market is keen to sell, and tend to sell their holdings to other investors who are keen to buy. So one can view this manager as a supplier of liquidity. If the trading of a fund manager shows an element of positive momentum (buying stocks that are going up and selling stocks when their prices are falling), then the market impact is likely to be more pronounced as this pattern of trading will be adding to and competing with a broader demand.

Maintenance of process purity.

Increased length of time required to build or exit a position in a stock might have a significant impact on the efficacy of manager’s investment process. For example, let’s say alpha generation is reliant on the timely allocation of capital before certain events (or “catalysts” to use investment jargon) or a speedy exit after a particular market event. In such instances the ability to trade in a cost-efficient manner over the course of many days becomes insufficient to judge the effect of asset growth on alpha generation potential.

In other words, if a portfolio manager is unable to build a big enough position before the target date, or dispose of his/her holding after, for example, an unexpected company announcement, then the expected future outperformance will have to be adjusted down. A traditional liquidity or cost analysis framework could be rather irrelevant, if not misleading, as this sort of assessment would require a detailed knowledge of the manager’s trading patterns and behaviour.

Once again, this is extremely dependent on the capital allocation practice of an investment manager. Those who gradually build their positions and do not specifically target any particular company and/or market events are more likely to maintain the purity of their investment process as the assets grow. And those more likely to be affected by the loss of efficacy of their process as AUM levels rise could materially benefit from improved trading, use of alternative exchanges, algorithmic trading etc.

Access to investment opportunities where investment process has a greater efficacy.

This normally manifests itself as increasingly limited access to smaller capitalisation stocks as the strategy AUM grows. Or from another angle: reduced access to some sub-sectors or businesses that are likely to only exist in a smaller format (young IT, education, single brand retailers etc.). Sector and sub-sector composition of the equity markets are often very different as one moves from smaller caps to the larger end of the spectrum.

Finding an edge in a smaller cap company through bottom-up research is both relatively easier (as there are fewer professional investors and analysts to compete with, but also because smaller companies tend to be simpler in their structure) and more rewarding (smaller companies’ share prices tend to react in a more pronounced way). So if increased assets limits a portfolio manager’s access to smaller companies, the potential negative impact on those who previously depended on this segment of the market for alpha could be disproportionately or non-linearly high.

As with the other issues we discuss in this article, this is once again not a black and white issue. There are some effective adjustments that a portfolio manager could make to minimise the impact of this dynamic. For example, separating a portfolio into compartments and treating smaller/mid cap stocks differently from trading and rebalancing perspectives as well as smaller position sizing could allow them to maintain access to these stocks for much longer than would be simplistically implied by the asset growth.

Stock ownership and visibility.

Although some investment approaches actively seek the ability to build large stakes in investee businesses (normally those who aim to influence the way those companies run), the vast majority of active equity strategies favour agility and flexibility when investing in equity markets.

A higher AUM means that a typical desired position in a portfolio will require taking a larger stake in the company. This might take longer and be more difficult to execute. But it might also lead to a greater visibility of the portfolio manager's action in the market. Visible changes on company ownership registered by a successful investment manager often attract attention of the crowd, which could lead to a reduction of the upside. Small changes in these visible holdings often indicate to outsiders a direction of travel taken by the investment manager, which could materially impact supply and demand dynamic.

Portfolio managers' time spent on client service.

Growth of AUM is often accompanied by the increase in a number, nature and geographic location of clients. A rise in the number of clients also tends to lead to a greater complexity of reporting as various groups of investors tend to have different demands. The more time a portfolio manager spends reporting and visiting clients, the less time he/she spends managing investors' capital.

Increased complexity of the investment business.

Accommodating clients' specific requirements often leads to a proliferation of accounts, and perhaps some of those have slightly different guidelines and restrictions. This requires an additional continuous effort from the investment team that would need to manage, monitor and report on the wider range of investment portfolios. Also, we often see that within larger organisations the investment and commercial success of a portfolio manager leads to a greater managerial role that he/she is asked to play. Similarly to the previous point, any time spent by an investment manager on non-investment matters should be viewed as a negative in the context of their ability to manage investment portfolios.

An ever-changing investment landscape and opportunity set.

Over time, and independent from an investment manager's thesis, market dynamics could lead to material changes in the opportunity set. For example, the number of stocks available to a manager is relatively stable over the short term, but could change noticeably in the medium and long term. A combination of M&A and public-to-private activities (the latter has become a serious factor in the last several years due to a material growth of AUM in private equity and other alternative funds) could lead to a reduction of a number of stocks in the marketplace. On the other side new listings (IPOs), relaxation of capital controls, changes to index compositions and rules tend to expand the potential universe of stocks available.

A recent study[1] found that the number of US listed companies fell by roughly 50% between 1996 and 2016. As a result, a well-known Wilshire 5000 Total Market Index that was created in the 1970s to capture the 5,000 or so investable listed companies in the US now has only 3,492 stocks. In the UK the FTSE UK All-Share Index saw the number of constituent stocks fall from 724 back in 2002 to 600 in 2013 (and now stands at 636). The rest of the developed and emerging equity markets saw a number of listed equities increase, often materially, over the similar period.

Market level and valuation.

The reactions of different investment approaches to material changes in market price and valuation levels could be substantially different. Those who have absolute valuation anchors when initiating portfolio holdings will naturally see their opportunity set narrowing as markets move up (with the opposite also being true). This effect is most pronounced in some of the value or recovery investment processes, as well as those who use private equity techniques (both in private and public markets). On the other side of the spectrum, those who have set liquidity screening criteria will see a greater number of stocks going through those screens as wider equity markets appreciate. This should make their opportunity set and theoretical capacity of their approaches expand.

In practice, the markets are never that simple and the actual impact on a strategy will depend to a great extent on the nature and homogeneity of the market's advances or falls. For example, a value manager might still find enough interesting opportunities if the market advances are led by a narrow group of stocks and the rest of the market is left unloved (similarly to what we saw in the Nifty Fifty period and during the TMT bubble).

1. Credit Suisse – The Incredible Shrinking Universe of Stocks, Michael J. Mauboussin, 2017

Economies of scale

We often find that debates about capacity are focussed entirely on the negative consequences of asset growth. Industry practitioners, however, know about some of the positives that can result from the improved financial situation of an investment manager as assets grow. Almost without exception, a young investment team starts with relatively minimal resources that just about cover the main bases. So naturally as the assets of a successful new investment strategy start climbing, the additional financial resources are often invested in making the investment proposition stronger. Examples of such improvements could be hiring additional analysts, access to additional external resources, data and research that previously could not be afforded. One can view this as an economy of scale effect.

At a more mature stage, an even healthier financial standing could be used to add investment manager support (product specialists, higher calibre client managers), improve dealing, decision-making analytics or building a proprietary research capability to better evolve the process over time. The other examples of mitigating some of the road blocks are efforts to rationalise and slimline the complexity of the client accounts, investments in technology to improve communication, extending clients' expected holding period by offering preferential terms to those who are prepared to commit to longer holding periods or less frequent dealing.

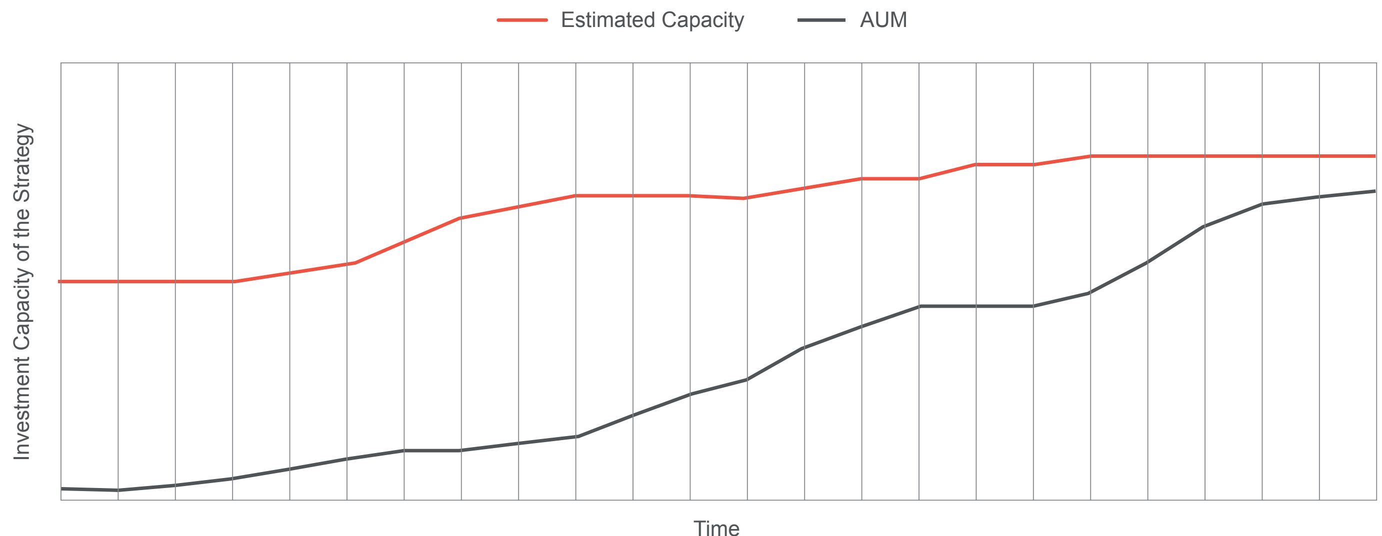
Our approach

In our more holistic framework of capacity assessment these sort of actions are often viewed as capacity-enhancing, as they target mitigation of the negative impacts associated with asset growth.

If one takes into account these considerations then the theoretical capacity of an investment strategy looks like an upward sloping line with most of the steepness achieved in early stages – a bit like a traditional bond yield curve. This model leads us to believe that an investment manager's willingness, ability and actual steps to reinvest in its alpha engine should potentially be important additional angles in the broader discussion of capacity between investment managers and their customers.

FIGURE 1

Evolution of Investment Capacity with Asset Growth



Source: RWC. Shown for illustrative purposes only

There are also less tangible, but perhaps just as important, effects of asset growth. When improved financial resources are used wisely by an asset management company they are likely to reduce investors' counterparty risk. In other words, a portfolio manager becomes a less risky, more sustainable partner to investors whose assets he or she is trusted to manage. There are a number of operational, business, investment team stability, behavioural and even emotional considerations that are often improved in a more mature stage of the investment strategy life cycle.

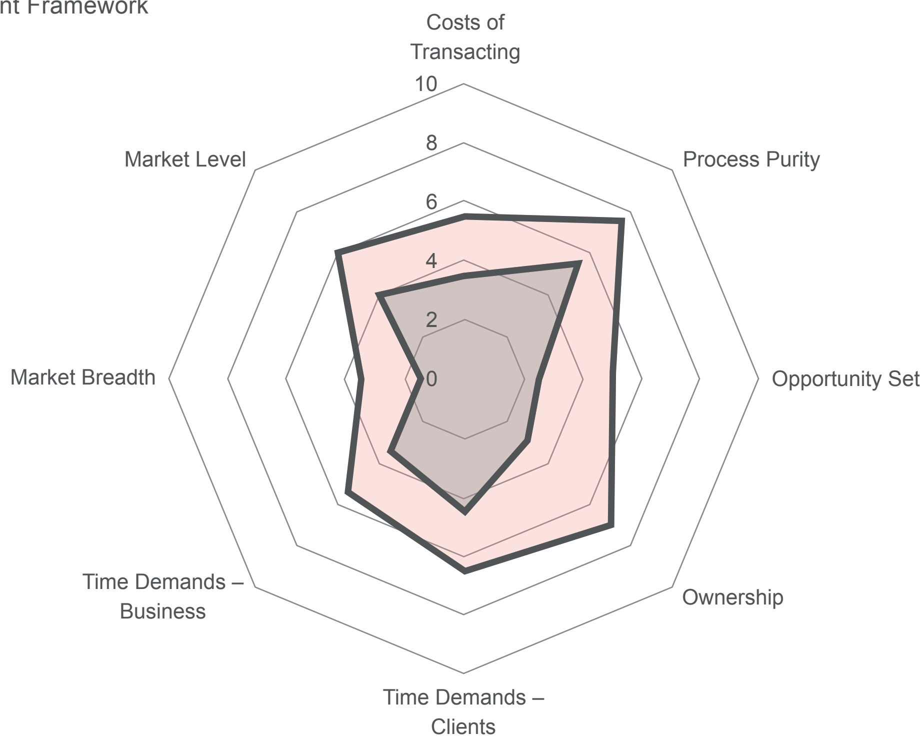
So let's now look at our definition of capacity one more time.

We stated it as a ***perceived* maximum level of assets that could be managed in an investment strategy without a *material* negative impact on the strategy's alpha generation *potential***. We have now highlighted three words that point at a high degree of uncertainty in the definition itself (*perceived, material and potential*). All this indicates that boiling any analysis to a single number is likely to be overly simplistic, if not misleading. Instead we should focus on identifying the right set of parameters and criteria through which a particular investment strategy and approach are examined. Only some of the alpha-threatening considerations that we outlined above could be quantified; the rest require qualitative and subjective analysis. This framework should take into account the nuances and features of each investment approach and of the underlying financial market in which it operates. Given that some of the underlying features of the market and strategy are likely to change over time or in reaction to actions of an investment manager, capacity analysis is best updated periodically.

At RWC we have developed a framework that takes into account the issues that we discuss in this short paper. This framework consists of eight main assessment criteria that we believe could affect the alpha potential of each strategy, as discussed above (please see spider diagram below).

FIGURE 2

Capacity Assessment Framework



Source: RWC. Shown for illustrative purposes only

This approach allows us to analyse capacity in a manner that is consistent both across all strategies and over time. The importance and application of each of the eight differs from fund to fund and is greatly influenced by a portfolio manager's style and capital allocation techniques. We find this framework extremely useful when discussing capacity within our organisation and with our clients.

In summary

We have considered our views on investment capacity and illustrated why such discussions should not be simplified to costs considerations alone. We encourage clients who are concerned about this issue to engage in deeper conversations with their investment managers in order to go beyond the obvious traditional issues.

We advocate a framework that incorporates a number of investment, business and market considerations that are likely to have an impact on a manager's ability to invest his or her clients' capital effectively. We have illustrated that a material degree of uncertainty is involved in almost every aspect of capacity assessment and how sensitive it could be to investment manager's style and actions, as well as how it could change with time. Such complexity, in our view, also importantly implies that there may not be a firm number assigned to capacity, but rather an estimate at that point in time.

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Arthur is Head of Investment Strategy. He joined RWC Partners in early 2017 and focuses on a wide range of investment, strategy and management issues.

Arthur started his investment career at the Central Bank of Turkmenistan where he spent five years developing and managing the bank's foreign exchange reserves. He then joined Mercer Investment Consulting in London to focus on advising large UK pension schemes. Prior to joining RWC Partners, Arthur spent twelve years with Stonehage Fleming as a Head of Investments and most recently as a joint CIO. He managed a range of multi asset and global equity strategies and had an overall responsibility for the firm's investment proposition.

Arthur has a BSc in Mechanical Engineering from the State University of Turkmenistan and an MSc in Investment Analysis from the University of Stirling. He is a CFA Charterholder and a member of the CFA Institute.

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