Why big is not always better in asset management

Mammoth fund sizes can actually have the effect of lowering the ability of fund managers to generate alpha, according to Moz Afzal and Rebekah Chuan of EFG Asset Management.

Active asset managers must learn to co-exist – not compete – with passive product providers.

There is a growing recognition that passives instruments are likely to become a standard feature in global client portfolios. As a result, active fund managers must learn to live side-by-side, according to Moz Afzal, global chief investment officer at EFG Asset Management (EFGAM) and chief executive officer in London as well as Rebekah Chuan, head of investment in Asia and chief executive officer in Singapore.

"We recognise that we are moving towards an environment where we have to build portfolios in which active funds complement ETFs, not replace them. It is how our business model is evolving," notes Afzal.

In addition, with the growth in passives in recent years, active asset managers will have to work that much harder to prove they can generate alpha and are, therefore, worth the added cost in a portfolio.

As part of a strategy to ramp up alpha ideas, EFGAM has increased its number of equity and fixed income analysts in the past few years, as it continues to expand its investment team. "There is a strong focus on selection and increasing the level of our research substantially," explain Chuan.

Indeed, Afzal adds that the firm has been investing in talented research individual across the globe for enhancing its expertise in everything from US equities to Asian equities.

MOZ AFZAL
EFG Asset Management

FIGHT FOR ALPHA

Nevertheless, alpha generation has been tough in recent years, with only a handful of active managers outperforming benchmarks. The low-interest rate, low-growth environment has inevitably been a major factor in this dynamic. But so has size; studies show that beyond an optimum level, the growth in assets of a fund can turn

REBEKAH CHUAN
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into a hindrance rather than spurring out-performance.

He believes the active asset management sector will soon have to start thinking aggressively about paring vast fund sizes – and portfolio holdings – if it hopes to return to form.

That will have implications for private banking product platforms, too, which tend to on-board very large and well-established funds.

If asset managers decide they don't want to chase assets in the early cycle of a fund, or they decide to limit fund capacity, distributors will struggle to keep the fund on the platform.

Yet having a slew of mammoth funds on the platform might not be useful, as they could fail to generate the required alpha. It's something private banks will need to think about and adapt to, says Afzal. "The trend is already catching on in Europe and the US; it is only a matter of time before it reaches Asia."

The quest for alpha is one key reason why EFGAM prefers controlled asset growth, even with its popular funds.

For instance, one of its most successful funds is the New Capital China Equity fund, run by Mansfield Mok from Hong Kong. The fund has about USD180 million in AUM at the moment. "[Mok] runs a 33-stock portfolio and his capacity is probably USD1 billion," notes Afzal. "But we would like the fund size at levels that can generate substantial alpha."

Another related industry trend that could gain ground is asset managers offering funds to a select group of clients only. For instance, EFGAM recently launched a US equity strategy that was made available only to EFG Bank clients. "It has been extremely well received," says Afzal. "And because it is exclusive to our private bank clients, fund size can be managed as well."

NOT TOO BIG, NOT TOO SMALL

Of course, the growing trend away from the very largest funds doesn't necessarily mean small is better: Boutique firms also have their own set of problems, adds Afzal.

For one thing, increasing compliance and regulatory costs are pushing up break-even levels, so a business without much scale won't be able to sustain itself for too long.

Tough new regulations in the form of MiFID II (in Europe) are coming in as well. One of the requirements under this regime is to unbundle research from trading and execution.

Asset managers have typically lumped together the fees they pay investment banks for research and trading – and passed on these costs to investors. The unbundling requirement will call on sell-side firms to become much more aware of the costs of research services. Some experts believe this will lead firms to pick and choose specific sectors and regions they want to focus on in terms of research coverage.

For smaller firms, this will add more pressure on already soaring costs.

Eventually, it will lead to more concentrated AUM levels and products, predicts Afzal, adding that the ones which will survive over the long haul will be mid-sized managers, such as EFGAM. "On the one hand, you have spiralling costs due to compliance and suitability requirements, etc, so a fund house cannot be too small. On the other hand if it is too big, the ability to generate alpha is lower and the fund could lose out to ETFs," he explains.

Chuan adds that during such times, it becomes even more critical to have a differentiated proposition.

In the case of EFGAM, she believes clients are very clear in what it offers to clients. "We are a strong institutional asset manager and we bring those strengths to our private clients. We also have a strong research platform that covers macro-security-specific and thematic research."

In addition, she says clients are aware of the firm's client-centric focus. "They know we are here to grow and protect their wealth, not just sell products to them," says Chuan. ■