Feeling Bloated?

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We all know the feeling. After a big meal or a night of over-indulgence, our stomach expands, our energy falls, and we feel tired and lazy. Maybe even a little guilty. Well guess what? Your mutual fund may feel the same way – bloated, that is. Asset bloat is a phenomenon that affects all too many funds. It occurs when a fund's assets swell to a size that makes it difficult to manage. As a fund absorbs large inflows of new money, it too may need to crack out the Pepto as the prognosis for this condition isn't pretty.

One possible outcome of asset bloat is portfolio dilution. Fund managers only have so many investment options, and if they don't want to spread their portfolio too thin, they may have trouble investing large sums of new money in their best ideas. A manager may compromise their investment philosophy by adding new names to a fund for the sake of putting incoming cash to work. These new names may fall outside the manager's area of expertise and could change the face of the fund. Or, the manager may run with a large cash position for an extended period of time, earning T-bill returns instead of equity returns. The end result is that returns suffer.

Another side effect is lack of agility. That is, an inability to swiftly buy or sell a meaningful position in a stock. This problem is exacerbated with small-cap funds, where liquidity issues are more pronounced. Suppose that a manager runs a $1 billion fund and wants to initiate a new position in a stock. To buy a reasonable position, say 3%, she would have to place a buy order for $30 million. Depending on the stock and the market it trades on, this can be a lot easier said than done. It may take a number of weeks, or even months, to fill the order. Not to mention that the large bid could put significant upward pressure on the price of the stock such that she may be stuck buying it at an inflated price. And when it comes time to sell, the opposite could happen. It's the elephant in the room syndrome – no room to move without causing damage.

A related issue arises if the stock has a relatively small float (number of publicly traded shares). Mutual fund regulations prohibit a fund from owning more than 10% of the outstanding voting shares of an issuer. Turning to our above example, if the outstanding shares of the stock that the manager wants to purchase are worth $200 million, she could only purchase $20 million worth of shares (a 2% position in the fund). You can see how asset bloat can especially impact a small-cap manager.

There are a number of well-documented cases of asset bloat, but the most talked about in financial circles is the Fidelity Magellan Fund (available in the U.S.). The fund evolved from an opportunistic, index-smashing fund in the 1980s to a lethargic, mega fund in the 90s. It has suffered from redemptions in recent years but still has over $US45 billion in assets. Not surprisingly, its 5- and 10-year returns look remarkably similar to those of the S&P 500 Index. Here at home, there are a number of funds that have more than $10 billion in assets under management. Moreover, many of these funds invest primarily in the Canadian market, which is quite narrowly led (non-diversified) and doesn't have nearly the same liquidity as its U.S. and European counterparts.

Most fund managers would agree that asset bloat impacts their ability to effectively manage money. Yet, the more money a fund takes in, the more the fund company makes. Here lies the dilemma. Fund companies, especially publicly traded ones, want to maximize their revenues and returns to shareholders. Yet, at what point are they compromising their investment philosophy – to the detriment of existing unitholders – by taking on more assets?

There's no hard and fast answer to this question. Large-cap funds with a global mandate have a lot more "capacity" than small- or mid-cap funds that focus on a specific geographical region. Nonetheless, in this investor's opinion, I'd closely re-evaluate a fund when it closes in on the $1 billion mark to ensure that the manager is still able to do what he was doing when the fund had $100 million in assets (for small-cap funds, I'd start doing my homework when the fund hits $200-300 million). Here are some signs to look for:

- Has the fund's total number of holdings increased over time? This may indicate that the manager is having trouble investing new cash inflows in his best ideas and is adding new stocks instead.

- Are "filler" stocks starting to emerge in the portfolio? These are small positions (i.e., less than 1%) that indicate the manager may be investing in new names simply to keep the fund fully invested.

- Has the fund's cash position gradually increased? This is not always an indication of asset bloat, as some managers strategically run with large cash positions at times when they are not finding value. But it may be a sign that the fund's assets are exceeding the manager's investable ideas.

- When a stock is added or removed from the fund is the position established/eliminated in a timely fashion? This one is difficult to determine, as most managers don't make this information publicly available. But if you can get your hands on this info, it can be a good sign of just how agile the manager is.

A fund may also reach capacity constraints at a much lower level of AUM (assets under management) if the manager also runs a similar mandate(s) for another fund company(s). For example, assume XYZ Investment Management manages the Excelsior Small-Cap Equity Fund, which has $100 million in AUM. If XYZ also manages a small-cap offering for another fund company that has AUM of $500 million, the Excelsior fund may well be feeling bloated already, as XYZ in fact manages a total of $600 million in their small-cap mandate. It's therefore important to consider a fund manager's total assets under management, not just the assets of one fund they manage.

Fund companies that have their investors' best interests in mind will close a fund when its assets reach a level that may start to impede the manager's abilities. Examples of successful managers that have capped their funds at reasonable levels in recent years include Mawer and Bissett, among others. Unfortunately, this practice constitutes the exception rather than the norm, even though it can be a great marketing tactic ("get in while you can").

While many investors may not be aware of asset bloat and its impact on a fund, a number of prominent industry participants are starting to bang the drum on the issue. The folks at the mutual fund research firm Morningstar have trumpeted the dangers of asset bloat on a number of occasions as have popular authors on investing, William Bernstein and David Swensen. Perhaps Swensen, the Chief Investment Officer at Yale University and an outspoken critic of the fund industry, sums it up best in his book *Unconventional Success – A Fundamental Approach to Personal Investment*: "Because size constitutes the enemy of performance, fund inflows inevitably diminish future return prospects. The mutual fund investor loses as the asset-gathering manager wins. Bloated portfolios and excessive fees represent the most visible ways in which mutual fund manager agents extract rents from mutual fund investor principals."

If the belly's starting to bulge on your funds and the manager isn't willing to close the door, it may be time to put your portfolio on a diet and focus on leaner options. Poking another hole in the belt buckle never does anyone any good.

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