PCI
PRIVATE CLIENT INDICES

Does Portfolio Size Matter?

July PCI Commentary 2016

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Does Portfolio Size Matter?

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"What counts is not necessarily the size of the dog in the fight - it's the size of the fight in the dog."
Mark Twain

Q2 2016 Private Client Portfolio Performance Review

Anyone reading the headlines over the past six weeks would be forgiven for thinking that it had been a bad quarter for private client portfolio returns: trillions wiped off global financial markets; Sterling hitting thirty year lows; political turmoil and Scotland threatening to leave the United Kingdom. Markets were certainly volatile, but as highlighted in our commentary last quarter, the balanced approach adopted by a discretionary manager investing in a range of asset classes brings diversification and a smoothing of the gyrations of individual markets.

June started with global markets relatively flat and many regions rallied towards the 23rd June as a "Remain" vote seemed increasingly likely. The significant drawdowns experienced across the board as a result of the shock "Leave" vote began to reverse over the following week as it became clear that the UK government had no plans to trigger the exit process in a hurry. In some cases equity markets ended June higher than the pre-referendum position.

Private Client Index (PCI)	Risk relative to World Equities	GBP % Return	USD % Return	CHF % Return	EUR % Return
ARC Cautious PCI	0 – 40%	1.3	1.3	1.1	0.8
ARC Balanced Asset PCI	40 – 60%	1.9	0.7	1.9	0.4
ARC Steady Growth PCI	60 – 80%	2.7	0.3	2.2	0.4
ARC Equity Risk PCI	80 – 110%	3.6	0.2	3.1	0.2

The table above shows that on average, investors have experienced positive returns across all risk categories in all currencies during Q2. Equity markets were generally flat to slightly positive. The key driver of performance differences across the currencies was Sterling weakness relative to other currencies. For example, USD strengthened 7.5% versus GBP.

Sterling weakness led to a difference in performance between more domestically focussed managers and those with international exposure. The table on the right shows the range of return between the top and bottom quartile in each PCI category in Q2. For example, the table shows that the difference between top and bottom quartile for a Steady Growth Sterling investor was c. 1.6 percentage points; quite a wide range over just 3 months.

Private Client Index (PCI)	Percentile	GBP % Return	USD % Return	CHF % Return	EUR % Return
ARC Cautious PCI	25th	2.0	1.4	1.2	1.2
	75th	1.4	0.5	0.2	0.3
ARC Balanced Asset PCI	25th	2.9	0.7	2.5	1.0
	75th	1.6	(0.1)	1.1	(0.1)
ARC Steady Growth PCI	25th	3.6	0.6	3.1	1.0
	75th	2.0	(0.1)	1.0	(0.3)
ARC Equity Risk PCI	25th	4.6	0.4	3.4	1.4
	75th	1.8	(0.7)	1.8	(0.4)

In summary, last quarter was a good example of the importance of diversification and the benefit of employing a discretionary manager to navigate through difficult markets. It also highlights the importance of understanding the currency exposure of your portfolio and thus, how currency fluctuations may impact the overall performance of your portfolio. Furthermore, investing in financial markets is a long-term undertaking played out with a steady and considered approach; whereas, newspaper headlines are often designed for one day of sales and are certainly old news when it comes to making investment decisions.

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Do bigger portfolios outperform?

Conventional wisdom suggests that larger investment portfolios should outperform smaller investment portfolios for a number of reasons:

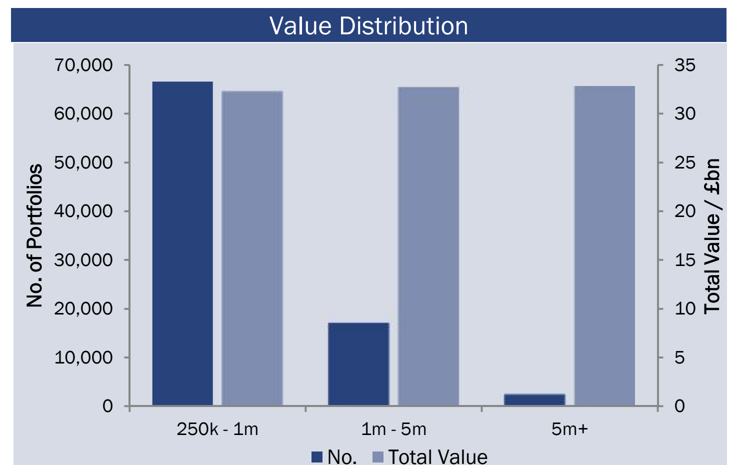
- Typically, discretionary manager fee scales have a tiered structure, such that the larger the portfolio the lower the basis point fee (ie 1% on the first £1 million & 0.75% thereafter);
- Smaller portfolios tend to constructed on a “portfolio of funds” basis whereas larger portfolios can invest directly into the global bond and equity markets, benefitting from the reduced cost;
- Larger portfolios have the ability to meet the minimum investment size criteria that are common for certain asset classes, notably hedge funds and private equity, that have historically offered attractive risk/return opportunities; and
- Star fund managers gravitate to investment firms with higher client minimum investment thresholds such that smaller investors cannot access the best talent.

However, recent developments in product structuring, portfolio construction and market conditions may challenge the consensus and the ARC Private Client Indices universe of over 100,000 portfolios from 68 investment managers provides a unique dataset to examine whether bigger discretionary portfolios outperform their smaller counterparts.

The ARC Private Client Indices Universe

As at June 2016, 68 investment managers are providing discretionary private client portfolio information as Data Contributors to the ARC Private Client Indices Universe. The total asset value of the portfolios is more than £100bn.

The chart on the right divides the universe into three size categories: up to £1 million; £1 - £5 million; and above £5 million. The distribution of the ARC PCI Universe by number and by total portfolio value has been plotted.



The chart above reveals that the total value of portfolios in each of the three size categories is very similar, at around £32.5 billion. However, as might be expected, the up to £1 million size category accounts for the majority of portfolios by number.

Performance by Size

To investigate the impact of portfolio size on performance, the constituents of the ARC Sterling Steady Growth PCI index were classified according to the three size categories set out above and performance for each size category computed. The results indicate that, for example, over the last five years there has been a significant differential, with smaller portfolios up 29.6%, middle ranking portfolios up 31.4% and larger portfolios up 33.0%. Thus, *prima facie*, it appears that bigger is indeed better.

To investigate the pattern of relative performance over time, consider the cumulative return and relative return charts below. These show that over the last 10 years whilst larger portfolios have tended to outperform smaller portfolios over the period as a whole, the overall differential in performance is relatively modest and is not persistent across all time frames.

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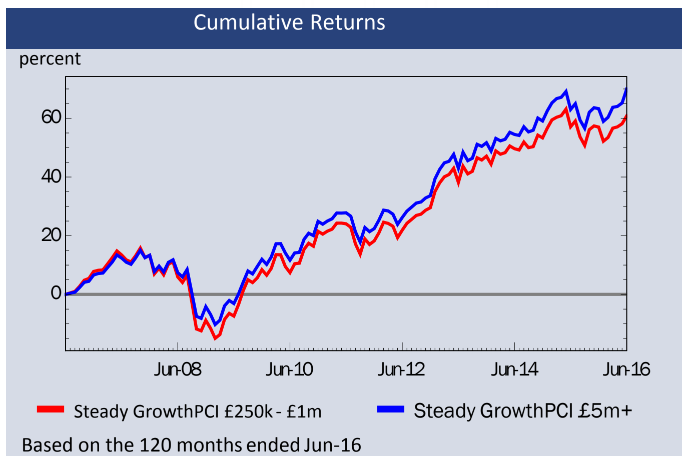

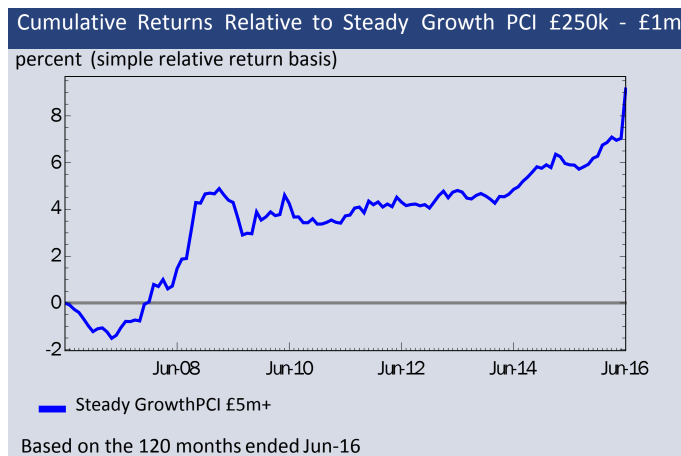

Putting numbers to this analysis, the 10 year returns for smaller portfolios averaged 60.8% versus 70.1% for larger portfolios. The period where larger portfolios outperformed to the greatest extent was during the financial crisis (around seven percentage points over 18 months) and also more recently. There have been periods where smaller portfolios have done better but these have tended to be short but more noticeably 2010 – 2014 there is little evidence of larger portfolios doing better.

Why the performance differential?

The first two bullet points above suggest that the performance differential is partly down to fees. To estimate what element of the outperformance can be attributed to fees, the net indices plotted above have been adjusted for the estimated average total expense ratio ('TER') for portfolios. ARC has calculated these adjustment factors based data compiled from Data Contributor due diligence questionnaires, many of which are available free of charge to investment advisers and intermediaries via www.suggestus.com

The table on the right shows the fee adjustment that has been made to each of the two performance series to create a gross of fees performance track record (see overleaf).

Portfolio Size Category	Average TER / %
£250,000 - £1m	1.64
£5m+	1.34

The fee adjustment process, unsurprisingly, results in much of the outperformance of larger portfolios being eliminated on a cumulative basis but perhaps more interestingly it also reveals that "size-related alpha" seems to have periods of being negative as well as positive periods. This finding points towards relative performance being at least partly driven by strategic asset allocation; tactical asset allocation; and potentially style bias.

Thus, potential sources of performance differentials include:

- The relative performance of domestic versus foreign equity and bond markets. Smaller portfolios tend to have a greater domestic bias; and
- The performance of alternative asset classes such as hedge funds and private equity both versus listed counterparts and versus traditional bond and equity exposure. Larger portfolios tend to have exposure to a greater variety of asset classes and instruments.

However, there are also industry trends working in favour of widening the opportunity set for smaller portfolios including:

- The proliferation of exchange traded funds, increasing access to asset classes and investment strategies previously only available to those able to meet sizeable minimum investments, for example, iShares Listed Private Equity UCITS ETF and Vanguard Global Momentum Factor ETF;

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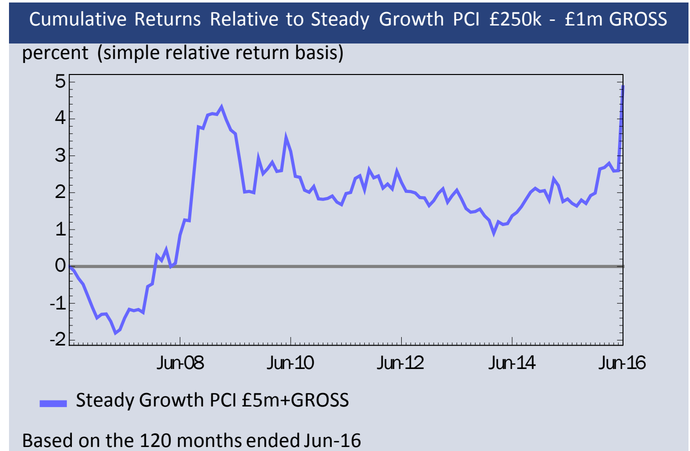
- Increasing standardisation of investment processes, facilitated by developments in platforms allowing more sophisticated strategies to be executed at scale and pressure from regulators on transparency and consistency of client outcomes.

Looking at the timing of relative outperformance of larger portfolios, the chart on the right emphasises the superior performance of larger portfolios during the financial crisis.

Yet, the fee-adjusted data also reveals that over the five year period from early 2010 to mid-2014 much of that outperformance was lost.

A trend of relative outperformance seems once again be evident over the last couple of years, with a roughly 3 percentage point swing in favour of larger portfolios.



What Next?

The task for chief strategists and chief investment officers looking ahead is to try to understand why larger portfolios have outperformed by 1.1 percentage points over the last quarter and if necessary, seek to innovate in the investment solutions being offered to clients with smaller portfolios so they do not get left behind.

Historically, discretionary managers have been able to offer larger investors a broader range of investment opportunities, such as hedge funds, private equity, infrastructure and asset backed securities, to incorporate into a well-diversified multi-asset portfolio. With the burgeoning growth of exchange traded funds offering exposure to specialist asset classes and “smart” investments, it seems unlikely that the degree of underperformance of smaller portfolios will approach the level experienced in 2008 despite the greater market uncertainty and volatility being experienced in 2016. However, June 2016 illustrates the fact that managers need to continue to innovate in providing investment solutions for smaller portfolios that mimic their larger counterparts.

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A full list of Data Contributors to PCI is available at www.suggestus.com