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The life cycle of investment funds

Introduction

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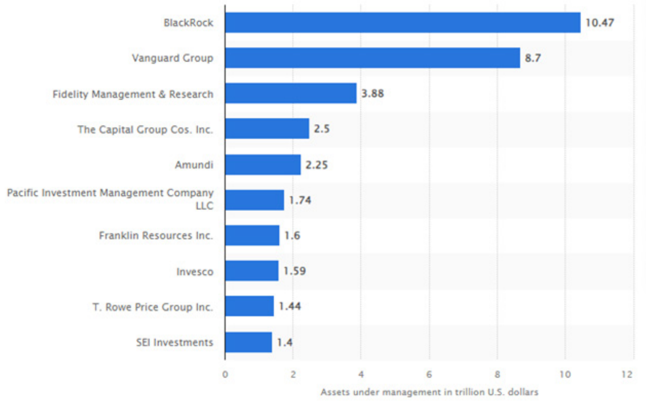
Many investors tend to prefer larger funds. Yet this is not the best time to invest - quite the contrary.

According to Statista (see chart below), the 10 largest asset management companies manage approximately 30% of the world's assets under management as of June 2024. And it's unlikely that this concentration of assets has fallen over the past two years. How can we explain such a craze for management behemoths? Among the reasons put forward are the near-obligation of pension schemes and sovereign wealth funds to favour size (notably for reasons of leverage ratio), the sense of security and stability offered by large management houses, the reduced need for detailed operational due diligence when managers are part of well-established groups, and the fact that fund selectors minimise their career risk when they favour funds held by the masses. But are they on the right track?

Chart 1: The largest asset management companies in 2024, ranked by assets under management (in trillion dollars)



Source: Statista

A fund's size does not always rhyme with Alpha

The process seems to be well established among most institutional investors, independent asset managers and banks: the first step in the fund selection process is to narrow down the investment universe to vehicles that have been in existence for at least five years and have assets under management of at least $300-500 million. This "screening" de facto eliminates a considerable number of candidates.

Yet several academic studies have demonstrated that a large AUM can have a negative impact on fund performance, as well as on the persistence of that performance. In 2005, a study by Getmansky suggested that beyond a certain AUM level, performance is impacted. In 2008, Boyson demonstrated that "performance persistence is strongest among newer funds".

It is also a well-known fact that many mutual funds decide to close to new subscriptions above a certain amount. It is not uncommon for hedge funds to return some or all of their capital to investors when the size of the fund becomes too large, as it becomes a drag on performance. Indeed, investment opportunities become more limited as the size of the fund grows. This is particularly true in the less liquid segments of the market (e.g., emerging markets, small caps, credit, etc.).

Warren Buffett referred to this problem in his 1995 letter to shareholders: "The giant disadvantage we face is size: in the early years, we needed only good ideas, but now we need good big ideas. Unfortunately, the difficulty of finding these grows in direct proportion to our financial success, a problem that increasingly erodes our strengths."

But there is another dimension that must also be taken into account when selecting funds and managers - the stage of development. In any company, or in the case of a product, the life cycle refers to the various stages of development - from start-up to expansion into new markets. Each stage has its own unique characteristics, and the manager's focus will reflect the stage of the life cycle.

While every fund manager is different and has a distinct life cycle, various research studies indicate that mutual funds generally exhibit similar patterns of progression.

The theory of the fund lifecycle

Sheelah Kolhatkar, a Wall Street columnist and former hedge fund analyst, compared the career trajectory of a fund manager to that of a rock star. She established four distinct stages:

"At the start of a fund's life, managers are over-motivated and humble enough to systematically challenge themselves. This is certainly an opportune time to invest in the fund, but also the riskiest, as funds tend to be sub-optimally sized (which often implies operational...and survival) risk."

"The second stage takes place once the fund has achieved some success and the decision-makers have built up confidence. However, the fund is not yet very well known, the size is not too large, and it is still possible to subscribe."

"Then comes the third stage - which corresponds to a kind of plateau. The fund has become fashionable and attracts the attention of a large number of investors, forcing the fund - in some cases - to refuse new subscriptions".

"The fourth stage corresponds to the decline. The manager is more concerned with life and activities outside the fund's daily routine: buying luxury real estate or yachts, sponsoring a soccer team, etc. At this stage, most funds no longer generate alpha. The manager becomes overconfident, and the size of the fund has become too large to allow any investment agility".

What Kolhatkar has highlighted is a well-known theory which suggests that the optimal time to enter a fund is when AUM is not too large and the number of years of existence is limited.

As mentioned above, the life cycle of a mutual fund can be classified into four stages: emerging, growth, maturity and decline (leading to closure or revitalisation). Each underlying stage has similar characteristics, as shown in the table below.

	Stages of the fund lifecycle			
	Emerging	**Growth**	**Maturity**	**Decline**
Size	Small	→		Large
Lifespan	New	→		Long
Operations & infrastructure	Simple	→		Complex
Operating mode	Entrepreneurial	→		Bureaucratic
Differentiation	Unique	→		In line with the market
Investor base	Early birds	→		Followers

When is the right time to invest in a fund?

Being able to identify a manager's or fund's stage of development has important implications for fund selectors, not only in terms of the timing of fund subscription and redemption, but also in terms of expectations of return, volatility, and correlation.

As shown in the graph below, the growth phase and the early years of the maturity stage of a fund represent the optimal time to invest. This is the time window when the fund manager is most likely to consistently generate alpha while economic risk is lower (sustainable profitability, stable operational infrastructure, etc.).

Chart 2: Excess return potential and business risk depending on the life cycle stage

Based on these studies, integrating life cycle analysis into the manager selection process could improve selection efficiency compared to a process based solely on historical performance ("past performance is not indicative of future results"). However, determining the life cycle stage of a manager relies on both qualitative and quantitative analysis. Investing in funds during the launch phase is not without risk. Support teams (back-office, risk, IT, etc.) are often smaller, which can lead to higher operational risk compared to larger funds. Moreover, analysing management boutiques involves more thorough due diligence. Identifying these emerging managers also requires a more robust network and makes reference verification all the more important.

It should be noted that the duration of each stage is not fixed and does not necessarily follow the same order. For example, some funds move directly from the "emerging" stage to the "maturity/decline" stage without going through the growth stage. It is also important to consider the fund's strategy, as optimal characteristics may differ from one strategy to another.

What can emerging or growth phase funds bring to a global portfolio?

Today, many investment professionals recognise the need to seek out new "gems" in management instead of solely favouring the giants. This is a rather positive evolution. There are now over 140,000 funds worldwide. Among them are many talented but unknown managers who can achieve better results than established funds but lack the marketing skills and/or distribution capabilities of the better-known brands.

A new way to build portfolios involves setting up a selection process that allows for regular rejuvenation of the selected funds' pool. In this approach, the selector identifies a number of emerging and/or growing funds that are likely to be introduced into the portfolio at the expense of funds that have reached maturity and are nearing the decline phase. The wise use of the fund life cycle should be seen as an opportunity to generate additional alpha.

Conclusion

Performance should be the main factor to consider when selecting collective investment funds. As we have seen, the size and lifespan of a fund do not guarantee future success – quite the opposite. Just like top athletes, most products, or companies, investment funds have their own life cycle. Integrating an additional analysis that identifies the development stage of the fund can improve the manager selection process.

It is evident that many asset allocators currently favour large, mature funds. This concentration of assets in the most mature funds offers excellent alpha opportunities for selectors capable of identifying emerging funds and managers. Many of these funds offer alpha potential far superior to those that have already entered a maturity phase.

For further information

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