FIS GROUP

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MARKET INSIGHTS ALERT

Big Is Bad (Really Bad) in Frontier Market Equities

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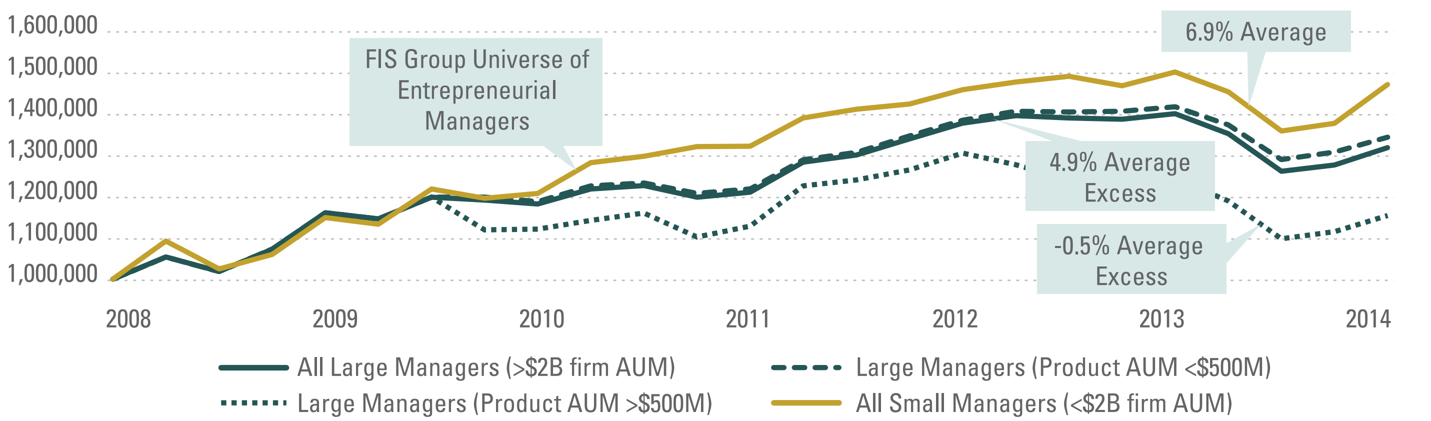
For 19 years FIS Group has successfully invested with entrepreneurial managers in global equities markets based on the considerable body of research suggesting that talented, high-active share, entrepreneurial managers are best positioned to outperform market benchmarks, net of fees. We believe that there are generally two reasons, both timeless and universal, why this inefficiency will continue. First, entrepreneurs with "skin in the game" are motivated to work harder, as entrepreneurs generally are in every other business across the time and space of human history. Second, in the modern markets of listed equities, size and scale are the enemies of alpha. While we have long known both of these simple (but nonetheless surprisingly ignored) truths to be self-evident in asset management, the significant opportunity of investing with entrepreneurial managers continues unabated. However in our firm's 19 years of investing and decades more of experience of our principals, we have rarely (if ever) seen so clear a demonstration of both of these sources of alpha in one simple chart.

CHART 1 Cumulative Excess Returns - Small vs. Large Frontier Markets Managers
Dec 2008 - Dec 2014



Number of Managers in Dataset

	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Large Managers (>$2B)	5	5	9	9	9	11	11	11	12	12	13	13	14	16	16	16	17	17	18	18	19	19	19	19
- Product (<$500M)	5	5	9	9	9	11	10	10	11	11	12	12	13	15	15	15	16	15	14	13	12	12	12	12
- Product (>$500M)	0	0	0	0	0	0	1	1	1	1	1	1	1	1	1	1	1	2	4	5	6	7	7	7
Small Managers (<$2B)	4	4	5	6	6	6	6	7	8	8	8	8	9	9	9	9	10	10	10	10	10	10	10	10

Sources: eVestments Alliance; FIS Group data – Dataset reflects the frontier universe in eVestments, adjusted for duplicate strategies, missing/incomplete data, etc. Seven additional managers' return streams added to the universe from FIS Group data. Returns are quarterly, self-reported.

FIS Group staff recently studied the returns of all the global frontier markets strategies for which we could obtain consistent performance and asset data. Most of this dataset is readily available to other institutional investors from eVestment Alliance, which is perhaps the most comprehensive database of long only managers and strategies (as opposed to funds) in the marketplace today. Despite this, the dataset included both performance and AUM data for only 22 strategies, to which we supplemented the dataset with a small handful of strategies for which we had sufficient data.[1] The intent of this study was to test whether our anecdotal hypothesis on the importance of firm and product size (already verified in other classes of listed equities) also held true in the universe of frontier market managers. In other words, have smaller managers actually outperformed larger managers in frontier markets and what impact has product size had on historical returns?

[1] *All return streams for which we had both performance and asset data were incorporated. There was no "cherry-picking" of the dataset.*

Our analysis confirmed both hypotheses, by significant margins. In general, the inefficiency of the frontier markets universe and benchmark has created significant alpha opportunities for managers of all sizes. Over the past 5 years (2009-2014) large firms with frontier markets products have delivered an average annual excess return of 4.9% and smaller firms have added an additional 2% of alpha on top of that for average annual excess returns of 6.9%.[1] In other words, big managers are good, but smaller managers are nonetheless better at delivering higher returns.

The most significant result of the study was the finding related to large products. Using the self-reported product AUM data in eVestment Alliance we were able to analyze the returns of those products as they grew their AUM. Based on our own observations of the universe of frontier markets, we used a cutoff of $500m in AUM in the firm's frontier strategy for our study. This number is merely the most commonly cited capacity limit for the majority of entrepreneurial/boutique firms with which FIS invests or has considered investing in frontier markets. Our analysis strongly points to one inexorable conclusion: managers who disregard or disrespect the capacity limits of this less liquid space do so at great peril to their clients' returns.

Over the past 5 years, according to the eVestment data, seven managers have been successful in raising assets in their global frontier strategies past the $500M mark. These managers, in order of asset growth (and the quarter they crossed the $500M mark in parentheses) are: Franklin Templeton (Q3 2010), Wasatch (Q2 2013), Morgan Stanley (Q3 2013), Lloyd George/BMO (Q3 2013), HSBC (Q4 2013), Aberdeen (Q1 2014), and Schroders (Q2 2014). All seven of these managers did so based on solid performance in their strategy in the early years (or quarters) of their lives. But as they approached and then crossed the $500M mark, all seven of these managers' performance began to deteriorate sharply and **over 70% (5 of 7) of these managers then started to produce negative excess returns as soon as they crossed the rubicon of $500 million product AUM**, indeed the very quarter following their accumulation of assets past the $500M level. The two exceptions were HSBC and Morgan Stanley, yet both saw marked deteriorations in performance. Prior to accumulating $500M in AUM, their quarterly average excess returns were 1.6% and 1.1%, but after hitting the $500 million level their returns deteriorated by over 70% to 0.6% and 0.15% quarterly average excess, respectively.[2]

CONCLUSION

As funds accumulate assets, they are forced to either overly diversify their portfolios (thus watering down the returns of their highest conviction positions) or to take increasingly large stakes in their existing portfolios. The latter approach would pose higher entry costs in tight markets and dangerously high exit costs in the event of deteriorating company fundamentals, or the strategy sees redemptions from other clients during periods of scarce liquidity. Smaller managers are able to be more nimble and responsive to idiosyncratic risks of these dynamic markets.

It is worth noting that the alpha erosion effect caused by reduced liquidity in the universe of frontier markets equities is applicable to other capacity constrained, non-US asset classes; but with higher absolute thresholds. Our own internal estimates put the equivalent thresholds for global emerging markets at about $3B and for international small cap at around $2.5B, just to name two other capacity constrained asset classes. At FIS Group, we believe that these capacity constrained universes are best tapped by nimbler managers whose business models do not depend upon asset gathering and we have spent years scouring the globe for the most talented such managers in each segment. We are excited by the opportunities that these markets offer, but encourage our clients and colleagues to ask tough questions of their managers about the capacity constraints of their strategies, and consider whether their managers' business interests are sufficiently aligned with the limitations of their asset class.

[1] *All returns were equal weighted across the strategies in the dataset.*

[2] *Returns data through December 31, 2014.*