REFOCUS

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This document describes our thinking behind selected recent portfolio management actions in our portfolios and provides context to their current positioning against the backdrop of their investment opportunity set. Our funds always consist of a diversified portfolio of opportunities and risks; please bear that in mind when evaluating our commentary about individual positions.

All Funds Great and Small - Investors Need Them All

"All funds bright and beautiful,
All managers great and small,
All funds wise and wonderful,
Investors need them all."

(with apologies to Cecil Frances Alexander)

In a market populated with large well-known and trusted investment firms, why should investors bother considering an allocation to a small manager such as RECM? Because allocating funds exclusively to large managers may reduce an investor's opportunity set by up to two thirds, and lead to high levels of concentration risk in a small number of stocks.

In a world of "bigger is better", you don't generally hear much bragging about who is the smallest. But there are definitely things in life that are better smaller – kidney stones, debt, earthquakes and marital disputes come to mind! In the asset management industry, large firms are usually perceived by investors as the safest places to invest their hard-earned cash. This is unsurprising – many of these managers attracted sizeable assets precisely because they proved themselves to be successful at investing when they were a lot smaller. As large managers they now have the resources to employ impressive teams of smart investment professionals and polished marketing specialists to reassure clients that their investments are in good hands. The irony is that the larger a manager gets, the more difficult it becomes for them to deliver the same active returns that attracted inflows in the first place. At some point, the size of a manager's assets begins to directly impede their ability to do their jobs successfully as active managers. In the South African context, how does investing almost exclusively with large managers potentially impact underlying investors?

To measure this, we considered the FTSE/JSE All Share Index as the full opportunity set of investable stocks. At the start of 2019, this included 164 stocks. To measure how an increase in assets impacts the number of stocks available to managers, we set two simple parameters: 1) At each level of assets, the manager needed to be able to still hold at least a 1% position in the stock for it to be considered meaningful; and 2) The manager would only be allowed to own up to one fifth of the free float (the shares that trade freely on the JSE) to ensure no liquidity issues arose. We then considered how many stocks were investable without breaching these two parameters at various levels of assets, starting with R4 billion of assets under management through to R300 billion. The results were as follows:

Assets under management	R4bn	R10bn	R50bn	R100bn	R300bn
Number of stocks available	164	163	135	107	59
% of universe available	100%	99%	82%	65%	36%

This means that if you are a manager looking after R4bn, you are able to invest in every single stock in the All Share Index without holding more than a fifth of the free float, while still having at least a 1% position. This flexibility is almost fully intact up to R10bn, and at R50bn, you still have 82% of the stocks available to you. But at R100bn, you lose one third of the opportunity set. If you happen to be managing more than R300bn, as many of South Africa's largest managers indeed are, you cannot invest in more than one third of the All Share Index without breaching one of the two parameters set. This means you only have one third of the opportunity set fully available to you –without even considering yet whether those stocks actually happen to be priced attractively at that time.

If your hunting ground as a manager is constrained to the top 40 stocks in the Index, but these stocks happen to be performing well, investors remain oblivious to the concentration risks involved. After the financial crisis, most large caps were priced attractively, and high quality stocks in particular were in demand. This saw the ALSI 40 performing well thereafter - and with this backdrop, size didn't appear much of a hindrance.

However, when the ALSI 40 is down – as was the case in 2018, when all but 7 stocks delivered negative returns – a high concentration of funds which are similarly positioned because they are similarly constrained can have dire overall consequences for investors with little exposure outside of this. No matter how many smart people very large managers have in their investment teams, if there is no room to hide within their narrow opportunity set, as was the case in 2018, their funds will perform poorly. This does not represent a lack of investment skill but a lack of investment manoeuvrability.

In contrast, the RECM Equity Fund was one of only two equity funds that delivered a positive return after fees in 2018. This is a result of two things: our small size, which gives us flexibility, and our style as a value manager – undervalued stocks, being cheap already, often have the benefit of holding their ground reasonably well when the rest of the market is down. This combination of size and style results in very different holdings – one that has very low correlations to most other funds' returns.

Investing only with large managers may feel comfortable, but can translate into portfolios which may be highly correlated to each other and the market at precisely the time you need diversification - in market downturns. Ignoring small managers can mean to up to two thirds of the market is unavailable to you as an investor. If investors are serious about diversification, as all the literature suggests we should be, portfolios need to be populated with different funds with different holdings – whether this is by virtue of differences in manager size or style or both.