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The Right Amount of Assets Under Management

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The Right Amount of Assets Under Management

There are diseconomies of scale in active management stemming from the increased costs associated with larger transactions. As assets under management increase, position sizes also increase, and the portfolio return as a percentage of assets declines. Even though returns decline, wealth created (in dollars) increases, up to a point. This wealth-maximizing point is reached when the cost of additional trading exceeds the opportunity cost of not trading. Further growth in assets leads to an increase in unexecuted trades, hence larger opportunity costs and lower percentage returns. Total wealth created is unaffected by increased opportunity costs.

If the management fee is a fixed percentage of assets, client wealth declines as opportunity costs rise, creating a divergence between firm and client interests. With performance fees, there is less of a problem: The firm loses revenues if accounts are added (and the assets traded) beyond the wealth-maximizing amount. Performance fees are a way of giving good firms sufficient inducement to contain their growth.

With diseconomies of scale, new clients dilute the returns to existing clients. Client ownership of a portion of the firm or its revenue stream is a potential solution to this problem.

YOU ARE a successful active equity manager. Performance has been good, and asset growth is strong. Should you turn down new accounts? Quite possibly.

There are diseconomies of scale in active management, which stem from the relation between market impact and transaction size. Large trades are more difficult to execute than small trades. Performance thus erodes with size.

What is the "right" amount of assets to have under management? The criterion is not obvious. If the goal is to maximize rate of return, the right amount is, effectively, zero.[1] That is, to maximize rate of return, you should exit the money management business and sell your advice in the form of a newsletter. That way, your performance will be judged only on paper, unencumbered by the drag imposed by real-world implementation.

We argue that, rather than rate of return, the goal should be maximization of the total dollar return—the total wealth the investment process is capable of creating. By this criterion, the right amount of assets will depend primarily on three things—the quality of your research, your transaction needs and market depth. The right amount of assets for one investment process may be quite inappropriate for another. Under certain circumstances, the right amount can be many billions of dollars. For many managers, however, it will be a surprisingly small number.

Clients, too, should be concerned about the size problem. Typically, however, they will not know enough about the manager to be able to make a meaningful assessment. Their best hope is that their and the manager's interests will coincide. Unfortunately, flat fees or, worse, fees

1. Footnotes appear at end of article.

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