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Elston Insights

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Navigating fund concentration risk

- It's not the name on the tin, it's what's *in* the tin
- Provider due diligence is crucial
- Size matters

Is there a risk in holding a number of funds from the same provider?

It is necessary to differentiate between active funds and index funds when addressing this question. With index funds, splitting fund holdings across a variety of established providers for the same exposure, for example FTSE100 or S&P500, carries very little value, provides no additional diversification and creates unnecessary duplication and inefficiency.

For active funds, the question becomes more relevant. Fund management companies rarely fail, but that is not the case for a fund holding poorly-selected investments by a particular manager. We all know the case studies. Ultimately, a fund's holdings are much more important than its label. Holding several funds from the same provider may not be a problem per se but it can be a problem if it creates unintentional or misplaced biases within a portfolio. For example, advisers who had several funds managed by an equity manager with a structural Growth bias - which worked until 2021 - were then punished when Growth de-rated and Value dominated in 2022.

A more diversified approach across styles may have led to holding funds from different providers that could have helped mitigate this. However, as already emphasised, it is not the name of the house that saves you, it is the diversification and adaptation of style factor. Also, total allocation to a provider is more important than a threshold number of funds as that will dictate the provider risk in a portfolio.

How carefully should investors consider a provider's financial strength?

Focusing on provider risk is very important. Evaluating the financial strength of a manufacturer is a key obligation within a product governance framework. Understanding a fund's viability is crucial. Provider risk is low for firms that have an independent risk management committee with authority to overrule the manager if needed. But as before, the most important thing is what is inside the fund, not just the size and viability of the provider managing it.

Should portfolios have a limit on the number of funds from each provider?

We think a painting by numbers approach is too simplistic. It's what's inside the funds and how they behave in a changing market environment that matters, rather than name checking providers. Again, the answer is different when looking at active funds or index funds.

We would have no problem constructing a portfolio using index funds from a sole provider if it has got all the exposures we need to deliver that strategy. With index funds there is full transparency, so we can have a lens through to all the underlying holdings. It doesn't really matter what the label of the fund wrapper is: we are targeting those underlying exposures, and the efficiency with which an index is tracked, which is a quantitative evaluation process.

With active funds it really depends on what you're looking for. It's unlikely that a firm will have strength in active management across all markets. Active fund selection will be driven by choosing the best-in-class for each exposure, which will typically lead to an array of different fund houses. Constraining this by fund count doesn't make sense, the focus should be on the manager and their team instead.

If we did see a portfolio that used active funds only from one provider, we would certainly challenge it, as it suggests that there is not sufficient review of funds being held. This is possibly because selection is heavily thematic (a particular style or philosophy is favoured) or sometimes more relationship-driven rather than process driven for each exposure. Understanding portfolio biases that each fund creates and contributes to is key. This is why we focus so much on analytics.

Size of firm, or size of fund – which is more important?

The size of the investment management firm matters, but the size of the fund relative to its market matters more. Again, we would differentiate between active and index funds. For index funds from established providers, investors can take a more flexible approach to size, particularly for new launches. After all, the behaviour of the fund will mirror the behaviour of the index which it tracks.

The performance track record of an index fund is less of an issue as we have the index to go by. Investors also have full visibility and transparency of everything inside the fund and respective index so there are no nasty surprises. We do monitor AUM traction within newly-launched index funds and ETFs in case there are any concerns around commercial viability. Providers can be quite brutal and if a fund is not gaining assets - even if it is cost-capped - they might decide to kill it off. A walk around the ETF graveyard will show you that.

For active funds, size can be critical at both ends of the spectrum. An active fund that is too large for its market may have difficulty seeking out alpha opportunities and require more risk-taking in order to make a difference. An active fund that is too small may be subject to commercial viability issues.

Again, it is important to focus on what is inside the fund. If an active fund owns a very high proportion of the securities in the fund to the extent that redemptions could damage the price of its own holdings, then that becomes a major concern. If a particular asset class or exposure is out of favour, redemptions will gather pace, negatively impacting the price of the assets in the fund - possibly owing to liquidity issues – and that is your next Woodford.

We want to help the advisers we work with look beyond the brand and the bluster and avoid having their clients gated at a time when they want to sell. That's why our key message to advisers is to focus less on the brand names and more on the DNA of each fund.

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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