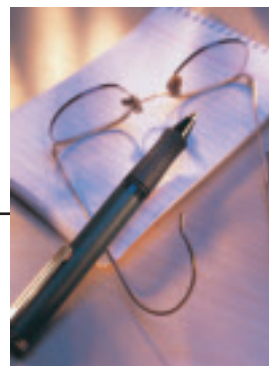


# Does size matter?

The impact of portfolio size on investment decisions.

FIELD NOTES

BY JONATHAN SINGER



The Canadian marketplace presents a unique and growing challenge for the investment of pension plan assets. The constraints of the recently scrapped Foreign Property Rule coupled with the increasingly concentrated Canadian equity market continuously test the abilities of plan sponsors and investment managers to successfully invest within the parameters set out in pension legislation, while adhering to the fundamentals of portfolio management.

Over the past few years, many Canadians experienced first-hand the shortcomings of our increasingly concentrated market. In the late 1990s and early 2000, the technology boom created a situation where a single stock—Nortel Networks—had the ability to dictate the daily performance of the S&P/TSX index. Industry consolidation and foreign acquisition of Canadian companies decreased the number of attractive stocks that populated the index, while a tightening of universe standards in 2002 reduced the composition of the S&P/TSX to fewer than 230 companies.

As a result of this industry consolidation and acquisition, the bursting of the technology bubble, and the modifications implemented by Standard & Poor's, a new index leader has emerged. However, unlike Nortel, it is not a single company that is dominating both its sector and the universe, but a group of interest-sensitive stocks often referred to as the Big Five: Royal Bank of Canada, Bank of Nova Scotia, Bank of Montreal, Toronto-Dominion Bank, and Canadian Imperial Bank of Commerce. As of December 31, 2004, these five banks accounted for an impressive 18.4% of the S&P/TSX index and consequently now hold commanding positions in many managers' actively managed Canadian equity portfolios.

When the portfolio holdings of the largest

Canadian investment managers were recently examined in an effort to explore the Big Five's influence on them, every manager had invested in at least three of the five banks. Many investment managers had taken large positions in four or even all five of the banks, with single-stock weights reaching as high as 9.8%. These results prompt a question: do Canadian banks actually represent an attractive opportunity, or are these large positions simply a product of a concentrated Canadian market?

One explanation for these large portfolio weightings in the banks may involve reluctance on the part of managers to stray too far from the overall composition of the index. In the last decade, there have been two remarkable style swings in the market: during the mid-to-late 1990s, growth stocks soared to unimaginable valuations, only to come crashing down in 2001 and 2002, when value investing came back into favour. Undoubtedly, these were extremely difficult times—performance-wise and revenue-wise—for managers who stuck to their convictions and remained true to their style. Thus, after witnessing wild style swings in the market, firms may have made the business decision to curtail the tracking error of their portfolios.

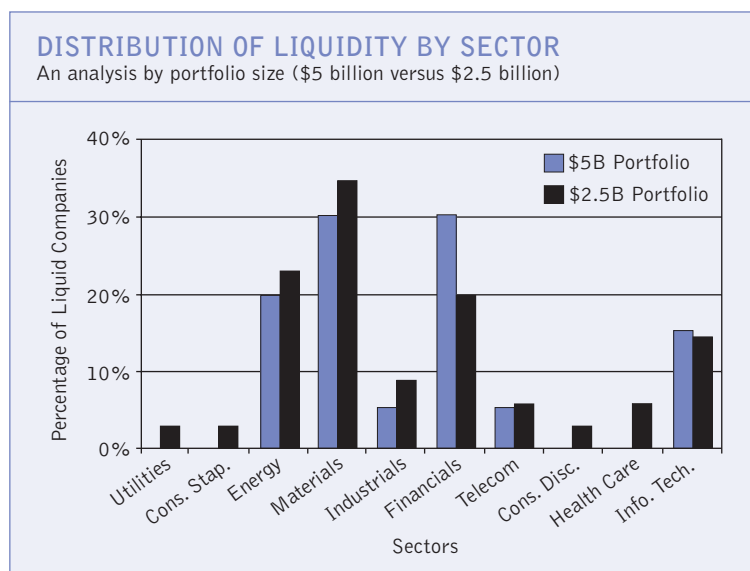
The examination of these portfolios revealed an item of greater interest: some of the larger firms were among those who had taken on some of the more substantial positions with the banks. This finding begged the question of whether liquidity played a factor in their investment decisions. To examine this point further, the impact of liquidity on firms of different sizes—in terms of assets under management—was compared. A liquid stock was defined as one being able to move in or out of position within five trading days. For this exercise, the management

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## FIELD NOTES



of a \$5 billion portfolio was first considered and the number of liquid stocks in the universe at a 5% portfolio weighting (i.e., \$250 million) was examined. It turned out that only 21 companies currently listed on the S&P/TSX remained liquid under this definition, and these names were mostly concentrated in the Energy, Financials, Information Technology and Material sectors.

The same exercise was repeated maintaining the 5% single-stock portfolio weighting, but reducing the portfolio size to \$2.5 billion. This resulted in a doubling of the number of liquid names to 42. In addition, the reduction in portfolio size alleviated some the sector bias. Both of these outcomes provide evidence that the size of Canadian portfolios can have significant impact on one’s portfolio construction process.

The graph above plots the distribution of the liquid names in the \$5-billion and under-\$2.5-billion portfolios across the ten global industry classification sectors on a percentage basis. One can see that as the size of the portfolio is reduced, the concentration of liquid names across the sectors is lessened.

It may be the case with some of the larger firms in Canada that they are in fact unknowingly running two Canadian equity portfolios—one portion of their portfolio dictated by liquidity and the other by fundamentals. Does this mean that committees and consultants should be assigning a more significant weighting to a firm’s asset size in their evaluation process?

The impact of liquidity on Canadian equity funds today needs to be assessed on a case-by-case basis. When one is evaluating

its effects on existing or potential new equity funds, a number of factors related to liquidity must be considered such as portfolio concentrations, investment horizons, market capitalization biases, investment styles and assets under management. Needless to say, the opportunity for large Canadian equity funds to add value through a moderate style bias still exists today. However, this is a more challenging goal relative to smaller funds as large funds’ investment opportunities are limited in comparison.

So what are sponsors of mid-sized plans to do in the face of these challenges? Here are some suggestions:

- Invest with smaller Canadian investment managers where liquidity concerns might not be as serious as with some of the larger Canadian firms.
- Select investment managers who have longer time horizons for their holdings, since managers who trade frequently tend to require more liquidity and consequently hold larger cap stocks.
- Maintain existing relationships with larger Canadian managers, but realize their growth in assets may have produced an additional hurdle when it comes to duplicating past performance. ■