Questions & Answers from Zeno AN Solutions' Thursday, July 23, 2020 Webinar

For more information about **Liquidity Threshold Analysis**, go to https://www.abelnoser.com/liquidity-threshold-ca.html.

Link to view the recording: https://register.gotowebinar.com/recording/2616358695293492225

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Question 1: *I'm surprised at how much of Manager 2 and 3's overall returns were eaten up by their projected trading costs. Is that what you normally see?*

Answer 1: You're not alone in being surprised at the impact trading can have on performance. Many investment officers underestimate the true size of trading costs, and therefore don't think of it as a significant factor in "performance attribution." Unfortunately, the numbers seen in the Case Study are not particularly out of the ordinary. For example, the average trading costs incurred by Small Cap Growth managers in 2019 was -125 bp and ranged as high as -200+ bp. When you take turnover rates into account, the impact on their overall returns ranged from a median impact of slightly over -1.5% to almost -6.0%!

Importantly, this dynamic is not limited to small cap securities. Even with Large Cap Value strategies, the impact can be meaningful. For example, while the median cost incurred by Large Cap Value strategies in 2019 was less than -20 bp, some Large Cap Value strategies incurred costs of over -100 bp. And when taking turnover into account, the impact on overall performance ranged from a median impact of around -15 bp to almost -2.0%!

Question 2: *Can a manager simply tweak their investment process in order to push their capacity threshold further out?*

Answer 2: The short answer is Yes. As alluded to during the webinar, thoughtful managers can modify their investment process so as to extend the alpha threshold. This could entail, for example, either increasing the number of holdings held in a portfolio (thereby reducing liquidity needs), and/or implementing a slightly longer “buy&hold” strategy (thereby reducing turnover rates). However, it goes without saying that these changes need to be made in a thoughtful manner, and are often easier said than done.

To begin with, if a manager fundamentally alters their investment process too much, the asset owner may rightfully question if the manager is now offering a completely different strategy than what the asset owner originally thought they were hiring. It also begs the question as to whether the strong historical returns generated by that manager can still be attributed to the new investment process.

Even when the manager only slightly modifies their process, doing so successfully can be challenging. For example, adding names to the list of portfolio holdings may indeed subsequently result in more liquid trades. However it also necessarily involves holding stocks that the Portfolio Manager believes offer less alpha potential than their original top holdings (e.g. instead of a manager holding just their top 50 investment ideas, they may now add in their 20 next best ideas).

Ultimately, all changes to an investment process require a careful balancing of the benefits and potential pitfalls. The manager’s challenge is to find the optimal balance (while still maintaining their fundamental investment process). In this fashion, a liquidity threshold analysis can sometimes be thought of as an exercise in prudent portfolio construction.

Question 3: *Is Liquidity Threshold Analysis most useful for small and mid-cap but not large cap? What about international small cap?*

Answer 3: The answer to this question is similar to Question #1 (i.e. are the costs seen in the Case Study typical?). The answer is: to the extent small and mid-cap stocks are generally less liquid than large cap stocks, that’s an important factor. However, capitalization/liquidity is only one of several key factors that need to be considered (such as: growth verses value, the number of holdings, and turnover rates).

In point of fact, depending on those other factors, a large-cap portfolio may easily be more susceptible to Liquidity Threshold Analysis than certain small cap portfolios. That is why having a quantitative model, which takes all of these factors into account, is critical. Bottom-line, no one should assume upfront that a particular manager strategy/product doesn’t have an Alpha Threshold.