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Woodford's Woes

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A case study on the challenges of active management

Neil Woodford – one of the UK's best known fund managers – has recently had to suspend trading in the Woodford Equity Income Fund. This note takes a look at the causes and lessons of his 'dark and terrible moment' as it has been described. Some investors are claiming not to know how the fund was invested, which is surprising given his well-known contrarian approach and his transparent strategy for allocating capital to smaller firms, alongside large cap stocks. Woodford, investors, best-buy lists, potential conflicts of interest, the press, and regulators all share some of the blame.

The key lesson to be learned is that active management adds additional layers of risk including stock concentration, tracking error, liquidity and manager strategy risk to portfolios. In a world where markets work pretty well and manager fees are high relative to likely skill, one should question whether these risks are worth taking. Woodford provides a salutary reminder of the challenges and dangers of doing so.

'Nobody else will ever care about your life savings as you should'

Ian Cowie, Sunday Times 9th June 2019

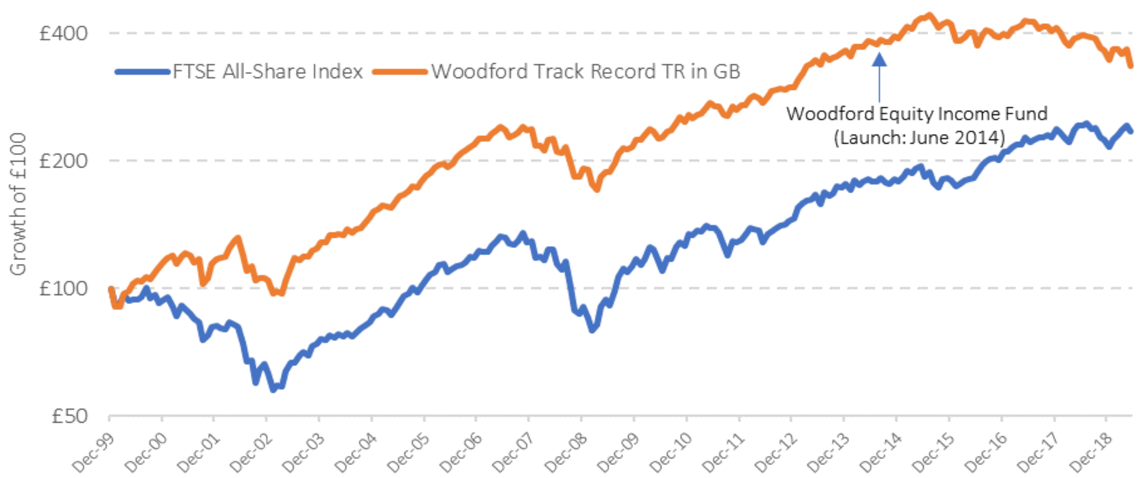
The very real (and costly) challenges of active management

It is entirely without any sense of Schadenfreude that we pen this note on the 'dark and terrible moment' that Neil Woodford and the team at Woodford Investment Management (Woodford) are facing today. This Sunday's papers made for grim and – at times unfair – criticism of one of the UK's most renowned investment managers. Is Woodford a villain or victim in this tragedy? In a sense, a bit of both. We explore the root causes of events culminating in last week's suspension of the Woodford Equity Income Fund for an initial 28 days, which prevents investors from withdrawing assets from the fund, to allow him time to remodel the portfolio.

A bit of background

Woodford made his name at Invesco Perpetual, where he managed the successful and extremely popular Invesco Perpetual Income Fund. To get a measure of the man, it is worth remembering that he has always been a high conviction, contrarian investor with a keen focus on UK companies that he deems to have attractive valuations. In his Invesco days the bulk of his portfolio was invested in larger companies, although at times his search for attractive valuations led him to holding almost 30% in smaller companies. The chart below provides an indication of his (former) 'star' status[1].

Figure 1: Woodford has added value to his patient, long-term clients (1/2000 to 5/2019)



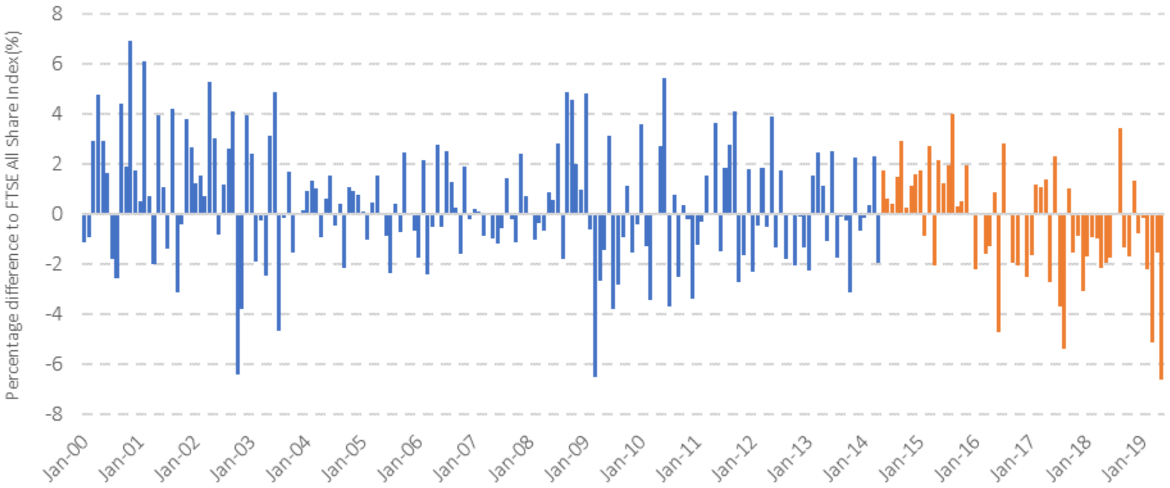
1 Note that this data set is comprises his 'manager' track record at Invesco Perpetual where he managed more than one fund (as calculated by FE Analytics) and the Woodford Equity Income from inception in June 2014.

Data: Financial Analytics (refer to footnote 1 below) © All rights reserved. Note: Log scale used.

Over the entire period, the total return of the UK market was 135% and Neil Woodford's track record delivered 235%. He has made a number of major calls on the portfolio: not to get caught up in the Technology bubble of the late 1990s; to avoid large exposure to the banks prior to the Credit Crisis of 2009; to own tobacco stocks when many were abandoning the sector; and finally to back UK-centric stocks, in a belief that they would weather Brexit better than the market anticipates. Three out of four times his thesis was correct, and no-one yet knows if his fourth call is right or wrong.

On account of his approach, his portfolio would have looked and behaved very differently from the UK market. Below, we plot his monthly returns relative to the FTSE All Share Index.

Figure 2: The difference between Woodford and the UK market (monthly 1/2000 to 5/2019)



Data: Financial Analytics (refer to footnote 1) © All rights reserved.

Note: Woodford Equity Income Fund performance is in orange and Woodford's manager return is in blue for his time at Invesco Perpetual.

What is clearly evident is that the difference between his track record and the UK market – known as tracking error – is consistently wide. On an annualised basis this tracking error has been a little over 8% for the whole period and more or less the same before and after setting up Woodford. In plain English that means that Woodford delivered annual returns in a range of 8% a year above or below the market two thirds of the time and 16% above or below the market 95% of the time. If you take on tracking error, it works both for and against you.

What went wrong?

When Neil Woodford set up Woodford, in addition to launching his equity income fund, he raised money for a closed-ended investment trust to hold unquoted stocks of small early stage businesses, which offer strong valuations. It was made abundantly clear that these were high risk, long-term, illiquid holdings, hence the Patient Capital Trust moniker. The Woodford Equity Income fund, on the other hand, is an open-ended fund structure, which allows for daily subscription and redemptions and, being a UCITs regulated fund, is only allowed a maximum of 10% in unquoted companies.

There is much academic debate around the degree to which luck plays a role in investment returns, which is largely beyond the scope of this note[2]. However, what we do know is that being a high conviction manager, who owns a portfolio significantly different to the broad market, means that there will inevitably be periods of time when the investment thesis will be right (or lucky) and other times when it will be wrong (or unlucky).

Poor performance since July 2015 and high-profile issues surrounding a couple of the Woodford Equity Income Fund's holdings in unquoted companies (Prothena and Circassia) raised investors' awareness

2 Our view is that it is mainly luck and that the evidence suggest that only a handful of managers are skilled enough to deliver returns that exceed their costs and they are hard to identify in advance.

that there might be some concerns. Redemptions began. In order to meet those redemptions, the fund needed to sell off its more liquid, larger stocks. As weak performance persisted – from July 2015 to May 2019 the UK market was up around 27% while the fund was down 22% – more redemptions ensued. The spiral of selling larger, more liquid stocks to meet these redemptions resulted in a growing concentration in smaller listed companies and unquoted start-up companies. The table below provides an indication of how the fund's structure changed over time.

Table 1: Large and smaller company allocations

Company size	June 2014 (fund launch)	September 2017	March 2019
Large Cap	73%	30%	5%
Mid Cap	11%	22%	23%
Small Cap	16%	48%	72%

Data source: Morningstar, as quoted in The Times June 8. 2019

Woodford's problems then grew as he hit the maximum 10% allocation to illiquid, unquoted shares allowed in a UCITs fund. Given the need to meet the now withering redemptions – and being unable or unwilling to offload these unquoted stocks at fire-sale prices – he sought other means of meeting this restriction, including listing some of the unquoted companies on the Guernsey Stock Exchange, which did little in terms of providing liquidity. He also sold some to his Patient Capital Trust in return for shares in the Trust, which is listed. It remains to be seen what the FCA will make of all this down the line. Eventually, with redemptions continuing (£187 million in the past month) and with the Kent County Council pension fund looking to redeem its £263 million exposure, he took the sensible decision to protect the existing shareholders interests by suspending the fund. A fund that had once reached over £10 billion in assets now manages around £3.7 billion. St James Place is in the process of replacing Woodford as the manager to its equity income fund, and Hargreaves Lansdown has (eventually) taken it off its Wealth 50 best-buy list.

Who is to blame?

We have some sympathy for Neil Woodford, who is a long-term, high conviction investor, and who has been entirely transparent with the holdings in the fund, which are published monthly on the firm's website. Only the naïve, or the ill-advised, should have been surprised that his fund could deliver returns materially below (as well as above) the market, given his track record and his well-publicised liking for smaller, often unquoted, company stocks. In hindsight, his key mistake was that, for his aggressive active style of management, a closed-ended investment trust might have been a more appropriate structure to manage a portfolio owning illiquid assets. Investors would then have been able to buy and sell shares in the trust in the market to meet any personal liquidity needs. The liquidity mismatch between daily redemptions and illiquid holdings sit at the center of the current debacle. To date, Woodford have refused to drop their charges on the locked-in funds, although the FCA's head, Andrew Bailey, suggested to Radio 4 that it would be 'the right thing to do'. Daily fees have been estimated at more than £75,000.

Investors and their advisers should not escape the hook for this either. To only take the good times and run for the door in the bad times strikes us as being evidence that these investors should be allowed nowhere near an actively managed fund of this nature. Many appear not to know how the fund is structured, have little stomach for tracking error and lack patience.

Advisers, who put their clients into the fund – one presumes in the hope that some of the stardust would rub off on them, in return for the fees their clients pay – should be asking themselves if they truly understood their clients, and if their ongoing due diligence and governance was all it should have been. Online brokerages, such as Hargreaves Lansdown (HL), also share some of the responsibility. Best-buy lists do not constitute financial advice, but perhaps they should; without any doubt they can materially influence investors, some of whom may not have much experience of investing. Hargreaves were a major distributor of the funds and had negotiated a large reduction in the fees from Woodford. Investors (<£250,000) pay HL 0.45% per annum for administering their assets. Woodford Equity Income remained on the Wealth 50 best-buy list until last week.

The FCA appears to have stepped in quite late. No doubt they will investigate what has been going on but should reflect on how they monitor funds with illiquid stocks, the use of best-buy lists, possible conflicts of interests between fund management firms and platforms, and general suitability when it comes to recommending highly active funds. Finally, the press and the front-runners and short-sellers, circling like vultures, have added to the stampede and the steep fall in prices. No-one has covered themselves in glory.

Lessons to be learned

This sorry state of affairs reinforces some very important lessons for investors, which have come at great cost to those invested in the Woodford fund.

1. Risk and return go hand-in-hand: if you own an actively managed fund that is quite different to the market, it returns will be too, both on the up and the downside.
2. Skill is very rare, and luck plays a major role in most active managers' periods of outperformance. Markets work pretty well, and market-beating performance is likely to come only from taking on higher risks e.g. owning smaller companies. After costs, the empirical evidence suggests that very few active managers deliver skill-based returns sufficient to cover their costs over the sort of horizons that investors require.
3. In the same way that noise and luck play a big role in fund manager outcomes, so it does when trying to pick active funds. Best-buy lists and advisers active fund picks are highly susceptible to this noise.
4. Concentrated stock positions, combined with low levels of liquidity, is a dangerously potent cocktail that represents a material risk to investors' wealth.
5. High levels of diversification in liquid, quoted companies, ensuring that no small set of companies dominates outcomes, is essential. That is why the total number of stocks held in our clients' portfolio is up in the thousands.
6. Gambling on which fund is going to beat the market is an exceptionally low probability strategy. Capturing the market return is a valid and worthy objective.

In conclusion

The ongoing tale of the Woodford Equity Income fund is a salutary reminder that investing is a tricky game, which can have material costs if you get it wrong. It is hard enough owning the equity market, without the added the additional risks of active management outlined in this note. We believe that a systematic, well-diversified, low cost approach to investing that avoids active manager, concentration and liquidity risks, is sensible way to go. It will certainly help avoid the problems and stress that Neil Woodford and his team are facing. Neil Woodford did receive 65% of a £35 million dividend last year paid by Woodford, so don't feel too sorry for him!

Other notes and risk warnings

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