BEACON POINTE ADVISORS

BEACON POINTE RESEARCH
WHITE PAPER

WHY DO FUNDS CLOSE? – DODGE & COX EQUITY
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Introduction

Dodge & Cox, a manager presently on Beacon Pointe's recommended list, recently announced closure of their product to institutional separately managed accounts due to tremendous asset growth in recent times. However, the fund is still open for mutual fund investors.

This brief white paper examines the reasons why funds close and explores in some detail whether these actions are in the interests of or are against the interests of the investors.

Why Do Funds Close?

There are several reasons why funds close ranging from asset size, lack of marketing, mergers & acquisition, and performance related issues.

Just as in individual stocks, attractive investment opportunities tend to draw an inordinate amount of attention from investors resulting in bloated asset size. Huge assets inflows can create difficulties as managers find it difficult to deploy the money into stocks as the number of attractive investment candidates may be limited at the time of the inflows. Thus, popular funds that tend to become as large as several billion dollars pose a challenge for the managers as they attempt to put the money to good use. Money can come in at a rate so fast that the managers may have a hard time deciding what securities to purchase or what current positions to add.

Large assets limit investment flexibility and act against the interest of the existing shareholders.

These problems arise from a portfolio construction perspective as adding positions to a current holding may make the holding much larger as a percentage of the portfolio, violating the maximum position of a single security. Adding securities may also violate the maximum number positions a portfolio may have. As the managers are required by law to invest the new cash quickly, they are forced to close the fund in order to stem the inflow of new cash into the funds in order to avoid these problems. As a result, money managers, in order to prevent impairment of investment flexibility and act in the interest of the existing shareholders, tend to close their funds.

Large assets affect liquidity.

Large asset size poses another problem for money managers. Large asset size means that even a one percent position in a security may be a large percentage of the outstanding shares of a stock, thus affecting liquidity of the stock. For example, for a $25 billion fund like Dodge & Cox Stock Fund, a one percent position would amount to $250 million. At $250 million, Dodge & Cox will have to invest in companies that have market capitalization that are greater than $2.5 billion in order to have less than 10% of the outstanding shares of the stock in which they invest in. Even if they do invest in similar or slightly larger companies, the fund might take several trading days to establish a full position thus driving up the price. Conversely, when fundamentals of these investments turn south, selling becomes an issue because of the large position and can lead to a steep decline in prices thus making an already bad situation worse. Thus, money managers will close their funds to new investors, thus limiting asset growth.

As an alternative to closing, funds may increase minimums to limit cash inflows.

Some funds, rather than closing the funds completely, may increase the minimum investment to slow the inflow of funds. Dodge & Cox, a few months back, did take this step and increased the minimum for a separate account from $50 million to $75 million.

However, due to outstanding performance, even raising the minimum might not be enough to deter investor enthusiasm as it happened to Dodge & Cox. Eventually they took the unprecedented step of closing the product for separate accounts although the mutual fund is still open.

Unmanageable asset growth may affect performance, resulting flight of capital leading to shrinking asset base and possibly closing of funds.

Sometimes, as asset growth limits investment flexibility, performance can be negatively affected. In anticipation of future underperformance due to the rather rapid inflow of cash into the fund, managers choose to close the fund as underperformance can lead to flight of capital.

Poor performance over a period of time can lead to investors pulling their money and investing elsewhere leading to a smaller asset base. The revenues generated from the smaller asset base might not be sufficient to offset the cost of administering and marketing of the fund leading to losses. This can force the managers or the administration of the fund to close it and either get rid of the assets or re-deploy the assets elsewhere in the organization.

Mergers and acquisition may cause closing of funds.

In these days of mergers & acquisitions in the financial services industry, oftentimes a fund might be bought over by a firm that may offer similar investment strategies. In this case, a decision may be made to close one of the funds to reduce the cost incurred in administering and marketing of the fund.

Investors chasing hot sectors can create closure of sectors that are out of favor.

Hot sector funds also tend to draw inflow of cash as investors chase the latest fad causing asset size to bloat faster than the money manager is able to deploy the cash. On the flip side, as the sector cools off, investors chasing the next hot sector withdraw assets. When the asset size dwindles, reduced revenues lead to depressed bottom lines, forcing managers to close the fund. Funds are also closed when the asset size bloats beyond manageable levels.

Dodge & Cox – Closing of Separate Accounts

Funds may close funds to limit number of client relationship to maintain high level of client service.

In late June, Dodge & Cox informed us that they would be closing their separate accounts for all new prospective clients, as they felt uncomfortable with the rapid pace of asset growth forcing them to take this rather unprecedented step. Dodge & Cox has assured us that the current asset size does not pose a problem but would rather limit future inflows and hence the decision to close the fund to new separate accounts. However, the fund is still available in the mutual fund format for investors seeking exposure to the large value asset class. Dodge & Cox also believes in restricting the number of client relationships they would have in order to maintain the highest level of client service.

We commend Dodge & Cox taking this and will continue to closely monitor the fund's performance. Typically, in the mutual fund world, funds tend to underperform in the following three years of closing per a study by Morningstar. However, we have full confidence in the investment professionals at Dodge & Cox and believe that they are capable of managing the current asset size in the fund. We will strive to keep our clients posted of any developments, adverse or otherwise, that would affect our clients' investment objectives.

Conclusion

- Funds close for a variety of reasons ranging from unmanageable asset growth, underperformance, mergers & acquisitions, and sector rotation. Closing of funds is generally in the interest of the existing shareholders.

- Please contact your Beacon Pointe consultant should you have any questions.