In-House Investment Management

Making and Implementing the Decision

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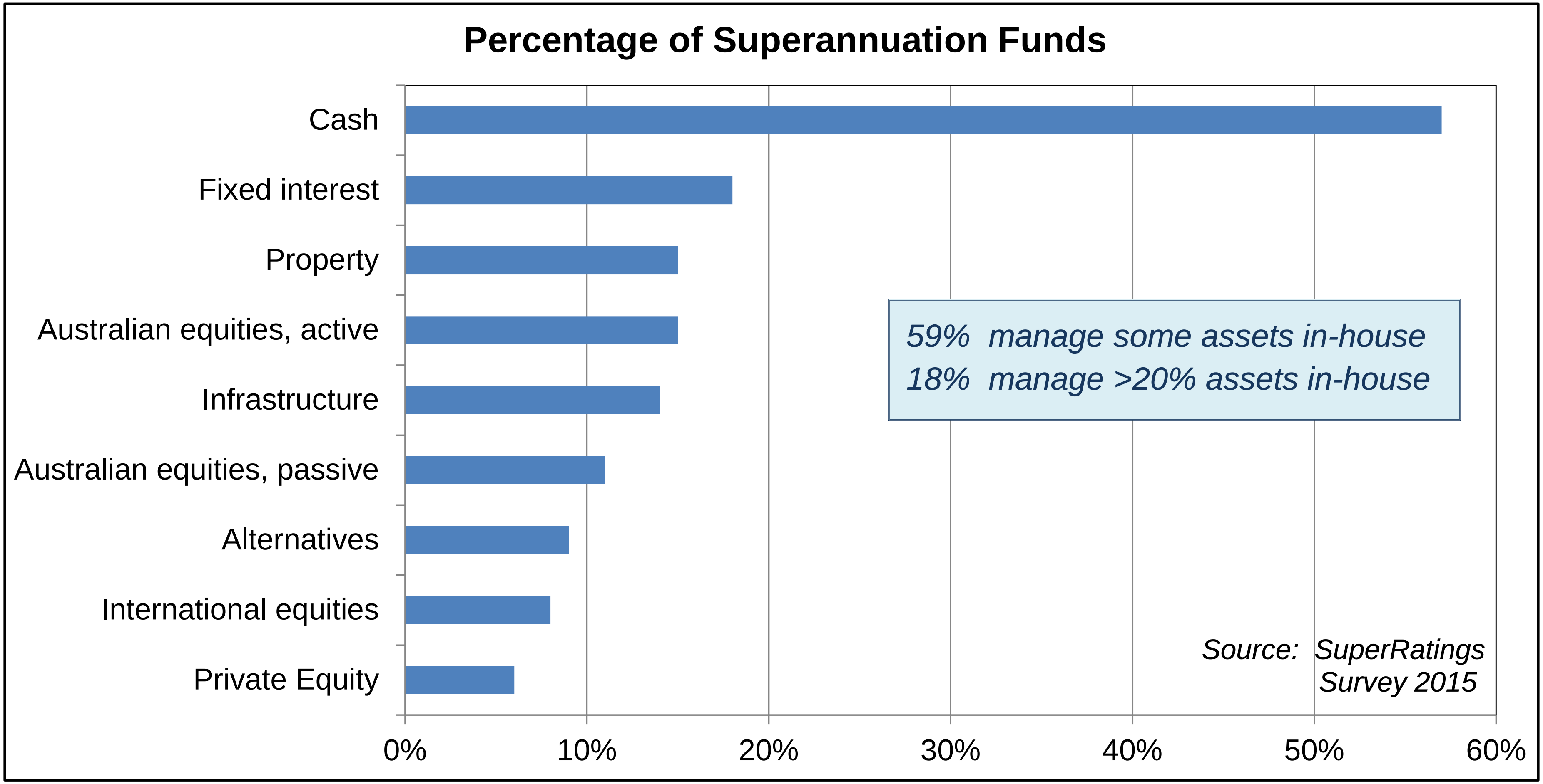
Overview

- **Topic: *in-house asset management by superannuation funds***
  - Of assets directly (not asset allocation, currency, etc)
  - Versus an alternative of out-sourcing to external managers

- **Contributions:**
  - ***Account*** of approaches and views in Australian super industry
  - ***Framework*** for making and implementing the decision
  - ***Comment*** on applicability of existing in-sourcing theories

- **Qualitative approach:**
  - Interviewed 20 executives (13 not-for-profit funds; 7 'advisers')

Assets Managed In-House



What emerged from our interviews

- ***On the surface*** – agreement over the main areas to consider, with at least 75% of interview participants placing importance on:
  a) Return impact
  b) Alignment
  c) Governance
  d) Staff
  e) Culture
  f) Systems and processes

- ***Beneath the surface*** **–** striking diversity in how the decision is conceptualised, and the aspects deemed most important …

Go in-house to enhance returns, or to reduce costs?

"You make better decisions, you make them quickly, you do them without the agency risks, you do them at a flat cost. And then why do you make the decisions better? Well you've got more information; you've got more understanding."

"Cost and performance are equally important. … Actually the risk-return payoff is probably quite skewed in terms of lower cost and [lower] performance."

"Cost is a very positive outcome. If you're doing it for cost, you're doing it for the wrong reasons."

"I did the internal poll on this … and cost was sort of, clearly, the main thing."

Does tailoring require managing in-house?

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“The primary drivers are to develop tailored portfolios. That is the huge advantage of in-house asset management.”

“In-house management was absolutely fundamental to manage that defined benefit portfolio.”

“We are looking for strategies that complement what we can get across the overall portfolio, rather than try and replicate or duplicate what we can buy that is readily available out there in the marketplace.”

“If we wanted to create a certain objective from a portfolio, we could do that through a mandate as opposed to having to manage it ourselves.”

Are systems a major hurdle?

"Risk around internal management is obviously significantly higher … you effectively wear the cost internally if your trade goes the wrong way."

"The systems are the easiest ones for me to tick off, you just say, 'Off the shelf. Bloomberg.' … Processes are fine. They're easy to overcome. … All I do is have to convince myself that I'm going to get people that are suitably qualified."

Drivers of the decision to bring assets in-house

1. **Net returns** expected to increase

2. **Scale**
   a) Management expenses: variable => fixed cost
   b) Capacity constraints with external active management
      – e.g. $2-$3 billion mandate limit for Australian equities

3. **Competitive advantage**, e.g. access, control, engagement, horizon

4. **Alignment** – desire to tailor, or overcome agency issues

5. **Capacity to implement / risk** – important box to check for some

6. **Personalities involved** – experience and belief set

Benefits mentioned during interviews

SCALE-RELATED	%
Address capacity constraints; scalable	**55%**
Lower management expense ratio	45%
Scale-related returns	30%
Scale Benefits Mentioned	***80%***

RETURNS	%
Broad focus:	
Net return benefit *(return net of costs)*	**70%**
Cost reduction in isolation	25%
Return sources:	
Access to opportunities	**65%**
Competitive advantage	30%
ESG / SRI: engagement	25%
Long-term investing	20%
Tax efficiencies	15%
Return Benefits Mentioned	***100%***

Green = individual item mentioned by > 50%

ALIGNMENT	%
Related to Tailoring:	
Tailoring	**90%**
Control	**55%**
Transparency	40%
Tailoring Benefits Mentioned	***100%***
Other Alignment Benefits:	
Mitigating agency problems	35%
Member perceptions	20%
ESG / SRI policy embeded	15%
Long-term objectives	15%
Culture	10%
Alignment Benefits Mentioned	***100%***

MARKET INSIGHTS	%
Access to information and skills	**65%**
Better oversight of external managers	30%
Insight Benefits Mentioned	***75%***

Challenges mentioned during interviews

STAFF	%
Attracting skilled and aligned staff	95%
Remuneration	80%
Retention	60%
Terminating if required	55%
Staff Issues Mentioned	*95%*

GOVERNANCE	%
General recognition	70%
Specific aspects mentioned:	
Performance evaluation	65%
Supportive Board	60%
Managing in-house teams	55%
Delegations	35%
Governance Issues Mentioned	*95%*

BEHAVIOURAL	%
Culture clashes	95%
Behavioural pitfalls of success	25%
Commitment upon underperformance	20%
Behavioural Issues Mentioned	*95%*

SYSTEMS & PROCESSES	*75%*

OTHER	%
Exposure to errors	55%
Set-up costs are substantial	35%
Intellectual property issues	30%
Capture by in-house team	20%
Loss of flexibility	10%
Loss of insights from managers	5%

Staff issues – Attracting and retaining skilled staff

“Ability to attract and retain I think is a real issue. The performance-based bonuses just aren't going to be of the size that you can get in the funds management industry.”

“… where they perform very well … and if they have a good reputation, you risk losing them either to another fund manager or going out as a boutique, or demanding a bigger cut and then being spun off.”

Staff issues – Culture and alignment

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“A junior portfolio manager or a senior analyst might be getting paid more than the CEO. That’s challenging for the ethos.”

“How do you ensure that your internal team doesn’t start to operate like any third party provider, which is to optimise their segment of the portfolio, not necessarily to optimise outcomes at the fund level?”

“The cultural challenges are huge … [the implications of] introducing an exotic species into your organisation shouldn’t be underestimated.”

“You need the investment team to have a level of confidence and a level of, dare I say, arrogance to be good at what they do. But … I can’t have a culture of [the investment] people being different … It’s got to be a consistent business. … you’re constantly kind of playing whack-a-mole.”

One solution: Target culturally-align staff

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"There's a lot to like about working here. … Investing people like to invest. Plenty of dollars to invest. There's no marketing. There's a sense of mission in what you're trying to achieve."

"… they like their autonomy… [in some areas] we are the market leader, so they like that. They like to be the big swinging ..."

"I would have said 90% of people who have been recruited by all profit-to-members super funds believe in that ethos."

Key issue: Is there a large enough pool of suitable employees who are willing to work for a bit less? *(Yes, probably.)*

*(**Other solutions**: pay more; avoid strategies that rely on personal skill)*

Structures

1. **Dedicated internal manager** – asset managed 100% in-house
   - Relatively rare: cuts against desire to avoid ‘capture’, to retain flexibility
   - Cash is a notable exception
2. **Hybrid** – mix of internal and external managers
   - Common in ‘core’ listed assets, e.g. equities, fixed income
   - Fully-integrated (‘completion’) => segmented (‘another manager’)
3. **Co-investment**
   - Piggy-backing on manager through taking a ‘slice on the side’
   - Provides access using modest resources; but control is limited
4. **Partnership**
   - Either (a) with an external manager, or (b) with other funds

What about the risks?

- We became ***less skeptical*** after having done the research
- ***Reasons:***
  - *Benefits became more apparent, e.g. scalability and control*
  - *Key risks seemed more manageable, e.g. by seeking culturally-aligned staff; obtaining external reviews*
  - *In-house management is limited in scope; occurs in often-unrelated pockets across a fund*
- ***Activities cutting across the entire fund are far more dangerous*** e.g. active asset allocation, currency management
- Nevertheless, ***mistakes WILL be made***!!!
- **Aim is to identify and manage the risks, not avoid them**

Decision frameworks

- **Conceptual frames within the literature:**
  - ***Transaction cost theory*** (Coase; Williamson; Grossman/Hart/etc)
  - ***Incomplete contracts*** (Alchian & Demsetz; Holmstrom & Milgrom)
  - ***Value creation*** - capabilities and purpose (Pitelis & Teece)

    … also …

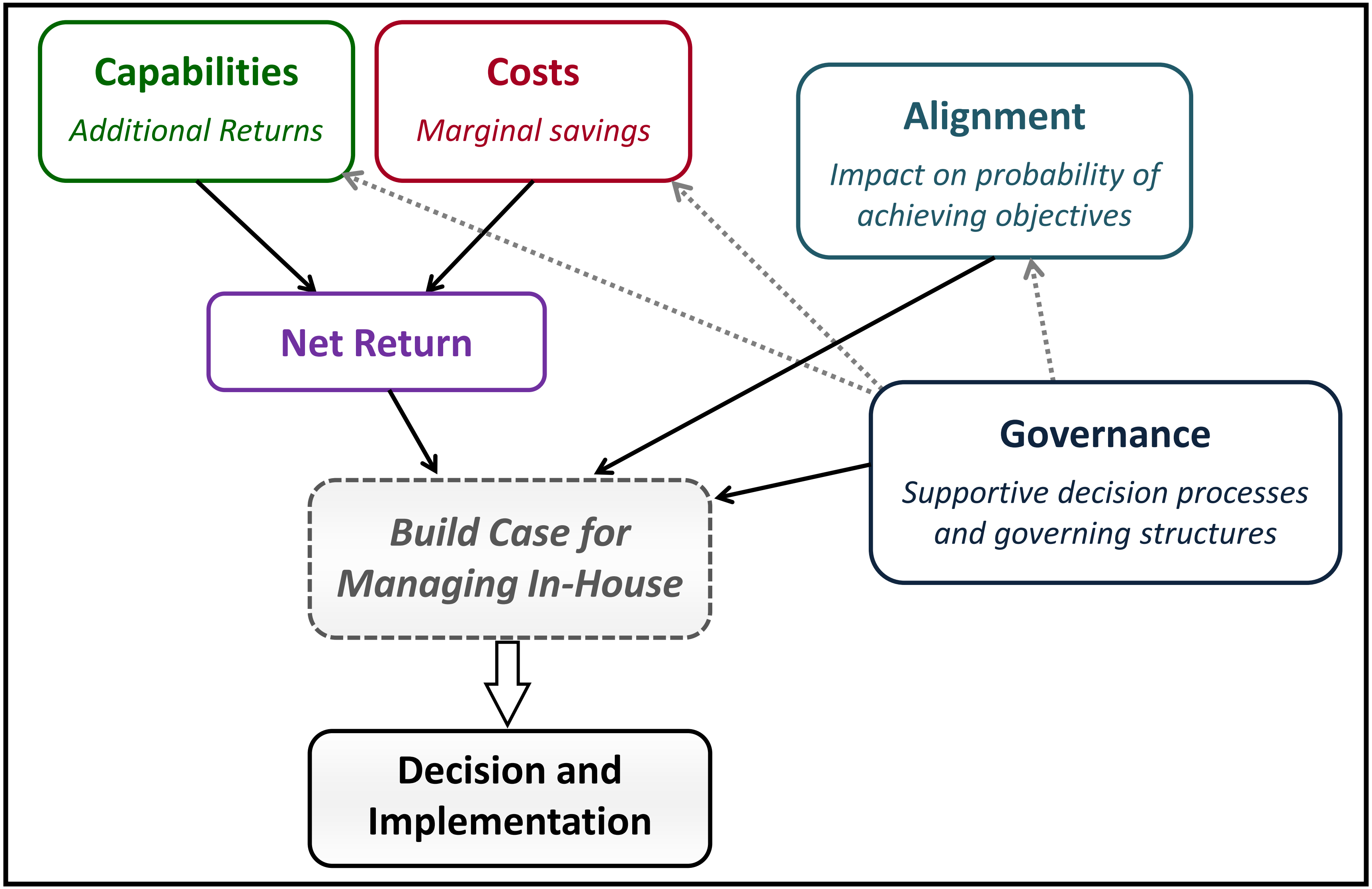
  - Concern with ***governance*** in fund management setting (Clark & Monk)

- Literature did not gel with how the issues were discussed, *so …*

- We propose describing decision frameworks using four elements:

  Costs, ***Capabilities***, ***Alignment*** *and* ***Governance***

Framework – Decision process



Framework – Aspects considered

Governance

- Board – supportive; clear reasons; realistic expectations
- Responsibility and accountability
  - Delegations
  - Definition of success or failure
- Monitoring and performance evaluation
- Risk identification and management
- Compliance protocols

Structures

- Dedicated internal
- Hybrid internal/external model
  - Segmented vs. integrated
  - Intellectual property protocol
- Co-investment
- Partnerships

Net Return

Capabilities

- Competitive advantage?
- Access to skilled staff
- Scalability of active investing
- Ability to capture opportunities
  - Access to assets / markets
  - Flexibility / agility
- ESG / SRI engagement
- Market intelligence
  - Insight from being in market
  - Better manager monitoring
- Systems and resources
  - Implementation / dealing
  - Portfolio management
  - Risk management
  - Tax management

Relative Cost

- Expense ratio
  - Economies of scale
  - Fixed vs. variable cost (manager fee scales)
- Establishment costs
- Diversion of resources
  - Management time
  - Reporting needs
- Ancillary exposures
  - Operational risk
  - Reputational risk

Agency and Alignment

- Board commitment
- Tailoring to objectives
  - Control / transparency
  - Liability-driven investing
  - Liquidity management
  - Long-term investing
  - ESG / SRI principles
  - Tax efficiency
- Investment team
  - Culturally aligned to organisation
  - Motivation and incentives
  - Team objectives and benchmarks
- Organisational culture
  - Shared beliefs and purpose
  - Tension: investment/other staff
- Other behavioural issues
  - Dealing with underperformance
  - Handling success: overconfidence, overextending, complacency

Final thoughts

- We are broadly supportive of managing assets in-house

  … *but* …

- Conditions need to be right; and must be implemented properly

- Establishes a platform for the future

  … *noting* …

- Greater use of in-house management seems inevitable

Questions?

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