Executive Summary

In-house Investment Management

An Internal CIFR Research Project

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In-house investment management is a hot topic in the Australian superannuation industry. Organic growth and industry consolidation is leading to an increasing number of funds attaining a size at which managing their investments in-house becomes a serious proposition. SuperRatings data reveals that about 60% of superannuation funds manage some assets in-house, with nearly one-fifth reporting a substantial commitment of 20% or more of assets.

Why Does In-house Management Matter?

The increasing tendency to manage assets in-house aligns with the policy agenda of improving the efficiency of the superannuation industry. Managing in-house, rather than contracting out to external investment managers, can reduce investment expenses for larger funds. Nevertheless, the efficiency gains go beyond just cost reduction. In-house management can offer opportunities to access additional returns, tailor the portfolio towards member needs, and address the capacity constraints that can be encountered as funds under management grow. In particular, it helps funds address the problem that active managers are able to handle mandates only up to a certain size. Thus, in-house management facilitates efficiency improvement through allowing superannuation funds to invest in ways that not only enhance member outcomes, but are also more scalable and hence better able to accommodate asset growth and perhaps consolidation.

A Natural Progression

The shift to in-house management can be seen as a natural extension of historical trends. Traditionally, most superannuation funds have been out-sourcers: initially of the entire investment process to a balanced manager (the 1980s model); then later by appointing specialist external investment managers, often under advice from asset consultants (the 1990s model). Over time, the industry has transitioned away from out-sourcing towards bringing more functions in-house. This has included construction of multi-manager asset portfolios, oversight of cash and currency management, and active asset allocation. These functions have required the creation of internal investment management teams. Once established, these teams provide a foundation for the next step: selective in-house management of assets. Indeed, much of the activity around in-house management can be traced to funds putting in place internal teams that possess the skills and confidence to directly manage the assets.

Examining The How and The Why

This CIFR study examines the decision to bring in-house the management of investments by asset owners like superannuation funds, in contrast to the traditional model of outsourcing to external investment managers. The research undertakes a review of the literature, and field interviews with 20 senior industry executives from superannuation funds, asset consultants, and research houses.

The study finds that the motivations in deciding to adopt in-house management many and varied. The decision is usually deeply thought through on a range of levels, such as: return impact; capacity considerations; governance structures; alignment and culture; ability to attract, retain and incentivise experienced investment professionals; risk management; and other considerations. While agreement exists in relation to the main focus areas, there is considerable diversity of opinion regarding how much each area matters, and in what way. Everyone met seemed to have a different approach to deciding whether assets should be managed in-house, both in terms of how they conceptualise the problem, and the management issues deemed most important. For instance, some believe that in-house management can provide access to higher returns; while others expect gross returns to fall, but

net returns to increase because costs fall even further. Some consider the ability to tailor investments to be of prime importance; while others argue that tailoring can be effectively achieved using external managers. Some perceive staff management and culture as major challenges; while others think that the problems can be readily solved simply by targeting culturally-aligned staff. Some view systems as critical and a significant source of risk; while others trivialise the difficulty of establishing reliable systems. In short, there little industry-wide consensus when you look beneath the surface.

The interviews reveal some common elements in how in-house management is being addressed. All participants approach the decision on an asset-class-by-asset-class basis; and typically in a measured, forward-looking and incremental fashion. They recognise that in-house management may not work for all assets or strategies; and that taking time helps facilitate learning and effective implementation. Cash is often the first candidate for managing in-house, given that investing in cash is relatively straightforward, can be implemented with modest resources, and has complementarities with fund liquidity management. Beyond that, there is only limited consistency across superannuation funds on what assets they prefer to manage in-house.

Structuring Options

Four broad approaches for structuring in-house management were encountered during the interviews:

(i) *Dedicated internal structure*, where an asset class is managed entirely in-house;

(ii) *Hybrid external/internal models*, under which the in-house team is responsible for a slice of the assets in conjunction with external managers;

(iii) *Co-investments*, where the fund piggy-backs on the ability of an external manager to identify and source assets through taking a 'slice on the side'; and,

(iv) *Partnerships*, either between funds or with an external manager, involving the fund providing capital while some management functions are performed externally.

The hybrid model appears popular in Australia, especially in core listed assets like equities and fixed income. Within the hybrid model, there is a further choice regarding the degree to which the in-house capability is *segmented* and treated as just another manager within the portfolio; versus being *integrated* and used to 'complete' the portfolio in some way. The hybrid model also raises the issue of respecting the intellectual property rights of external managers: again, there is a variety of views.

CIFR's Input: A Decision Framework, and Some Views

The study presents a framework that asset owners like superannuation funds might to use for making and implementing decisions to manage in-house. The framework is an organising structure that accommodates a broad range of views and preferences about what aspects to consider. It proposes addressing four elements: *capabilities*, *costs*, *alignment* and *governance*; including weighing up the potential impact on *net returns* along the way. Checklists are provided of potential aspects for consideration under each element.

Based on the research, CIFR is generally supportive of in-house management, with the caveat that the conditions must be right for the fund, and that it needs to be implemented appropriately. Done properly, in-house management can generate improved net returns with increased control, thus allowing assets to be managed in a way that is better directed to member needs and delivered with greater confidence. A further advantage is that an in-house capability establishes a platform for the future, if designed as scalable and flexible. Whereas the best structure will depend on a fund's objectives and situation, integrated hybrid models have merit. This structure allows the portfolio to be managed in a manner that can enhance returns while supporting tailoring and flexibility, yet retains many of the self-disciplinary benefits of having external managers within the structure.

The research acknowledges that some mistakes will inevitably be made by funds who manage in-house. However, fear of error should not prevent in-house management from being embraced where benefits are evident. In-house management is rarely of sufficient size to 'sink a fund' in its own right, as it typically occurs as discrete strategies across a range of asset classes, and often as one component within a hybrid structure. Rather, it is investment functions that cut across the entire portfolio – such as asset allocation and currency management – that carry more inherent risk. The key task for funds is to identify and mitigate the risks associated with managing assets in-house. For instance, many of the challenges around staffing and alignment might be addressed by targeting prospective employees who are culturally aligned. Risks in relation to governance, systems and team capability might be partly managed by commissioning regular independent reviews: some funds appoint asset consultants for this purpose. Overall, the risks associated with in-house management should be seen as something to manage, rather than avoid.

Looking Forward

The trend towards greater in-house investment management by superannuation funds has much further to run. Continued industry and fund growth, competitive tensions and innovation are all likely to result in an increase in the take-up and breadth of in-house management across the sector. The pioneering (and successful) efforts of certain asset owners thus far will provide encouragement. While members should benefit on balance, some bumps and set-backs are to be expected along the way. One interesting issue (and possible research question) is the impact on external managers – their pricing, product offerings and engagement – given that they are facing the rise of a powerful new player on their turf: asset owners.

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