



# Direct investing debate

**Considerations for  
institutional investors**

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# Introduction

Over the past 20-plus years, institutional investors, like other diversified investors, have had to survive the whipsaw of market swings, including the bursting of the “dot com” bubble in 2000 and the crash associated with the “The Great Recession” of 2008.

Unlike other institutional investors, however, many pension funds have fixed (or growing) liabilities on their balance sheets that must be managed, notwithstanding periods of low returns. As a result, pension funds are seeking higher returns to make good on their obligation to satisfy specific retirement funding levels for workers. This challenge has driven many pension funds to shift investments away from low-risk, fixed-income government and corporate bonds in favor of equities and alternative investments (alternatives).

This shift in investment allocation has resulted in greater volatility: funds posted annual gains of about 12 percent in 2013 and 17 percent in 2014, but only 2 percent in 2012, 4 percent in 2015, and 1 percent in 2016.<sup>1</sup>

For many, this change in asset allocation has also resulted in higher (and sometimes opaque) investment-related fees.<sup>2</sup> It is often difficult to obtain precise data in relation to investment fees. A report by the Pew Charitable Trust Foundation indicates that, as a group, funds paid \$4 billion in “unreported investment fees in 2014”—payments made mostly to private equity (PE) managers—and another \$10 billion in reported investment expenses. The fees, the report states, have increased 30 percent compared with the preceding 10 years.

For some investors, the reaction has been to rebalance (or remain) with a large or exclusive allocation to passive and/or less complex investments.

This approach has a number of benefits, not least of which is simplicity. What the approach generally lacks, however, is the ability to benefit from the special characteristics that institutional investors enjoy: scale, low cost of capital, and a long-term investment horizon. In certain arrangements, these attributes can provide outsized returns that smaller pools of short-term capital simply cannot achieve.

Other institutional investors have pursued a second investment model: insourcing of certain investment capabilities to directly and actively manage aspects of their own portfolios. Typically, the first asset class to move in-house is public capital markets. Movement of alternative investment activities is usually later since it requires more expertise and is generally more challenging to manage.


The benefits of an insourced model, as reported by certain funds, can include lower fees, increased net investment returns, increased control, and improved transparency. Many of the pension systems from Canada and Australia, as well as sovereign funds from other parts of the world, have successfully implemented insourcing programs in relation to public securities as well as alternatives. Institutional investors from other jurisdictions often seek to mirror programs in those jurisdictions.

What is sometimes missed, however, is that while successful insourcing programs can achieve benefits, external managers do provide investors with services and

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<sup>1</sup> “State Public Pension Funds Increase Use of Complex Investments,” The Pew Charitable Trusts. April 2017. The report tracked 70 large institutional funds in all 50 states.

<sup>2</sup> Ibid.



**Pension funds are seeking higher returns to make good on their obligation to satisfy specific retirement funding levels for workers.**





they often have significant expertise and infrastructure to support their activities. The question for institutional investors is whether the quality and value of the services and relationships delivered by external managers can be replicated internally for an improved result. Part of the analysis requires organizations to consider what they deem to be an appropriate profit split between the institutional investor (asset owners) and the manager. Splits can be in the range of 75 percent to owner and 25 percent to manager. If investors want to retain more profit, they may need to use managers less and insource more. There is no easy analysis to make this determination. And the choice is not binary: regardless of ambitions, all large funds will continue to require assistance from external asset managers to some degree.

Institutions must therefore determine the extent to which the services and functions provided by external managers should be insourced. There is no one right answer as funds approach this issue having different characteristics and capabilities. There is a wide spectrum of appropriate strategies that depend on the specific characteristics of each investor. For instance, an investment model with

some popularity in the United States is the outsourced chief investment officer (OCIO) model. In this model, a third-party organization fulfills the CIO role, supported by their own external investment analysts and operational staff. The OCIO model is a step towards greater outsourcing (beyond the traditional external pension consultant model) intended to be a cost-effective means of relieving funds of the need to invest in staff, technology, and infrastructure as the fund relies on the OCIO for these functions.<sup>3</sup>

This paper is intended to offer insights into certain considerations for institutional investors as they develop their strategy toward the possible expansion of in-house investment-related activities. Importantly, we aim to provoke debate and offer ideas for navigating the current cluttered landscape. We ask for readers' opinions, even if they may differ from our points of view that follow, on the developments that are changing the business and operating models of investors and asset managers alike. Both face pressing issues in a rapidly changing environment.

We look forward to engaging with you, and we invite your comments.

# The state of play

A large public pension fund reported<sup>3</sup> at its April 2015 board meeting that its top pension official could not provide a full accounting of all of its PE costs. Later that year, after an in-depth review of the matter, the fund reported it had paid \$3.4 billion in performance fees to PE managers since 1990. Since that time, other public pension funds have conducted similar examinations and reported their performance fees were as much as 100 percent more than originally reported in previous public disclosures.<sup>5</sup> This situation has caused many institutional investors to review their relationship with PE firms.

One finding stands out: Even though alternatives (PE funds, real estate funds, hedge funds, credit funds, and infrastructure funds) had higher returns than the other fund's assets over a two-decade period, the fees associated with PE investments generally are much more than other investments. The PE returns were 12.3 percent in the period (ending in June of 2015). But without fees and costs, the return would have been 600 basis points higher.<sup>6</sup>

Focusing on fees may be viewed as a distraction by some: Why be concerned with fees if the after-fee return is adequate? The counterpoint, often raised by pensioners and other stakeholders, is that the higher returns are attributable to the higher risk borne by capital when it is deployed into alternatives and that it is unfair to divert those higher returns to

managers who do not bear that risk; this particular counterpoint has been a topic of great discussion specific to hedge funds. Further, due to some high-profile inquiries, pensioners often have little confidence that the fees identified are accurate and comprehensive; there is a sense that actual fees may be even higher than those reported.

In any event, the revelation was not well received by the many thousands of teachers, firefighters, police officers, and other public employees who depend on the fund for a comfortable retirement. And, unsurprisingly, elected officials around the country started asking questions about transparency in reporting and how performance fees by asset managers were calculated and disclosed.

This same dynamic has provided the impetus for many institutional investors to consider moving some of their money away from external asset managers and instead attempt to manage some of their money through in-house efforts. For some investors, the move to in-house asset management has been successful. But for others . . . not so much. Some funds closed their in-house operations after suffering losses and coming to the realization that the organization was not positioned to successfully execute on an internal asset management program.



## Public pension fast facts:

- Total assets under management (AUM) for public pensions in the United States is \$3.6 trillion, about half of which is invested in equities, a quarter in bonds and cash, and a quarter in alternative investments such as PE, hedge funds, real estate, and commodities.
- Investment returns are anticipated to provide 60 percent of benefits to retirees, making investment returns vital for funds—and retirees.
- The assumed annual rate of investment return for these funds is 7.7 percent. The actual rate of return over a 10-year period is 6.6 percent.
- That shortfall often leads to one of two approaches: Either reducing the assumed rate of return below 7.7 percent, though that approach is unpopular because it requires increased government contributions, or finding potentially better returning investments (i.e., increase exposure to equities and alternative investments).
- Increasingly, over the past decade or more, funds have been moving toward the second option. Alternative investment assets in pension funds have more than doubled as a percentage of AUM from 11 percent to 25 percent in that period.

<sup>3</sup>“In this regard, an interesting debate can be had regarding the limits, if any, on the ability of pensions to outsource ever greater enterprise responsibilities to third parties.

<sup>4</sup>“Calpers is Sick of Paying Too Much for Private Equity,” *Wall Street Journal*, April 16, 2017

<sup>5</sup>Ibid.

<sup>6</sup>Ibid.

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Sources: KPMG Research Group; “State Public Pension Funds Increase Use of Complex Investments,” The Pew Charitable Trusts, April 2017





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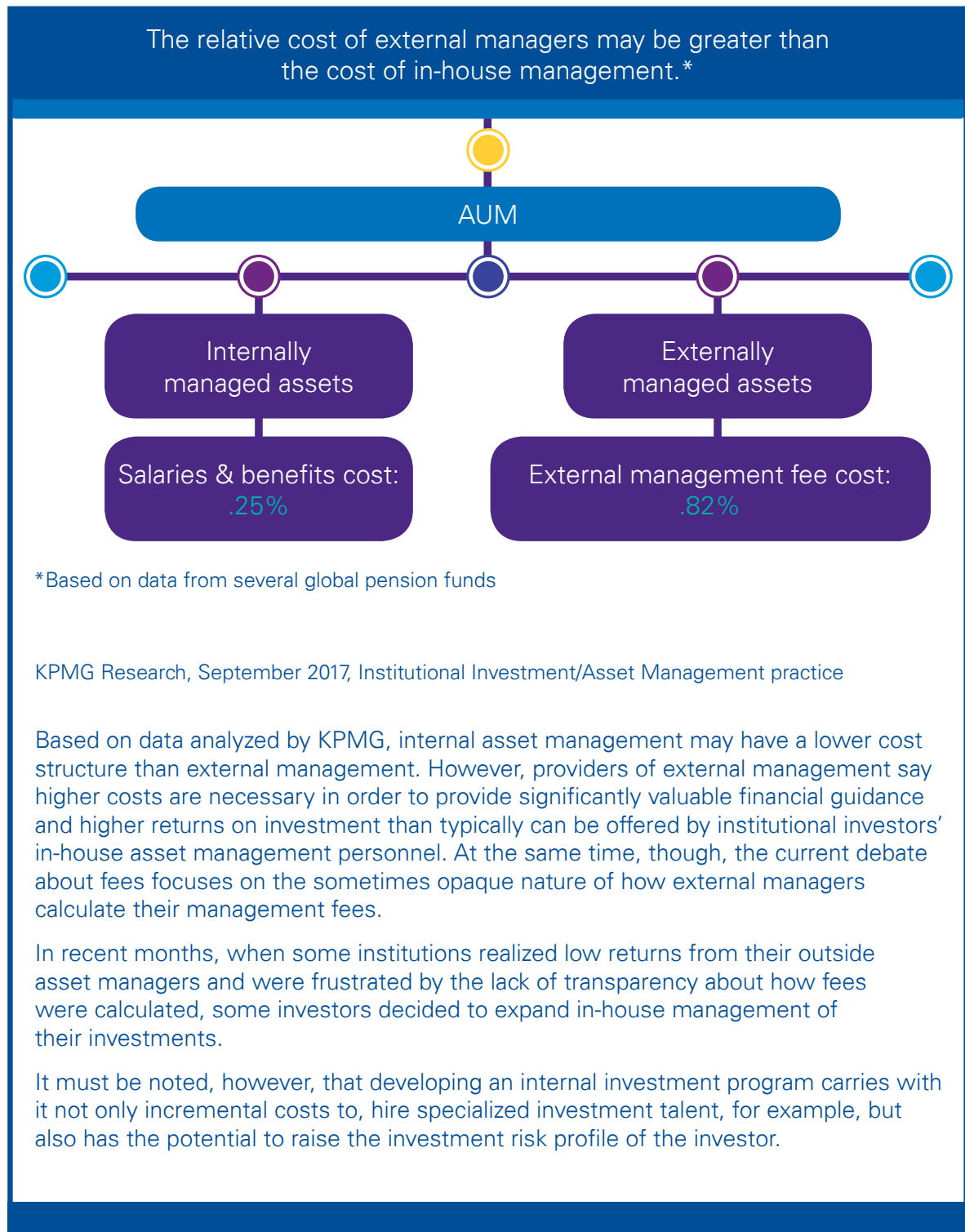
**“When funds are considering whether to take the work in-house, we suggest they consider a number of critical cross-functional aspects that they may have overlooked. These aspects often include their governance structures, which will come under scrutiny from a cross-section of stakeholders.**

**There are also operational issues to consider, such as the design of support functions, which include tax and finance. And we hold the view that they need to take a very close look at investment-related issues, such as segment connectivity, structuring, valuation, and compliance.”**

**—David M. Neuenhaus, Principal, Tax, GLocal Lead,  
Institutional Investor Group**



# External vs. internal management costs





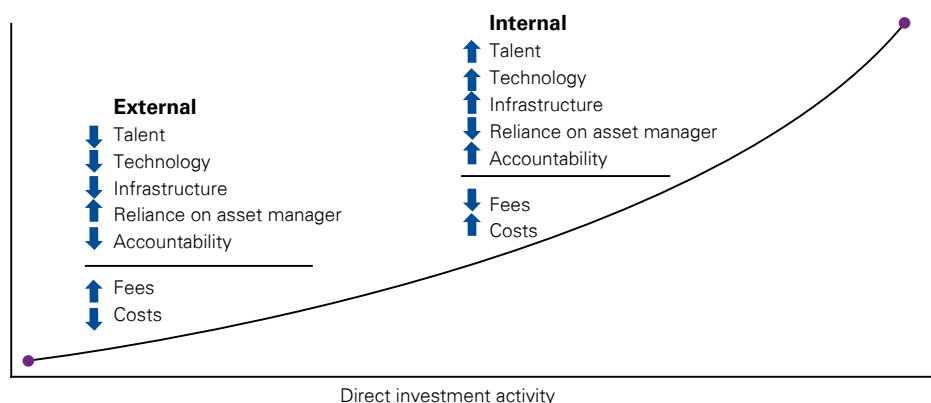
# KPMG's view

## From revolution to evolution

For some, the decision of whether to in-house certain alternative asset management functions is viewed as revolutionary. In reality, the situation might be best described (and best approached) as evolutionary.

In our experience, a sober up-front evaluation of current capabilities and a realistic understanding of intertwined key issues dramatically increases the likelihood of building a long-term, successful in-house program.

The evolution of internal asset management capabilities can be viewed as follows:



Considerations include:

### Does the organization have enterprise-wide support for taking this significant step?

Strong leadership support is needed to build a common view around the goals and risks of a direct investing program. Clarity is necessary on how major decisions—routine and those made under stress—will be made and implemented. Developing an internal investment model will have an impact across the organization for operations, risk, finance, tax, HR, compliance,

and legal. This will entail a significant cultural change for the fund. There are also broad practical and political considerations that an organization must anticipate. Investment decisions are the responsibility of the institution. Accountability for losses, risk failures, and governance missteps will lie with the institution, not the asset managers. This, of course, is a fundamental cultural consideration for an organization that can only be addressed by the senior leadership of an organization.



### **Does the fund have the ability to recruit and retain the requisite talent?**

In all successful examples of insourcing we have witnessed, significant investment has been required from a human resources perspective. A central challenge to any fund pondering an in-house move is whether it can identify and retain the needed investment and asset management talent, including all supporting functions. The organization must be willing to pay the wages that highly rated talent demands. For some funds, the remuneration hurdle will be difficult to clear. Nevertheless, market realities for the cost of talent cannot be ignored, especially if the talent comes from established investment funds or banks. Funds that successfully insource often develop unique strategies to successfully compete for such talent.

### **Is the fund positioned to solve for the increased technology demands?**

In-house investment and asset management capability requires substantial technology resources: hardware, software, and engineers. We expect no letup in the fierce competition across the asset management industry to attract data scientists and technology solutions. The most successful asset managers are quickly building technology solutions to harness internal and external information and to automate many functions. To compete in the manager space, institutions must be prepared to address this need. Here again, from a talent perspective, investors may need to be creative in “selling” the allure of their business to savvy data scientists who are sought after by high-profile organizations with attractive reputations.

Some funds fill the need by partnering with one or more fintech business and outside developers. Though unthinkable just a few years ago, the world’s largest and most sophisticated banks are allowing other organizations access to their own software code to increase agility. This is especially important at a time when innovation, creativity, and speed is greatly rewarded in the marketplace.

### **Can the fund’s infrastructure handle the heavy loads related to accounting, tax, business process, and other key demands?**

Insourcing brings with it a heavy demand across a wide spectrum of functions. The regulatory, tax, and legal

obligations imposed on managers are in a constant state of flux. Depending on the insource model, many of these obligations may become the responsibility of the fund. Assessing current capabilities in these functions and building a capable team to support is critical to a successful outcome.

### **Can the fund negotiate new arrangements with external asset managers on terms that address the fund’s main concerns?**

The trend toward increased insourcing has not gone unnoticed by the asset management industry, and traditional asset management companies are doing a better job of addressing certain investor concerns. Many have undertaken an in-depth examination of their fee structures and have also provided greater clarity and frequency of disclosures. Thus, external asset managers are similarly evolving to provide improved levels of service with greater efficiency and may prove more accommodating than in the past. The OCIO model mentioned above may be viewed, in part, as an industry response. We are also witnessing a trend of institutional investors seeking to deal on a more exclusive basis with fewer fund managers that offer improved strategic, and bespoke partnering opportunities. These opportunities should be understood by funds as they prioritize steps toward insourcing functions.

### **Is the fund interested in participating in consortium deals?**

Increasingly, like-minded investors are teaming up on investments, sometimes referred to as consortium deals. Such an approach generally spreads risks, can offer cost savings to the investors, and can provide structural and regulatory benefits. Further, consortium deals also provide investors with an opportunity to leverage their coinvestors’ relationships, expertise, and experiences. Strategic partnerships and institutional reputations are becoming differentiators; investors that are known for sophisticated capabilities are frequently the most highly sought after and successful coinvestors. Thus, the development of strong in-house capabilities can increase an organization’s access to large and sophisticated investment opportunities.



# Case study 1

## **Fund profile**

A large institutional investor with investments across all major asset classes. Historically, the client relied heavily on outsourced asset management companies.

## **Business challenge**

An enterprise-wide initiative was launched to consider a shift towards increased direct investment activities. As an initial step, client undertook the review and assessment of its businesswide processes and controls relating to its public and private market investments, liquidity and cash flow forecasting, valuation methodologies, risk management structures, performance measurement programs, as well as its custodial, finance, and operations functions.

## **How KPMG helped**

Our team recommended that senior management proactively get involved in all major initiatives relating to its investment and finance operations in

order to gain a deeper understanding of the client's readiness with respect to the overall business capabilities, IT systems, and governance processes.

We also teamed with the client's major third-party service providers to conduct a deep review of the client's risks and controls, and we provided support to the investment board in developing the implementation of an enterprise risk management framework. Further, there was a thorough assessment of its voluntary internal control over financial reporting certification.

In addition to ongoing support of the front-office investments team capabilities relating to due diligence, valuations, and corporate finance, KPMG also assisted with financial and management reporting reviews, IT vendor selection, procurement and supply chain guidance, process excellence, and continuous improvement.

# Case study 2

## **Fund profile**

Midsized pension fund adopting the strategy of a rapid shift into increased exposure to alternatives

## **Business challenge**

Dramatic increase in allocations to alternatives. The reallocation was completed in a rapid process, without thorough vetting of the challenges

and demands incumbent in such a strategy. Returns were below expectations, and diversification into alternative investments proved challenging for an inexperienced and inadequately staffed team/fund. The long-term, illiquid nature of the investments compounded the problem.

# Conclusion

As the debate about whether to bring additional asset management functions in house continues, our experience is that each organization must first undertake significant fact-finding efforts. Primary among these factors is senior leadership support across the organization to anticipate and address the functional and cultural impacts on an organization. Commercially, new opportunities and relationships will develop. Operationally, cost savings may be obtained and benefits, in terms of increased transparency and enhanced investment returns, may be realized. However, many hurdles will also be encountered and a significant amount of investment and coordination must be anticipated. Organizations should understand these challenges prior to undertaking a significant change in investment model. Only then can the organization make a fully informed decision.

We invite you to join the discussion with us as the asset management and alternative and institutional investment environments continue to evolve.

# Contacts

## **David M. Neuenhaus**

Principal, Tax, Global Lead, Institutional Investor Group

**T** 973-912-6348

**E** [dneuenhaus@kpmg.com](mailto:dneuenhaus@kpmg.com)

## **Cara Scarpino**

Director, Marketing Strategies  
and Programs – Alternative Investments

**T** +201-505-3405

**E** [cscarpino@kpmg.com](mailto:cscarpino@kpmg.com)

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