

The direct investing debate: Considerations for institutional investors

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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.

Uniquely, 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, paired with low interest rates, has driven many pension funds to shift investments away from lower-risk, fixed-income government and corporate bonds in favor of equities and alternative investments.

External vs. internal management costs

This shift in investment allocation has resulted in greater volatility and higher (and sometimes opaque) investment-related fees. While it is difficult to obtain precise data in relation to fees, a report by the Pew Charitable Trust Foundation indicates that, as a group, funds paid US\$4 billion in “unreported investment fees in 2014” — payments made mostly to private equity (PE) managers — and another US\$10 billion in reported investment expenses. The report states that fees have increased 30 percent compared with the preceding 10 years.

For some investors, the reaction has been to rebalance (or remain) with a large allocation to passive or less complex investments. This approach has a number of benefits, not least of which is simplicity. However, the approach can limit 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 cannot achieve.

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Other institutional investors have therefore pursued a second investment model: insourcing of certain investment capabilities to directly and actively manage aspects of their own portfolios. 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 pension systems from, e.g., Canada and Australia, and sovereign funds from other parts of the world, have successfully implemented insourcing programs. Institutional investors from other jurisdictions seek to mirror those programs.

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

The evolution of internal asset management capabilities

Institutions must therefore determine the extent to which the services and functions provided by external managers may 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 goals and characteristics of each institution. Commercially, new opportunities and relationships will develop and improved returns/cost savings may be realized; however, hurdles will also be encountered. For instance, governance and decision making will come under direct scrutiny from a cross-section of stakeholders with important cultural and political implications. There are also operational issues to consider, such as the re-engineering of certain support functions including risk, tax and finance. From a resource perspective, additional (and potentially expensive) personnel and technology will also likely be needed too. Organizations must understand the broad needs and challenges involved with significant in-house investment programs. Only then can senior leadership make a fully informed decision and position the organization for success.

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Designed by Evalueserve. Publication name: The direct investing debate: Considerations for institutional investors. Publication number: 135157b-G.

Publication date: February 2018