

Part 1
BRINGING HOME THE INVESTMENT:
Building the Case for Internal
Investment Management

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by

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Introduction

This article is the first in a two-part series on assessing the feasibility of increasing internal investment management in public retirement systems. This first part deals with the key factors in assessing a system's readiness and the second part addresses identifying and understanding what it will take for a successful implementation.

A growing number of retirement systems are looking at ways to increase internal investment management to reduce the high fees paid to external managers and improve net returns for their fund. This is due to rising concerns about the value of external investment management fees as recently illustrated by Scott Stringer, the New York City Comptroller, who "released analysis of historical performance data for the \$160 billion system showing that after fees, manager performance was \$2.5 billion below benchmark over 10 years.

The analysis was completed by CIO Scott Evans and the New York City Bureau of Asset Management. "Right now, heads or tails, Wall Street wins," Stringer said. "In conjunction with our trustees, we are going to re-examine our entire fee structure so that our interests are better aligned and managers who do not create value will not continue to invest our funds."¹

The California Public Employees Retirement System (CalPERS) recently announced that it intends to cut the number of external investment managers by more than half "to gain the best deal on costs and fees that we can," according to Ted Eliopolis, CalPERS' CIO.² The move is expected to save hundreds of millions of dollars over the next five years.

As high investment management fees are increasingly under scrutiny, more systems are likely considering evaluating the feasibility of increasing internal investment management. The primary objective of such a feasibility study is to advise the Board of Trustees and their executives on whether it makes sense, both organizationally and economically, to invest in the necessary personnel and operational systems to effectively implement an internal investment management program.

Increasing internal investment management has already proven feasible as a growing number of retirement systems have successfully increased internal management and have reported significant savings. For example, the State of Wisconsin Investment Board (SWIB) recently stated on its web site: "Internal management of the trust funds by SWIB staff keeps costs low. Spending money on internal staff saves about \$50 million a year that otherwise would be paid to investment managers and is more than SWIB's operating budget." Keith Bozarth, SWIB's former executive director, believes these savings can arise from a variety of factors including "ownership profits/share staying with the fund; there are no marketing expenses; facility costs

¹ ai-CIO: April 10, 2015. NYC Comptroller Vows to Shake Up Wall St 'Status Quo'

² ai-CIO: June 8, 2015. "CalPERS Plans to Cut Managers by 50%"

are lower due to less of a tendency to have a "showplace" office and often being located in lower cost markets; compensation is still going to be less than the most expensive competition (various trade-offs can make public funds attractive to employees, even at a slightly lower compensation.); and finally, tax exempt status." He cautions, however, that investment infrastructure (systems and people) must keep pace with the investment strategy.

In a report to the Board Investment Committee of the Teacher Retirement System (TRS) of Texas in March 2015, the Investment Management Division staff reported that internal active management produced an annual cost savings of approximately \$100 million in a \$23 billion internally-managed portfolio.

Canadian funds such as the Alberta Investment Management Corporation (AIMCo), the Ontario Teachers Pension Plan (OTPP), the Ontario Municipal Employees Retirement System (OMERS) and Caisse de Dépôt et Placement du Québec have all demonstrated significant internal investment success given their autonomy and independence from the political system.³

What are the key feasibility factors?

In our experience, increasing in-house investment management becomes feasible once a system has: 1) a certain level of scale as measured by Assets Under Management (AUM); 2) a sufficient degree of budgetary control, i.e., the ability of the fund's fiduciary body to approve hiring additional staff and spending on infrastructure investments; 3) the willingness and ability to set staff compensation to market-competitive levels; and, 4) fiduciaries and staff with confidence in being able to improve net returns within an asset class through internal management.

Scale: Historically, most U.S. funds would not begin to seriously consider establishing internal management until they reached the \$20-25 billion AUM level. This is confirmed by a recent analysis by Toronto-based CEM Benchmarking Inc. which analyzed data from 186 global funds in the CEM database. Of funds in the £1 billion (US\$1.5 billion) range of total AUM, 65% have no internal management. In the £10 billion (US\$15 billion) AUM range, funds with no internal management is only 46%; this does not change dramatically for funds in the £20 billion (US\$30 billion) range, where 44% have no internal management.

If staffing costs are the only consideration, the threshold for economic justification can actually be much lower. According to CEM, "An average cost for active external management across all public equity asset classes is around 50 bps" explains John Simmonds, principal at CEM. At £1 billion (US\$1.5 billion) invested in public equity that equates to fees of £5 million (US\$7.5 million). Simmonds explains that the actual 'crossover' point, when it makes economic sense to

³ <http://www.wsj.com/articles/canadian-pension-fund-omers-generates-10-return-1425051929>

build an internal team is therefore around £0.5 billion (US\$750 million) for public equities. For fixed income the minimum size is closer to £1 billion (US\$1.5 billion). “Of course, the fact that it makes economic sense at that point doesn’t mean that every fund of that size should do so. There are a host of factors that need to be considered alongside cost,” Simmonds says. “At least we now know the starting point for having the conversation.”⁴

Let’s discuss some of those other factors.

Budgetary Control: Establishing an internal investment capability requires the ability to implement a long-term internal investment program within the fund. Experienced staff must be hired to manage investments and assess and monitor risk and compliance, and significant investments must be made in middle- and back-office capabilities such as trading systems, risk management and compliance systems, and other infrastructure upgrades.

According to the aforementioned CEM study, a fund should expect to hire two governance operations and support staff for each “front office” investment staffer to support internal management.⁵ At many funds where the legislature must approve headcount increases and/or investment budgets (i.e., more than half of U.S. state funds), the lack of ability to consistently invest throughout the economic cycle (e.g., avoiding across-the-board spending cuts during a recessionary period) typically results in a more limited approach to internal management, a greater reliance on outsourced service providers, and, often, underdeveloped risk and compliance capabilities.

Compensation: In addition to having the authority to recruit experienced, competent investment professionals, the fund must be willing and able to provide an overall compensation package competitive with the private sector. Packages offered by the more competitive public funds do not usually strive to match top tier Wall Street firms for most positions. They often aim to be near the median of a broader group of financial firms whom they benchmark on a regular basis. In some cases, higher compensation levels are to be reached over a phase-in period of several years.

Often, bonus pay for performance is a significant element of the overall package. Leading practices include awards that are based on net returns, emphasizing longer-term returns over near term, and in some cases deferring or not making awards if the total fund has a negative return. A fundamental decision is whether bonus compensation is limited only to investment

⁴ “What is the minimum AUM for internal management?” Amanda White, www.top1000funds.com May 20, 2015

⁵ “Fund growth and organisational change - Understanding what happens to pension funds as they grow,” John Simmonds, CEM Benchmarking Inc.

staff. Some funds include support staff to foster a “one team” approach that is likely to be even more important if the fund manages assets internally.

Although most states which require fund employees to be part of the state civil service employment system provide compensation exceptions for investment staff, many of them still have restrictions on base compensation and bonus pools. This can inhibit the ability to successfully recruit and retain investment professionals.

An additional factor can be the willingness of the fiduciaries to exercise their discretion to compensate investment staff and approve bonus pools due to member and/or public perception that they are squandering funds and overpaying pension fund staff. It is important to assess the political and public tolerance for the headcount and compensation structures required to run an investment management team. Success is also often related to the ability of the system to engage the support of its beneficiaries and other key stakeholders.

There are also very few, if any, U.S.-based public funds which have made the decision to bring alternative asset classes such as private equity or absolute return strategies in-house due to the compensation levels necessary to compete with the private sector for talent. Having said that, many of the largest public funds in Canada are building up their internal capabilities in these alternative asset classes and pay competitive compensation to their staff.

Performance: The business case for internal asset management presumes the internal staff can exceed the net performance achieved by the external managers. This requires that the new internal investment must achieve investment returns which are nearly equal to those of the external managers, or more precisely, any gross returns performance degradation resulting from bringing asset management in-house must be less than the net management cost savings achieved. It is not possible to know in advance what future investment performance levels can be achieved by a new internal staff, and funds must assume that they can hire competent, experienced staff who are capable of achieving improved net returns in whatever asset classes and strategies are pursued.

This can be further complicated by the fund’s location and ability to recruit competent investment staff to their locale. It is also important to maintain appropriate time horizons for measuring performance and maintaining accountability. One-year measures of performance success will encourage benchmark-hugging and undercut reasons for building an internal investment management team.

One common strategy for public funds setting up a new internal management capability is to begin with index funds because they can provide a lower risk foundation of valuable experience before taking on more active strategies with greater staffing, systems and risk management requirements. However, the cost savings and potential to outperform the net return of external managers are typically much smaller for index funds.

The board also needs to ask itself if it is ready to oversee internal investment management:

- What board member stakeholder representation / skills / competencies / training are needed for internal management?
- Is there a level of board (or advisory services) competence needed to effectively implement and monitor an internal investment program?
- Should we develop (or revise) investment beliefs about the role and strengths / weaknesses of the program in relation to its obligations – to keep the board, staff and stakeholders on the same path with a shared vision?
- Is there agreement on the time horizons for performance and risk evaluation (which is important from the start), with differentiation between individual portfolios and the entire fund?
- Might it take time to build an internal program, with addition of components in stages?
- How does internal management affect the ongoing stakeholder communications function?

What are the key challenges?

Retirement systems considering increasing internal asset management face a number of concurrent challenges:

- Recruiting, developing and retaining competent staff
- Building the required systems and controls infrastructure
- Establishing effective investment management and governance processes
- Engaging stakeholders effectively

As noted earlier, staff recruitment can present some challenges if the system is not in a major financial center. However, in our experience, funds can find capable staff if they are attracted to the lifestyle advantages a public fund offers. Having said that, it is important to offer a competitive compensation package and maintain a performance-based culture to attract top performers.

The infrastructure build-out takes planning, effort, and time, but should not be a barrier to success. Every system will need to consider make vs. buy and insource vs. outsource in some areas, but with strong leadership the organization should be able to craft an effective plan. Again, this is highly dependent on budgetary autonomy.

Managing assets internally requires new and/or modified governance and investment management policies, processes, reporting, and controls that are not required for management of external managers. While these are typically refined as the internal function matures, it is critical to develop the new policies, process, controls and reports prior to beginning the internal

management of assets. The ability to maintain independence of the investment process from direct political influence (via good policies, independent reviews, enforcement of ethics, compliance and conflicts policies and appropriate board membership and training) is also critical and needs to be reinforced through a strong ethical culture.

An aspect that should not be underestimated is the need to effectively engage stakeholders. In our experience, the most important message when bringing asset management in-house is the business case: the fund is investing and expanding staff to reduce outside management fees and increase net returns, and that will benefit the beneficiaries. All key stakeholders need to understand this message and accept that the board is acting responsibly and investing for the future.

Finally, it is important to make sure that all of these efforts are managed in concert. In particular, while staffing may be the limiting factor in starting the process, it can be imprudent to begin internal management without the infrastructure required for effective management and reporting. The timing of all the elements must be coordinated to achieve success.

Conclusion

If, after carefully considering the factors of scale, authority, compensation and confidence, you determine that your system is ready, then what needs to be done to determine what it will take to do it right? This is the subject of the next article in this two-part series which will address how to better understand and manage the cost/benefits, legal and regulatory hurdles, capital requirements, human resources and cultural issues and governance alignments.

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