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In-house asset management in the Australian superannuation industry

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Abstract

We examine how executives from the Australian superannuation industry perceive and approach the choice between managing assets in-house, versus outsourcing to external investment managers. We find that decision frameworks, as well as the perceived benefits and challenges of in-house management, can be described in terms of four elements: costs, capabilities, alignment and governance. Industry participants address these four elements in diverse ways. This is reflected in a variety of decision approaches, aspects that are considered and emphasised in decision-making, and implementation structures.

Key words: Superannuation funds; In-sourcing versus outsourcing; Portfolio construction; Governance

JEL classification: G11, G23, L33

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1. Introduction

Australian superannuation funds have been increasing the magnitude and scope of assets that are directly managed in-house, while reducing the percentage of assets outsourced to external investment managers. We examine the drivers behind the in-sourcing of investment management functions by drawing on interviews with executives from 20 organisations. We asked interview participants ('participants') about their frameworks for making decisions to in-source the management of asset class portfolios, and the expected benefits and challenges of managing assets in-house. Our main contribution is to provide an account of how the Australian superannuation industry views in-house management. We find that decision approaches, and the considerations that are taken into account, can be described as addressing four elements: ***costs***, ***capabilities***, ***alignment*** and ***governance***. Our taxonomy better accords with how the issues are discussed than existing theories of in-sourcing versus outsourcing, at least for our sample.

While decisions of whether to manage assets in-house can be described as addressing four elements, there is substantial diversity in the weight placed on each element, and aspects that are viewed as important to consider. For instance, all participants are concerned with the impact on fund returns from managing in-house. However, opinions differ on the role of ***costs*** versus ***capabilities*** as return drivers. Similarly, the vast majority of participants consider ***alignment*** and ***governance*** to be important, but no clear agreement emerges over the range of aspects that matter in these areas. Among the dozens of aspects and issues mentioned as relevant for decisions around in-house management, many are raised by a minority of participants, and only three attract agreement across 80% or more of our sample. These include perceptions that: (i) in-house management offers *tailoring* benefits; (ii) there exist staff-related challenges related to *attracting skilled and aligned staff* and *remuneration*; and (iii) there is potential for *culture clashes* between in-house teams and others within the organisation. Overall, there is little consistency in how decisions are approached, which manifests in a variety of assets being selected for in-house management and implementation structures.

A number of potential reasons exist for the diversity in approach. First, in-sourcing decisions are new to many funds, having recently arisen as a consequence of fund growth and the establishment of internal investment teams. Funds have been addressing the issues in isolation, without the benefit of strong precedent or broad experience with in-house management in the local industry. Subsequently, they have settled on a range of approaches. Second, funds face different capabilities and constraints due to variations in size and resourcing. Third, our analysis reveals that the preferences and experience of key decision-makers are influential, such that approaches vary with the personalities involved.

We proceed as follows. Section 2 presents background on the literature, and the history and status of in-house management in Australia. Section 3 outlines the research method and data. Section 4 presents the findings on decision frameworks.

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Section 5 reports on the perceived benefits and challenges of in-house management. Section 6 maps the aspects identified to the four elements. Section 7 concludes.

2. Background

2.1. Literature

An extensive body of literature considers in-sourcing versus outsourcing, and its relation to the nature and boundaries of the firm. This literature comprises conceptual frames that are complementary rather than competing. We summarise this literature, and relate it to the four elements of ***costs***, ***capabilities***, ***alignment*** and ***governance***.

Transaction cost theory focuses on the relative cost of procuring goods and services through the market versus from within the firm (see Coase, 1937; Klein *et al.*, 1978; Williamson, 1985; Grossman and Hart, 1986; Hart and Moore, 1990; Grossman and Helpman, 2001). Differences in costs can arise from the relative difficulty in identifying prices, negotiating and concluding contracts, and dealing with unforeseen contingencies under uncertainty. Under transaction cost theory, in-sourcing is likely to be more beneficial where control over assets is valuable, external markets are thinner and/or inefficient to search, assets are more specific, uncertainty is higher, and external providers have high bargaining power. Transaction cost theory broadly aligns with a focus on the relative ***costs*** of managing assets in-house versus outsourcing to external managers, although also relates to ***alignment*** where it has cost impacts.[1]

Incomplete contracts emphasises issues such as agency, monitoring, incentives and governance, arguing that the property rights focus adopted by transaction cost theory is too narrow (see Alchian and Demsetz, 1972; Holmstrom and Milgrom, 1991, 1994; Holmstrom, 1999). Under this frame, ownership infers contracting rights that allow firms to 'set the rules of the game' and design incentives. This helps overcome some of the agency problems associated with dealing in markets, particularly where there exists asymmetric information and difficulty in contracting over all possible outcomes. Ownership also allows firms to coherently direct and incentivise workers. An aligned notion is that of *formal versus relational contracts* (see Baker *et al.*, 2002). Relational contracts involve informal agreements and unwritten codes of conduct, and are often ongoing in nature. In-sourcing can be beneficial where high uncertainty makes it difficult to design formal contracts and measure performance for external parties, and more likely to use relational contracts. The incomplete contracts frame mainly accords with discussions by participants around ***alignment***. It indirectly relates to ***governance***, which helps moderate the problems associated with incomplete contracting.

[1] Recent examples where qualitative methods are incorporated into a mixed-method analysis of transaction cost theory in the context of Australian companies include Christensen and Kent (2015) and Giacobbe *et al.* (2015).

Value creation has received less attention in the literature. Pitelis and Teece (2009) argue that the transaction cost and incomplete contract frames are both too narrow as they focus only on market failure, and protecting rather than building value. They emphasise two aspects. First is dynamic creation and capture of value through combining resources and innovation, that is '***capabilities***'. Second is meeting the objectives of principals, that is 'purpose', which equates to ***alignment***.

The literature on in-sourcing versus outsourcing recognises the existence of multiple influences, and acknowledges that the choice will depend on the circumstances; for example, see Leiblein *et al.* (2002). This is in accordance with the differing approaches across funds that we observe.

The fund management literature considering in-sourcing versus outsourcing by asset owners is comparatively limited. Clark and Monk (2013a,b) discuss the 'geographical reach' of investment management organisations, observing how size and economies of scale matter for the in-sourcing decision. They consider large funds as more likely to pursue in-house management for its complementarity with fund objectives, emphasising those tasks that are cost-effective to perform internally. They observe the role for relational contracts and note the risks of potential capture or entrenchment by internal managers. Clark and Monk (2012) provide a list of benefits and success factors associated with in-house management. The five benefits identified are as follows: access to certain assets or markets; better alignment, or lower agency costs; improved internal capabilities; better performance, largely due to lower cost; and 'sustainability', which equates to better tailoring. They present a pyramid of success factors, with ***governance*** at the apex. The decision variables that Clark and Monk emphasise accord with ***costs***, ***capabilities*** and ***governance,*** while ***alignment*** emerges in their discussion of benefits and challenges.

MacIntosh and Scheibelhut (2012) examine 19 large pension funds, finding that the use of in-house management is a function of fund size and associated with better performance.[2] Rozanov (2015) observes a strong preference for in-house management by Canadian pension funds, driven by the ability to add value in less liquid assets and scale-related cost savings. Fang *et al.* (2015) identify benefits and pitfalls of in-house management, in the context of analysing direct investment versus co-investment in private equity. They list the benefits of in-house management as cost savings; improved control and flexibility; ability to pick deals; ability to time the market; avoidance of various agency problems; and capacity to customise exposures. The main challenge is seen as building capabilities not traditionally possessed by asset owners. Andonov (2014) also finds better performance for funds that invest in-house in alternative assets.

[2] MacIntosh and Scheibelhut (2012) find net value add to rise by 3.6 basis points for every 10% managed internally, although their regression contains no controls for other factors such as size.

Other fund management research is only tangentially relevant. The choice between internal and external managers in the mutual fund industry is examined by some authors (e.g. Chen *et al.*, 2013; Chuprinin *et al.*, 2015), but is not directly transferable to asset owners. Literature on delegated investment management considers agency problems arising with external managers (e.g. Elton and Gruber, 2004; Stracca, 2006; van Binsbergen *et al.*, 2008; Blake *et al.*, 2013). This work focuses on issues arising under external management, without comparison against managing in-house.

2.2. In-house management in Australia

A few participants with extensive industry experience noted that in-house management by Australian superannuation funds extends back over 30 years.[3] The initial phase is described as involving a small number of funds embracing in-house management due to a belief by key decision-makers that it offers a better solution. A subsequent broadening in use of in-house management appears to have been driven by three structural influences: emergence of larger funds, stemming from system growth and fund consolidation; building of internal management teams; and technology, which improves access to the required systems.

Table 1 reports the percentage of assets (Panel A) and asset classes (Panel B) managed in-house[4] according to a survey by SuperRatings of Australian superannuation funds during 2015. The survey finds that 59% of funds manage some assets in-house, with 18% managing 20% or more in-house. Cash is managed in-house by 57%, and by 97% of those managing at least one asset class internally. In other asset classes, in-house management is practised by between 6% and 18% of respondents. Thus, this survey reveals considerable variation in *which assets* are managed in-house.

Analysis of our data reveals that in-house management occurs within Australian superannuation funds under four different structures:

1 *Dedicated internal manager* – The asset class is managed entirely in-house. With the notable exception of cash, we heard of only two other instances of this model.
2 *Hybrid: internal and external managers* – An in-house management capability is combined with external managers to form a multimanager portfolio. This is the most widely used structure.

[3] We are putting aside the insurance companies (such as AMP) for this discussion, although this sector has a history of internally managing superannuation assets that extends further back. State Super of NSW also managed in-house during the 1980s and 1990s, although subsequently withdrew from internal management.

[4] Survey respondents self-report under the supplied definition of ‘having control over the purchase or sale of the underlying assets’.

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Table 1
Assets managed in-house

% of Assets in-house	% of Funds managing in-house	% of All funds (scaled by 59% and rounded)
Panel A: Percentage of assets internally managed		
<5%	16	9
5% to <10%	30	18
10% to <15%	14	8
15% to <20%	19	11
20% to <30%	5	3
30% or more	26	15
Panel B: Asset classes internally managed		
Core Assets		
Cash	97	57
Fixed interest	31	18
Australian equities, passive	18	11
Australian equities, active	26	15
International equities	13	8
Other Assets		
Infrastructure	23	14
Property	26	15
Private Equity	10	6
Alternatives	15	9

Source: SuperRatings.

3 *Co-investments* – Used by some funds in alternative assets, it involves piggybacking on the ability of an external manager to identify and source assets through taking a ‘slice on the side’.
4 *Partnerships* – We identify two partnership models. First is between funds, mainly evident for alternative assets such as direct infrastructure or property. Second are partnerships with external managers or other operators.

The variety of structures and choices of which assets to manage in-house reflects the diversity of decision approaches that we detail.

3. Method and sample

We draw on in-person interviews with executives from 20 organisations within the Australian superannuation industry,[5] supplemented by documents

[5] Other research that uses interview-based qualitative techniques to examine the decision processes of Australian superannuation funds includes Butt *et al.* (2015), and Foster and Warren (2016).

and media reports. We interview 13 medium–large not-for-profit superannuation funds,[6] and seven representatives from asset consultants or research houses which we denote as ‘advisers’. Our sampling strategy was to attain substantial coverage of the target group, which included Australian not-for-profit superannuation funds that are either pursuing in-house management or have been considering the possibility, as well as industry advisers who are required to form a view on in-house management and offer advice to clients. For-profit (i.e. retail) funds were excluded as their business models typically involve diversified, vertically integrated structures that include investment management operations.

We provide general rather than granular detail on the sample to preserve anonymity, given that we sample from a limited population. Based on data reported by the Australian Prudential Regulation Authority (APRA) at June 2015, funds in the sample managed 68% of total assets for large not-for-profit superannuation funds, and 76% of assets for funds in excess of $5 billion. Nine of the 13 funds managed superannuation assets in excess of A$20 billion, while the other four sat in the A$5-$20 billion range. All funds either currently manage assets in-house, or have considered the possibility. The fund sample spans a range of commitment levels to in-house asset management at the interview date. Five funds had made a substantial commitment, managing 20% or more of their assets in-house across a number of assets. A further five had moderate commitment, managing a narrow range of assets or small amounts internally. Three funds had nil or very limited commitment, managing at most cash in-house. We mainly interview Chief Investment Officers (CIOs), although the sample contains two Chief Executive Officers (CEOs). At the advisors, we spoke to either senior consultants or researchers, many in management positions. The advisory sample included five asset consultants and two research houses, including three of the four major consultants operating in the Australian market.[7] We believe the sample is highly representative of the target group, which is focused around key decision-makers and advisers for larger not-for-profit funds.

Interviews were conducted during late 2015. Two researchers attended each interview, one conducting the interview and the other taking notes and asking supplementary questions. Interviews were recorded and verbatim transcripts prepared. Interviews were semi-structured. General questions were asked to canvass participant opinions, without leading them in any direction. This was followed by queries to ensure that the research questions were adequately addressed. A number of the participants provided internal documents, including analysis and presentations on in-house management. Finally, we

[6] The not-for-profit sector contains funds from the industry, public and corporate sectors.

[7] The four major asset consultants at the time included Frontier Advisers, JANA, Mercer and Towers Watson, see: http://investmentmagazine.com.au/2015/07/the-big-four-investment-consultants/.

collected media reports of statements made by representatives of the sample organisations, as well as other industry commentators.

Six topics were covered during the interviews: background information; decision framework; benefits; challenges; influence of scale; and success factors. Analysis involved allocating statements in the interview transcripts and other data into categories (grouping of coding into 'nodes'[8]) that align with common themes, concepts, viewpoints or facts, but without specifying the categories in advance. The process was evolutionary and iterative. The number of categories continued to expand throughout the analysis as different perspectives were discovered, consistent with the high diversity of opinion that we discuss later.

Table 2 describes the relation between the two research questions, interview questions, code mapping and findings,[9] with code mapping linked to ***costs***, ***capabilities***, ***alignmen*t** and ***governance***. The research questions address the decision framework (Panel A), and the perceived benefits and challenges (Panel B).

Interview findings are reported through summaries of key themes, counts of the mentions of particular items and illustrative quotes. The counts indicate the breadth of concern with an item, but not the intensity of views. There could be two reasons for no count being recorded. First, a participant may fail to mention the item due to either attaching it no importance, or merely oversight. Second, they might disagree that the item is relevant. We attempt to draw out the intensity and range of views in the discussion of findings. Quotes are selected to be illustrative rather than comprehensive, and are lightly edited to improve flow without altering meaning. We identify whether quotes are sourced from a fund or an adviser.[10]

Three methods ensure that our analysis is trustworthy and consistent. First is researcher checking, under which the coding undertaken by one researcher is cross-checked against an independent review of the transcripts by another researcher who extracted key themes. Also, the analysis and interpretations were further reviewed by all researchers during the write-up. Second, participant checking was conducted by giving participants the opportunity to review and comment on their transcript,[11] as well as the draft paper. Third is data triangulation, under which interview data are crossed-checked against behaviour as reported in written documents or media reports. Data

[8] NVivo 10 software was used in the analysis.

[9] Table 2 follows the suggestions of Anfara *et al.* (2002) and Kaczynski *et al.* (2014), albeit designed to suit the nature of our analysis.

[10] We estimated the counts between funds and advisers, but did not to report the breakdown as no distinctions emerged.

[11] A number of participants suggested changes to the transcript text where it did not reflect their intent.

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Table 2
Research questions, interview questions, coding and mapping

			Code mapping: nodes to four key elements			
	Interview questions	Coding: related nodes	Costs	Capabilities	Alignment	Governance
Panel A						
Research Question 1		*Decision process*				
What framework describes the approach to deciding between in-sourcing and outsourcing of asset management?	How do you view in-house management in broad terms, that is from a philosophical, or decision framework, perspective?	Better utilise spending on manager fees	X			
		Capacity constraints addressed		X		
		Cost as a driver	X			
		Defined benefit vs. defined contribution			X	
		Diversification		X		
		Do-ability		X		X
		Filling gaps in external products		X		
		Flows from fund strategy, or objectives			X	X
		Clear reasons				X
		Information access (about markets)		X		
		Leverage competitive advantage, capabilities		X		
		Measured approach				X
		Personal bias to managing in-house				X
		Net return focus	X	X		
		Resource constraints		X		X
		Risk of internal management		X		X
		Scale	X	X		
		Willing to change governance, culture			X	X

(continued)

Table 2 (continued)

			Code mapping: nodes to four key elements			
	Interview questions	Coding: related nodes	Costs	Capabilities	Alignment	Governance
		Critical success factors				
	What are the critical elements for successful in-house management?	Board is on board				X
		Capabilities		X		
		Clear reasons				X
		Commitment				X
		Competitive advantage		X		
		Culture and alignment			X	
		Governance structure				X
		People		X	X	X
		Realistic view				X
		Resource properly		X		
		Risk management		X		X
		Systems and processes		X		X
Panel B						
Research Question 2		*Benefits and Reasons*				
What are the perceived benefits and challenges of in-house asset management?	What are the benefits of in-house management?	Access to opportunities		X		
		Accountability improved				X
		Agency problems reduced			X	
		Alpha generation improved		X		
		Better alignment or tailoring			X	
		Capturing scale benefits	X	X		
		Chance to rethink the model				X
		Control (over asset selection, trading)		X	X	
		Cos t reduction	X			

(continued)

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Table 2 (continued)

Interview questions	Coding: related nodes	Code mapping: nodes to four key elements			
		Costs	Capabilities	Alignment	Governance
	Cultural integration is enhanced			X	
	ESG/SRI; engagement with asset		X	X	
	Establish (fund management) business		X		
	Fit with overall fund strategy			X	
	Flexibility or agility		X		
	Market intelligence		X		
	Member perceptions			X	
	Net returns improved	X	X		
	Risk reduction (managing exposures)			X	X
	Scalable model	X	X		
	Tax management	X		X	
	Transparency				X
	Challenges & Pitfalls				
What are the pitfalls of in-house management, that is the costs, risks and challenges?	Alpha lower (vs. external managers)		X		
	Behavioural issues				X
	Blame cannot be passed on				X
	Capture by internal team			X	X
	Cost to set-up, maintain	X			
	Culture clashes				X
	Dealing with underperformance				X
	Distraction (to management/business)	X			X
	Flexibility lost (locked into internal team)		X		
	Governance is challenging				X
					X

(continued)

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Table 2 (continued)

		Code mapping: nodes to four key elements			
Interview questions	Coding: related nodes	Costs	Capabilities	Alignment	Governance
	Intellectual property issues with managers				
	Loss of insights from external managers		X		
	Performance evaluation and accountability				X
	Reporting requirements are onerous	X			
	Reputational risk				X
	Staff management		X	X	X
	Systems; operational risk	X	X		X
How is the effectiveness of in-house management related to fund scale?	Scale (upper limits, lower limits, projections, asset classes, trade-offs)	X	X		

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triangulation was limited in scope, but highly beneficial where alternative data sources were available.

4. Findings – decision frameworks

This section addresses the findings on frameworks underpinning decisions on whether to manage assets in-house. Section 4.1 summarises the general approach of each participant. Section 4.2 discusses decision influences. Our initial aim was to gauge whether participants discussed their decisions in terms of the theoretical frames appearing in the literature. We found this not to be the case, with these frames not according with the manner in which participants discussed the issues. Analysis of the data suggests that decision processes are better described as addressing ***costs***, ***capabilities***, ***alignment*** and ***governance***. While the four elements provide a useful taxonomy, we nevertheless encounter considerable diversity in terms of the weight placed on each element, and aspects that are emphasised in making decisions.

4.1. Approaches and aspects emphasised

Table 3 presents 2–3 line summaries of the essence of the broad approach and the main aspects considered by each participant, relating each summary to the four elements. Participants were sent these summaries, with all confirming that they accurately reflect their stance.[12] The main takeaway is the considerable variation in broad approach and the aspects viewed as most important. Effectively, we obtained 20 different opinions on how to address the issues.

Table 4 reinforces the finding of diverse viewpoints by listing the success factors mentioned by participants along with counts. Only three of the twelve success factors are identified by more than half the participants: *governance* (75%), *staff selection and management* (70%), and *systems and resourcing* (65%). About half of the sample identifies the next three items: *culture and alignment* (50%), *clear reasons for managing in-house* (45%) and *commitment from the Board* (45%). The other six items are identified as critical for success by no more than 35% of participants.

The diversity of approaches and points of emphasis is also reflected in the large number of nodes listed in Table 2. During data analysis, we found it necessary to continually add nodes as new perspectives or views emerged that we had not heard previously. The usual strategy under interview-based qualitative research is to sample up to a point of saturation, such that conducting additional interviews becomes unlikely to yield further insights (Guest *et al.*, 2006; Bowen, 2008). In this instance, we interviewed a substantial portion of a target audience, but were encountering different viewpoints until the end. This underlines the absence of any common decision framework or approach.

[12] Some participants requested adjustments to our initial drafting.

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Table 3
Key decision influences for each interview participant

Summary of approach	Related elements
Funds	
1. Risk-adjusted net return focus, where cost savings are traded off against investment quality (i.e. confidence in delivery), and operational risk is considered. The objective is to choose the most efficient structure for executing a strategy	Costs and capabilities; alignment
2. Ultimately, it is about the best return-risk outcomes for members. In-house management offers an ability to tailor and capture opportunities. Governance and resourcing can be important influences	Costs and capabilities; alignment; governance
3. Net long-term performance is the key driver. If an incremental approach is pursued, in-house management might be justified by various criteria that impact net returns, for example tailoring, access to opportunities, cost (but not cost alone). Any big bang shift must flow from overall fund strategy	Costs; capabilities; alignment
4. Issue is where skill exists, and where value can be added; considering aspects like diversification, operational risk, cost savings, and other benefits. 'What is the advantage?' is a key question	Capabilities and costs; governance (risk)
5. The fit with strategy and objectives is primary. After that, it is a matter of ability to execute: the capabilities, people, systems. Cost effectiveness can be a benefit, but should not be the driver	Alignment; then capabilities; then costs
6. Points of emphasis are competitive advantage, and dealing with capacity constraints on a forward-looking basis. After that, it is about building the required capabilities in a cautious, measured fashion.	Capabilities; also governance
7. Prime considerations are ability to tailor and then leveraging competitive advantages, especially those related to scale and execution. Bias is towards in-house management where these are evident	Alignment; capabilities
8. Three key criteria: (1) do-ability; (2) capacity constraints; and (3) cost savings. Other synergy benefits can matter. Trading off these criteria leads to a hierarchy of which assets to manage in-house	Capabilities and costs; also alignment
9. In-house management helps solve three size-related problems: (1) scale benefits accruing to agents; (2) agency risk/misalignment with objectives; (3) information asymmetry due to distance from assets. In-house should be used if it solves one of these problems, and a core competency exists	Costs; alignment; capabilities
10. Key issues are as follows: (1) capacity; (2) control; and (3) costs. In-house management of alternatives can reduce fees where they are highest and might be accessed using co-investment or partnership structures	Capabilities; alignment; costs
11. Three criteria: (1) no taking of active risk; (2) ability to manage the operational risks; and (3) clear and compelling cost advantage. Taking active risk requires a step up in governance, systems, culture, etc	Governance; costs; also capabilities
12. Our reasons for moving in-house have varied across assets and over time. They have included: enhanced ability to add value after costs,	Costs and capabilities; alignment

(continued)

Table 3 (continued)

Summary of approach	Related elements
supported by a competitive advantage; better alignment and pursuit of long-term investing; access to capacity; and duration management	
13. Key criteria are as follows: (1) possessing a core competency; (2) alignment with objectives; and (3) scale efficiencies. Resource constraints can be influential in limiting what might be pursued internally	Capabilities; alignment; costs
Advisers	
14. Funds should manage for total return after-tax. Any decision to manage in-house should be made after weighing up the strengths, weaknesses, opportunities and threats. There should be a willingness to change governance systems and culture	Costs and capabilities; governance; alignment
15. Value-chain framework can be used, focusing on comparative risk-adjusted return in each component of the chain. Economies of scale, and value of fund differentiation, are considerations	Costs and capabilities; also alignment
16. Net return enhancement is central, and is largely a function of the combination of value-add, costs and capacity as size increases. Once the box is ticked on the ability to generate active net return vs. passive alternatives, then the scalability of in-house management comes into play	Costs and capabilities
17. Net benefit should be the dominant focus, while ensuring robust governance and systems are in place. In-house management should be a value assessment, rather than pursued to reduce costs alone	Capabilities and costs; governance
18. Two focal points are as follows: cost reduction that comes with scale, and a move away from ad valorem fee structures; potential 'strategic benefits' that come from being an owner rather than just an investor, for example control over assets; ESG; tailoring to objectives. In-sourcing is a strategic decision	Costs; capabilities; alignment; governance
19. Net returns can be improved by reducing costs at certain scale; plus can better tailor to objectives. Additional alpha should not be expected; and governance and alignment issues need to be sorted	Costs; alignment; governance
20. Main considerations are consistency with strategy and objectives plus cost savings. The question of how value is going to be added also needs to be answered. The bias is towards in-house management	Alignment; governance; costs; capabilities

4.2. Influences

We now discuss six influences on the decision to manage assets in-house. Five are explicitly identified by participants: returns; scale; competitive advantage; alignment; and concern over implementation and/or risk. The sixth is largely based on our own observation and relates to personal experience and beliefs.

4.2.1. Returns

Returns reflect the balance between the change in gross return (or 'alpha') and management expenses, and hence encapsulate ***capabilities*** and ***costs***. All 20 participants comment that in-house management could potentially increase

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Table 4
Success factors mentioned by interview participants

Success factor	Number of mentions	Portion of participants (%)	Relates to
1. Governance	15	75	Governance
2. Staff selection and management	14	70	Capabilities; alignment; governance
3. Systems and resourcing	13	65	Capabilities; governance
4. Culture and alignment	10	50	Alignment
5. Clear reasons for managing in-house	9	45	Governance
6. Commitment from Board	9	45	Governance
7. Competitive advantage evident	7	35	Capabilities
8. Linked to fund objectives	5	25	Alignment
9. Realistic expectations	5	25	Governance
10. Managing the operational risk	4	20	Governance
11. Capability to implement	4	20	Capabilities; governance
12. Decision processes	3	15	Governance
Success Factors Per Participant			
Minimum	2		
Median	4.5		
Maximum	9		

returns, with seven referring to net return as their *primary* decision criterion. Return impacts are discussed in various ways. Fourteen participants (70%) refer to explicitly adopting a net return focus, while five (25%) talk about cost reduction as a driver in isolation. Some thought that in-house management can enhance gross returns as well as reduce costs, through either leveraging some competitive advantage (see Section 4.2.3) or other benefits such as access to opportunities or greater market insight (see Section 5):

> ‘It’s all about performance at the end of the day: after-fee performance . . . The best way to get strong after fees/after tax performance is to reduce agency risk, to reduce costs, and to improve decision-making. . . . If 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’. (FUND)

Another view was that gross returns will be lower, but net returns should increase due to substantial decreases in management expenses (discussed below):

> ‘I’d say cost and performance are equally important. . . . Actually the risk-return payoff is probably quite skewed in terms of lower cost and [lower] performance’. (FUND)

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The extent to which ***costs*** are the primary decision driver differs. These quotes reflect the tenor of the debate:

> 'I did the internal poll on this ... and cost was sort of, clearly, the main thing'. (ADVISER)

> 'Cost is a very positive outcome. If you're doing it for cost, you're doing it for the wrong reasons'. (FUND)

4.2.2. Scale

Scale is mentioned by 16 participants as important for decisions to manage assets in-house. We asked for rough indications of the funds under management (FUM) at which in-house management is worth contemplating. At the lower end, some thought that in-house management might be considered at FUM as low as A$5–$10 billion, albeit in limited formats such as management of cash or special situations. At the upper end, A$50 billion was mentioned a few times as a level at which in-house management becomes nearly inevitable due to potential cost savings and capacity considerations. The A$10-$50 billion range appears to be the grey area where it depends on the circumstances. Scale considerations span three aspects: management expenses, capacity constraints and return benefits.

Management expenses. Nine participants refer to how potential to reduce management expense ratios (MERs) increases with FUM, which relates to ***costs***. A number refer to the dollar magnitude of fees paid to external managers, what it could 'buy' in terms of in-house management capability, and how this depends on FUM:

> 'If you're thinking about a $100 billion fund; if they're paying external managers 25 basis points, then that's $250 million. So that buys you an awful lot of expertise, right?' (FUND)

> 'at a billion-dollar core equity portfolio ... if you think 15 basis points is a $1.5 million management fee ... What we said was, well for $1.5 million, can we actually manufacture something with confidence that we can get that same level of alpha, be confident we're not going to make mistakes? And we just said ... at this stage, no. ... [but at] $10 billion for our core equity exposure, you should have a good look at it'. (FUND)

The basis point fees charged by external managers amount to a variable cost for asset owners.[13] Meanwhile, an in-house management team approximates a

[13] While fees charged by managers tend to decline with mandate size, the rate falls at a slower pace than the rise in FUM. Further, a couple of participants note that large funds have moved well past the FUM threshold for the minimum fee, and are receiving no further discount for scale.

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fixed cost. At high FUM, the variable costs associated with external management equates to a much larger MER than the fixed cost of establishing an in-house capability. Another description is that in-house management allows a fund to retain the economies of scale for its members, rather than have it captured by external managers.

Capacity constraints. In-house management can help address the capacity constraints associated with external managers that are encountered as FUM increases. This is mentioned by 11 participants and relates to ***capabilities***. The link between scale and capacity was described by a few participants using a parable about Australian equities along the following lines. Most active managers are unable to digest mandates above the A$2–3 billion mark. Hence, once a fund has A$10–15 billion allocated to Australian equities, pursuit of active management through external managers requires adding more managers beyond the optimal level of (say) 5–6 managers. This generates redundancy, so that returns converge towards the index without any reduction in cost. Accordingly, as FUM grows, the fund must choose between adding passive exposure versus bringing some of the funds in-house. If one believes that active management can outperform the index – which has been the experience in Australian equities – then actively managing a slice of the assets in-house is the preferred option. Further, in-house management can be designed to be scalable.

One participant raised a contrary view that capacity issues relate to investment strategies, not mandate size. Thus, problems can remain unresolved if in-house teams merely replicate the strategies of external managers.

Return benefits. Six participants allude to how certain competitive advantages associated with size might be better captured through in-house management. This relates to ***capabilities***. For example, in-house teams can facilitate direct participation in opportunities that arise from the capacity to make substantial capital commitments, such as investing in corporate recapitalisations or unlisted assets.

4.2.3. Competitive advantage

A meaningful portion of our sample perceive in-house management as providing access to competitive advantages that may enhance returns over those available from external managers. These advantages relate to ***capabilities*** and are detailed in Section 5.1.2. Within this, five participants (25%) cite the existence of some competitive advantage as a key decision factor. The following quotes reflect the stance of this group:

> 'We concentrate our internal efforts on that part of the investment value chain over which we have comparative advantage ... [for instance] we believe the illiquidity premium can only by sustainably accessed via control'. (FUND)

> 'We [ask ourselves]: "would we have a competitive edge"? For example, Aussie equities was considered twice before and rejected. We couldn't work out where we'd have a competitive edge, or how would we fit it into our current portfolio'. (FUND)

> '... what asset classes we do in-house depends on where we think we've got skill and where we add value' (FUND)

4.2.4. Alignment

The issue of ***alignment*** figures prominently. All 20 participants identify alignment benefits (see Section 5.1.3), with about half viewing improved alignment as a key consideration in the decision. Funds look for in-house management to enhance alignment in two broad ways. The first is via *improved tailoring* towards objectives. The second is *avoiding agency risks* associated with external managers.

Some participants view the need for in-house management as being intimately linked to the fund's mission, strategy or objectives. For this group, choosing in-house management is about the best way to achieve desired outcomes:

> 'What's the purpose of the organisation and its role? You've got to start with that, plus the values of the organisation'. (FUND)

> '... comes down to your investment philosophy. What are you actually trying to achieve? Are you going to protect members on the downside? Do you just want to capture the upside because you're a growing fund, so you're growth orientated? I mean it really comes down to your investment philosophy'. (ADVISER)

> 'The primary drivers are to develop tailored portfolios. That is the huge advantage of in-house asset management'. (FUND)

One nuance on tailoring is that in-house management can complement external managers, augmenting the portfolio so that it is better aligned with objectives:

> '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 in the marketplace'. (FUND)

Some look for in-house management to assist with cash flow or liability management:

> '... being able to underwrite the liquidity in assets effectively is an important part of the liquidity management of the fund'. (FUND)

> 'In-house management was absolutely fundamental to manage that defined benefit portfolio. … Once you're in that liability-driven investing world, I'm not going to out-source to a whole bunch of different parties, because how do you actually get the fund managed as you look after the liability? So we had to take control over managing to the whole liability base. And the most efficient way of doing that was through in-house management'. (FUND)

For a handful of participants, the decision to manage in-house relates to a desire to overcome agency problems. Concerns relate to external managers being incentivised in ways that may lead to return leakage or actions that are inconsistent with the fund's objectives. For instance, external managers may be too concerned with pursuing short-term performance and accumulating FUM, or make ill-advised investments because they are anchored to benchmarks:

> 'One of the problems with the specialist out-sourced model is the siloed nature of it, and that leads to leakages' (FUND)

> '… alignment with the fund and the outcome for members … [in-house management provides] a trusted partner of the fund … we didn't feel that we got the greatest alignment out of the external portfolio manager to the outcome for our members … alignment is very, very important' (FUND)

> '. … They can't do it is the short answer'. Fund managers don't come in the door with answers to the problems that we're working on. They come in the door with a product …. they're selling…. The offer to tailor is always there; but to get that tailoring actually happening, you've virtually got to give them a desk because they've got to be part of the culture, part of the journey, grappling with the problem of governance and reporting and liquidity' (FUND)

> '[With alternative assets,] information asymmetry means that you can buy into transactions for which the governance regime, the reporting, the cash flow fit, the portfolio construction, the dimension, the sensitivity, is far more tailored than simply subscribing for units in a manager's fund. The inherent conflict of interest in managers' funds in this asset class is real. So they raise piles of money and they've got to deploy it. There is a disincentive to buy well because if you don't get the money away, it gets taken off you … the tendency is to get deals done'. (FUND)

4.2.5. Concern over implementation and/or risk

A majority of participants acknowledge the importance of effective implementation of in-house strategies through appropriate governance, processes, people, systems and the like. For some, confidence in the capacity to implement influences whether managing in-house is even contemplated. Capacity to implement is mainly associated with ***capabilities,*** although it may also relate to ***governance*** structures or ***alignment*** with organisational culture. These quotes give a sense of how capacity to implement could enter the decision:

> '. . .[one of our criteria is that] we feel we can completely manage the operational risks involved . . . we just felt that for the foreseeable future, we couldn't really build up the culture and the support mechanisms to successfully do [active in-house management in certain assets]. . . we certainly haven't bitten off more than we can chew' (FUND)

> '. . . if we can do it in a low risk way internally . . . I'd have no chance of getting it up unless I could convince the Committee that this is the right strategy for this fund, and we've got the people and the capability on Board'. (FUND)

> 'To build an Aussie equities internal team is a lot easier than building a global equities internal team, and a lot easier than building a private equity team. Some things we thought would be more do-able; and we biased ourselves toward the more do-able ones'. (FUND)

In a related vein, the potential risks feature prominently in the decision for a minority. While operational risk is most commonly mentioned, we also heard of reputational risk, peer group risk and imposing a return hurdle on managing in-house in recognition of greater risks. These aspects relate to ***governance***, as well as ***capabilities***. Nevertheless, concerns over implementation and/or risk are not a barrier for the majority, who take the stance that these issues needed to be understood and managed.

4.2.6. Role of personal experience and beliefs

The personal experiences and beliefs of decision-makers appear quite influential for both the decision to manage in-house, and the manner in which it is done. A number of participants elaborated on the role of personalities in driving the roll-out of in-house management within Australian superannuation funds. They describe how a particular fund opted for in-house management in the late 1990s due to key staff with investment management experience having the confidence and belief that managing in-house drives better member outcomes. This group of people subsequently became influential in the development of in-house management at other funds. In addition, the format for in-house management often reflects the background of the people involved. For instance, listed markets might be emphasised where this aligns with the experience of the investment team. This links to ***capabilities***.

Comments by participants confirm the influence of personal experience and beliefs. For instance, two participants express their predilection towards managing in-house:

> 'I'm turning the question around and saying everything should be in-house unless you tell me otherwise. . . . the default position is to manage the funds in-house.. . . If we do not believe that we can ex-ante deliver competitive returns, then we will outsource'. (FUND)

> 'I think in-house management is both viable and practical; and if you can, you should do it'. (ADVISER)

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There is reference to the role of experience in the decision to manage assets in-house:

> '. . . they were all money managers. So from day one they managed the portfolio in-house, and there was no question as to why you wouldn't do that'. (FUND)

> 'I had a history of doing in-house management, which probably biased me a little bit' (FUND)

Experience also plays a role in establishing the capability and confidence to go in-house:

> 'But that CIO . . . comes from that background; he's run equities before, he's very comfortable being on the ball with that, and I'm not'. (FUND, discussing another)

> 'It also comes down to capability, because the guy that I hired had worked for a fund manager. . . had experience in face-to-face negotiations . . . run funds himself in a previous life. Whereas if I'd hired someone who'd only ever hired funds, we'd be stuck with that model'. (FUND)

5. Findings – perceived benefits and challenges

Section 4 described the approaches used and aspects emphasised in deciding to manage assets in-house. We now provide additional detail on the perceived benefits and challenges, and the debate surrounding them.

5.1. Benefits

Table 5 lists the benefits identified and the number of mentions, arranged into four categories: *scale-related benefits*, *return enhancement*, *alignment* and *market insights*. Benefits span ***costs***, ***capabilities*** and ***alignment***. Reported at the base of each category is the number of participants that mention at least one item in that category. These intersections stand at 100% for *return enhancement*; 100% for *alignment*, which largely stems from recognition of the *tailoring* benefits; 80% for *scale-related benefits*; and 75% for *market insights*. Counts drop away for the individual items, with many being mentioned by only a minority of participants. This indicates that, while there is agreement regarding the broad categories of benefits, there is only limited consistency around what aspects are considered important within each area.

5.1.1. Scale-related benefits

As the nature of the scale-related benefits was described in Section 4.2.2, our discussion focuses on the counts. The fact that 80% of participants refer to scale-related benefits indicates broad acknowledgment that larger funds have more to gain from in-house management. However, the counts on the three

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Table 5
Benefits mentioned by interview participants

Benefit identified	Number of mentions	Portion of participants (%)	Notes
(1) Scale-related benefits			
Addressing capacity constraints; scalable	11	55	External model not scalable due to mandate size constraints
Lower management expense ratio	9	45	Savings increase with FUM; convert variable fee to fixed cost
Additional returns related to scale	6	30	Asset access leveraged when combined with large FUM
Scale benefits mentioned	16	80	80% refer to some link between benefits and FUM
(2) Return enhancement			
Broad focus			
Net return benefit (return net of costs)	14	70	Majority see potential to increase gross returns less cost
Cost reduction in isolation	5	25	Minority refer to lower costs without referring to net return
Return sources			
Access to opportunities	13	65	Access enhanced via leveraging size, capabilities or agility
Competitive advantage	6	30	Exploiting or creating an advantage not available externally
ESG/SRI: engagement	5	25	Creating value through direct engagement with investments
Long-term investing	4	20	Returns to adopting long-term view, providing patient capital
Tax efficiencies	3	15	Three see meaningful efficiencies (further 4 see small benefit)
Return benefits mentioned	20	100	100% saw potential to improve returns in some way
(3) Alignment			
Related to tailoring			
Tailor to goals or investment objectives	18	90	Capacity to structure portfolios for a particular purpose
Control	11	55	Influence over the asset and/or trade decision
Transparency	8	40	Improved understanding of investments and exposures
Tailoring benefits mentioned	20	100	100% perceive some kind of tailoring benefit
Other alignment benefits			
Mitigating agency problems	7	35	Avoiding agency issues with external managers
Member perceptions	4	20	Improves visibility and credibility with members
ESG/SRI policy embedded	3	15	Improved ability to align portfolio with ESG/SRI policy

(continued)

Table 5 (continued)

Benefit identified	Number of mentions	Portion of participants (%)	Notes
Long-term objectives	3	15	Working towards long-term objectives
Culture	2	10	Improves culture by sharpening organisational focus
Alignment benefits mentioned	20	100	100% identify some type of alignment benefit
(4) Market insights			
Access to information and skills	13	65	Advantages from skilled staff who are present in the markets
Better oversight of external managers	6	30	Improved capacity to monitor and negotiate with managers
Insight benefits mentioned	15	75	75% saw additional insights that bring ancillary benefits

items are somewhat lower, with 55% referring to *addressing capacity constraints and/or enhancing scalability*, 45% mentioning *lower MER* and 30% discussing *additional returns related to scale*. This indicates only moderate agreement over the nature of scale-related benefits.

5.1.2. Return enhancement

While all participants see potential to enhance returns, there is far from complete agreement on the nature of the return benefits. The broad focus on net returns versus cost reduction was discussed in Section 4.2.1; hence, we focus here on specific return sources.

Access to opportunities receives the most mentions by 13 participants (65%). This relates to improved capacity to identify and capture opportunities from being actively involved in asset markets. In addition to the ability to leverage scale (see Section 4.2.2), another major component is having the flexibility and agility to respond quickly when opportunities arise. Reference is also made to how in-house teams are better able to distinguish good from poor opportunities.

Six participants explicitly talk about access to *competitive advantages*, which are discussed as a decision criterion in Section 4.2.3. In many cases, these relate to exploiting a unique position that arises from being an asset owner that can bring to bear capital and influence:

> '… the number one benefit [is] the strategic benefit to think like an owner rather than an investor … that's how you outperform. You take strategic stakes in companies, you don't just invest and follow the herd. You get to have a say in how they're managed'. (ADVISER)

> '… the benefit of being an active player in the market is that things will come to you directly … you can take advantage of opportunities … use your capacity and deploy it in an area where there is not as much capital going in, then you can use yourself as a provider of liquidity to your advantage … can see how those investments fit into a total portfolio sense, and not be afraid of making investments that don't fit in the traditional measure of tracking error versus market'. (FUND)

Five participants mention the scope to generate additional returns through the *ESG/SRI*[14] function, specifically via *engagement* (mainly with companies). A further four allude to enhancing returns through *long-term investing*:

> '… take on some of these very, very long-term strategies which we believe will make money over time … you can use some patience … probably only one

[14] ESG refers to environmental, social and governance considerations, while SRI refers to socially responsible investing. We use the ESG/SRI identifier to capture various forms of responsible investing programmes.

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> strategy that I would say is more alpha-seeking, but it lives off the fact that we've got this long horizon'. (FUND)

Not all participants agreed. Three made statements indicating they perceive in-house management as offering no real advantages over external managers. Two of the six arguing for return benefits suggest that any advantage is likely to exist in alternative assets only.

5.1.3. Alignment

Within the ***alignment*** category, all 20 participants acknowledge the existence of *tailoring* benefits, which include ability to *tailor to goals or investment objectives* (18 mentions); *control* (11 mentions); and *transparency* (eight mentions). Listed below are the types of tailoring benefits mentioned. The modest counts reveal differing views on the specific nature of the tailoring benefits:

- Building bespoke products or strategies *(eight mentions, four related to income products)*
- Liability-driven investing *(six mentions)*
- Liquidity management *(five mentions)*
- Risk or exposure management *(five mentions)*
- General mention of tailoring benefits, no specifics *(three participants)*
- Investing to a time horizon *(three mentions, two referring to long-term investing)*
- Downside protection *(two mentions)*
- Inflation hedging *(two mentions)*
- Thematic investing *(two mentions)*
- Selection and sizing in alternative assets *(two mentions, plus one disagreeing this was feasible)*
- Portfolio completion *(one mention)*

Control is closely related to tailoring in that it enhances the ability to 'work' assets towards achieving objectives, but is often mentioned in its own right. While comments on control are typically made in relation to direct investments or large stakes that bring influence, there is considerable variation. Some just refer to control as a valuable attribute in a general sense. Others make mention of particular advantages, including the ability to manage the exit decision and hence liquidity needs; liability matching; the scope to influence how the asset is managed; and better risk management.

Transparency supports tailoring and control benefits by enhancing understanding of exposures and the drivers of performance. Through transparency, in-house management might facilitate better evaluation of investments and their connection to the portfolio and fund objectives.

The extent to which in-house management can assist in *mitigating agency problems* that can arise with external managers is mentioned by seven participants.[15] The main benefit is that in-house teams can be better structured and incentivised to work towards fund objectives. Meanwhile, external managers tend to be more concerned with aspects such as delivering on their mandate rather than the overall fund objectives; accumulating FUM; short-term performance; bonuses; and careers.

Other alignment benefits mentioned include potential for improved *member perceptions* (four mentions), which may arise from being seen to directly hold and engage with investments; improved scope to have an *ESG/SRI policy embedded* in the portfolio (three mentions); and better *culture* arising from sharpening of organisational focus (two mentions).

Some dispute the relative importance of the alignment benefits. Four participants argue that external mandates can be designed to meet nearly any purpose, while three suggest that external managers cover most requirements:

> '. . . we'd argue that we can instruct managers to manage to the objectives and we can design mandates. 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'. (FUND)

> 'I think if you can't find an external manager to help you manage that portfolio I'd be amazed. I mean we've got 7000 managers'. (ADVISER)

5.1.4. Market insights

Fifteen participants refer to *market insights* that arise from in-house investment teams which operate in the markets. Two types of benefit are mentioned, both related to ***capabilities***. First, in-house teams provide *access to information or skills* (13 mentions) that can be useful for functions such as asset allocation, identifying and evaluating assets, or improving the understanding of market forces. Second, in-house teams can support *better oversight of external managers* (six mentions) by improving monitoring and evaluation skills, and/or enhancing the ability to negotiate mandates.

5.2. Challenges

We now report on the perceived challenges – the potential problems, costs and pitfalls with in-house management. Table 6 arranges the challenges mentioned into five categories. Counts reflect either an expressed concern that an item is associated with potential downside, or a meaningful issue to address.

[15] This seems low, given the attention that agency risk often receives. For instance, agency risk is a central element to the incomplete contracts frame from the in-sourcing versus outsourcing literature, and tends to be prominent in discussions of problems in the investment management industry.

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Table 6
Challenges mentioned by interview participants

Challenge identified	Number of Mentions	Portion of Participants (%)	Notes
(1) Staff			
Attracting skilled and aligned staff	19	95	Nexus between securing ‘right’ staff, remuneration and culture
Remuneration	16	80	Constrained by concern with culture, harmony or alignment
Retention	12	60	Becomes an issue if staff are skilled and/or outperforming
Terminating if required	11	55	Becomes an issue if teams are underperforming
Staff Issues Mentioned	19	95	95% saw staff management as a challenge (varying degrees)
(2) Governance			
General recognition	14	70	Importance of governance structure recognised in general
Specific aspects mentioned:			
Performance evaluation	13	65	Benchmarking and attribution, especially under integrated structures
Supportive Board	12	60	Board commitment, willingness to delegate, capabilities
Managing in-house teams	11	55	Absorbs management time; distracts organisation; onerous reporting
Delegations	7	35	Appropriately structured delegations are required
Governance Issues Mentioned	19	95	95% attach importance to governance around in-house teams
(3) Behavioural			
Culture clashes	19	95	Remuneration/jealousy; managing change and egos; limiting disruption
Behavioural pitfalls of success	5	25	Overconfidence, overextending (empire building), complacency
Commitment upon underperformance	4	20	Commitment either tested, or inhibits taking action
Behavioural Issues Mentioned	19	95	95% saw need to manage behaviours, particularly culture
Systems & Processes	15	75	75% viewed systems as important (others dismissed as trivial)
(4) Other			
Exposure to errors	11	55	External managers can make good losses, or bear the blame
Set-up costs are substantial	7	35	In-house management costly to set up; can take years to pay off
Intellectual property issues	6	30	Some thought IP issues were meaningful (others dismissed them)
Capture by in-house team	4	20	Risk that fund gets captured by internal teams
Loss of flexibility	2	10	Harder to change strategy
Loss of insights from managers	1	5	May inhibit ability to extract insights from external managers

Nineteen participants (95%) mention at least one item in the *staff*, *governance* and *behavioural* categories, indicating broad agreement that meaningful challenges exist in these areas. *Systems and processes* are mentioned by 75% of participants. The most notable item in the *other* category is *exposure to errors* (55%). While the challenges span all elements, they most closely relate to ***alignment*** and ***governance***. Again the counts tend to drop away for individual items, albeit to a lesser degree than for the benefits. The key exceptions are high counts for *attracting skilled and aligned staff* (95%) and *culture clashes* (95%), indicating that nearly all participants view these as important challenges. Many of the items listed are subject to dispute by a notable minority. We draw out the contrary views in the discussion. Overall, our analysis confirms that while there is agreement over the broad areas of challenge, there is limited consensus over which aspects matter most under each area. Most participants view the challenges as aspects to be recognised and managed.

5.2.1. Staff

The staff-related challenges with in-house management comprise *attracting skilled and aligned staff* (19 mentions); *remuneration* (16 mentions); *retention* (12 mentions); and *terminating if required* (11 mentions). Staff issues mainly relate to both ***capabilities*** and ***alignment***. Another aspect is *performance evaluation*, which is addressed in Section 5.2.2 under ***governance***. We encounter a wide range of opinions on the gravity of the staff-related challenges. Some see staff issues as substantive, and almost insurmountable on certain dimensions. At the other end of the spectrum, one participant dismissed all the major concerns expressed by others. The majority consider staff management as an important but surmountable challenge.

Attracting skilled and aligned staff: remuneration versus culture. Most participants want to attract staff possessing two characteristics: required skills and cultural affinity. Many view the skill characteristic as pitched against constraints on the ability to remunerate staff, relative to what investment managers earn in the market:

> ‘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. … whether they can continue to pay those salaries and get the necessary uplift that some of these guys are interested in is going to be challenging’. (ADVISER)

Thirteen participants put forward the view that remuneration constraints can be overcome by targeting skilled and culturally aligned staff who may be content working for less due to other perceived benefits. Cultural affinity is seen as pivotal, and a pathway to securing staff under remuneration constraints

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while maintaining alignment.[16] Other benefits of managing investments for a superannuation fund that may help attract staff include ability to concentrate on investing without having to undertake marketing activities; potential to 'make a difference'; opportunities to learn, especially for less senior staff; and the prestige of managing large sums of money. Many participants suggest that the pool of people who are willing to trade off a lower salary for other benefits is sufficiently large, with some observing they are not constrained in accessing skilled staff:

> '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. Less competitive internally. I'm not sure our performance objectives are any less demanding, but probably a better culture'. (FUND)

> 'I think you've got to remunerate at a level that is competitive. But if you want to make the most money you possibly can, you're not coming to a super fund. … It changes the sort of person that you get. And the reason it does is that there are some real benefits from working in a super fund … you don't live and die by your last call. You've got time, generally. … You don't have to raise capital. … Generally you don't have to deal with clients. You don't have to deal with worrying about big chunks of money walking out the door, providing you're actually performing and doing your job'. (FUND)

> 'There's a lot of good portfolio managers out there in boutique firms or with big institutions who would jump at the opportunity to work for a large industry fund, because when they go to work, all they have to do is worry about investing. … Probably the word plenty is too strong, but there's enough of them around – it's competitive to get these jobs'. (ADVISER)

Remuneration constraints. The perception of *remuneration* constraints occurs notwithstanding that paying market rates is financially well within reach for large funds, and would have an almost undetectable impact on MERs. The chief issue appears to be the impact on organisational culture, harmony and alignment. Such concerns are raised by 11 participants, with these quotes providing a sense:

> 'If the competitive remuneration structures required to retain an internal investment capability involve incentive payments tied to performance, then how do you ensure that you are not compromising the alignment motivations for internal management? That is, 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 (which may involve underperformance of their sub-segment benchmarks for a period)? Also, in

[16] This notion accords with culture as a sorting mechanism (see Van den Steen, 2005; Kosfeld and von Siemens, 2011).

> the case of strong success, how do you ensure you don't end up with a two-tier team? Apart from cost, one of the major motivations for internalisation of investment execution is alignment and tailoring to evolving fund-level needs'. (FUND)

> 'So a junior portfolio manager or a senior analyst might be getting paid more than the CEO. That's challenging for just the ethos, and challenging for the CEO, I'm sure. They might have to get disclosed … now that a lot of industry funds have gone quite public with remuneration… the Board are going to be challenged about how they pay the team enough to retain them, but don't pay them too much so it's completely out of whack with the rest of the organisation'. (ADVISER)

Again there were some contrary views. One participant did not see remuneration as a constraint. Another argued that the industry should change its mindset and accept paying high remuneration provided that members are rewarded by higher returns, noting that funds effectively pay for talent anyway when outsourcing to external managers via the management fee.

Retention. While twelve participants refer to the staff *retention* challenge if highly skilled staff outperform, again we heard a variety of views. One participant acknowledges the issue, but suggests that the problem might be mitigated by focusing on strategies that do not rely on individual skill:

> '… 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 that they want a bigger cut and then being spun off. I've seen that happen. So I know that's a risk. What I'm mindful of is trying to get a strategy that's more robust than an individual … be a bit thoughtful about the nature of the strategy you take internally, compared to just trying to compete in a vanilla sense against others'. (FUND)

Another view is that the main area of concern is the middle tier of employees who are keen to advance their careers. A further perspective is that the importance of retaining investment staff is overstated, as they are not mission-critical in a superannuation fund where the 'clients' (members) are unaware who is actually managing their money:

> 'People who run money in an asset management business are always the revenue generators. But they're not revenue generators in a super fund, they're service providers. In fact, from a client perspective, I'm more worried about my employer relationship people leaving than my investment team leaving, from the impact it would have on the business. … If I lose my investment team in a super fund, my members don't even know'. (FUND CEO)

Termination. There is a variety of views over whether *terminating if required* is more problematic for in-house investment staff, which relates to ***governance*** but

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may have implications for ***capabilities***. Six participants express a genuine concern along these lines:

> ‘When we come to the ongoing potential pitfalls, the biggest one is just the age old question of how do you terminate an underperforming team? The agency problems of terminating your own team are a lot harder than terminating an external team’. (ADVISER)

Three participants advance a contrary view that in-house teams can be placed under comparable scrutiny to external managers through robust evaluation structures with multiple points of review, so that individual relationships become unlikely to dominate:

> ‘I am of the view that Trustee Boards are sufficiently at arms’ length from in-house teams, that if things got off the rails, they would have no hesitation to take action. That’s a Trustee Board. Let’s go through the whole spectrum: the internal team itself ... has a head ... then there’s a CIO. Then there’s a CEO. Then there’s a Board. All of them have to have a soft spot for that entity that’s done some wrong ... I’m not convinced that you could get all those ducks lined up sufficiently’. (FUND)

> ‘Given all the focus on your internal team, I reckon the internal team will be under high scrutiny. ... I think that’s a bit of a furphy argument to say that you won’t do it’. (FUND)

A range of views sat between the extremes. Six participants admit that there may be a tendency to be slower to react to poor performance when an in-house team is involved, although two saw this as a virtue as it supports investing with a longer horizon. Four participants refer to reluctance to terminate as a behavioural issue to be managed. One participant put forward a contrary view that in-house management offers more control as it affords the opportunity to terminate underperforming people, whereas with external managers you can only sack the organisation.

5.2.2. Governance

Nineteen participants refer to ***governance*** challenges.[17] Fourteen acknowledge governance in a general sense. Others single out certain aspects for attention. We discuss the key ones below.

Thirteen participants comment on the challenges of *performance evaluation* for in-house teams. Two problems include the benchmark to use, and how to attribute responsibility for performance. While many consider it desirable to benchmark against external managers, this is problematic when an in-house

[17] One participant did not focus on governance, apart from making a comment that any Board constraint is *‘more perceived than real’*.

team is not set up as a discrete manager with a clear mandate. In these situations, comparability with external managers breaks down, and how performance should be benchmarked and attributed becomes unclear. Further, focusing on peer relativities could create perverse incentives that undermine alignment:

> 'The Investment Committee puts us through the same hoops that we put an external manager through. So we look at performance, we look at key risks, we go through the same sort of portfolio attribution analysis, all that sort of stuff. … It's very difficult to look at specific attribution of in-house. We could look at the in-house strategies versus their respective benchmarks, and that's very easy to quantify. But then you've got to do an extra calculation – how does that add, at a total option level; which is what the member sees'. (FUND)

> 'The danger of that is if you start hitting people over the head if they underperform their peer group … they gravitate more and more towards the peer group. It's just natural, it just happens. So you're going to lose the advantage of having the tailoring'. (FUND)

Benchmarking and attribution are also problematic for alternative assets, where performance is driven as much by the availability of suitable opportunities as manager skill:

> '… look at your infrastructure manager. He might be lucky if he's bought three or four assets in two or three years. So over what timeframe, and are you going to give him a chance to get his portfolio set and mature, and does that ever really get set and mature when you're growing at 20% per annum … so he's got to buy new assets all the time?' (ADVISER)

Some participants suggest addressing the problem that investment performance may be not fully revealing of contribution for in-house teams by including subjective or team components in bonus calculations, or obtaining external reviews:

> '[Our asset consultant] comes and visits us, as they do any other external manager on a quarterly basis [and they do a] review of the operation of the portfolios and how they're being managed … we offer short-term incentives for people operating in investment management roles. Ultimately, a large chunk is [based] on the investment performance of the portfolio itself … and then a component of that short-term incentive is paid on [the] contribution to the business. We call them the soft issues, but they're the hard issues – team building, managing resources, and all of those matters'. (FUND)

A *supportive Board* is seen as critical for success by 12 participants. Two issues are Board commitment and its willingness to delegate, although there were occasional hints of concern with Board capability. Some refer to securing Board support through engagement, transparency and assurance via review.

> 'Trustee Boards need to come along on the ride. They need to agree to delegation'. (FUND)

> ‘You’ve got to bring your Board and [Investment] Committee along … you just need to convince yourself and your Committee that the right strategy is there, and we’ve got the guys that can execute … To give them comfort, we get auditors to come through and check regularly. I’ve always had our own internal compliance group. We’ve got a Chief Risk Officer … We had to go through a process of getting a full-on review from the asset consultant to review the strategy’. (FUND)

> ‘It’s transparency … No surprises, keep them informed’. (FUND)

Eleven participants explicitly refer to difficulties associated with *managing in-house teams*, mainly due to absorption of management time and potential distraction to the broader business. Seven participants mention the importance of establishing a clear structure of *delegations*.

5.2.3. Behavioural

The dominant *behavioural* concern is potential for *culture clashes*, which is mentioned by 19 participants[18] and relates to ***alignment***. Underlying issues include that fund management cultures differ to those traditionally associated with superannuation funds, and problems associated with bringing investment managers into the organisation:

> ‘There is a huge difference in the culture between an out-sourced trustee model and a funds management model’. (FUND)

> ‘The cultural challenges are huge … [the implications of] introducing an exotic species into your organisation shouldn’t be underestimated’. (ADVISER)

Perceptions differ about the precise nature of potential cultural problems. Ten refer to remuneration differences as the main point of tension, with six linking this to jealousy:

> ‘There’s an issue that for some Boards, paying someone half a million dollars is a big deal, especially when your culture is low cost’. (FUND)

> ‘If you want to attract a good portfolio manager to an organisation, you probably have to pay them more than you’re paying the CEO. What does that do to the culture of the organisation? People are going to be jealous, etcetera, etcetera’. (ADVISER)

Seven participants focus on the scope for disharmony, typically noting the tendency for investment managers to have large egos and a sense of entitlement:

[18] One participant admitted to being initially concerned about cultural issues, but then found that they proved not to be a problem due to employing staff that are culturally aligned.

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> '… very different cultures in terms of investment teams … There's some big egos in investment teams, there's no doubt about that, and managing those relationships for the CEOs and the executive is not a simple thing to do'. (ADVISER)

> '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 then you also don't want that arrogance to be overflowing, and having them think that the superannuation fund is there to support their investment activity. … I can't have a culture of [the investment team] being different… It's got to be a consistent business … you're constantly kind of playing whack-a-mole'. (FUND)

Seven participants refer to differing cultures potentially disrupting business operations, largely by creating silos or undermining cooperation:

> 'Not-for-profits have always had a really strong, good culture, very collaborative, work closely together. As funds get larger, there's no doubt that becomes harder. What we are seeing for those funds that have internalised, it's almost a bit of an us-and-them type culture between those internal investment teams, and your product and compliance teams. It's not a collaborative working environment as much as it used to be. So I think bedding down that culture is difficult and will be a challenge'. (ADVISER)

One question that arises is whether the trend to managing in-house entails an element of hubris or overconfidence, which may leave some funds, or even the superannuation industry, exposed. The evidence is mixed. Participants made few statements revealing any clear evidence of unbridled hubris or overconfidence. Rather, the prevailing tone was one of caution. A large majority of participants described a measured and incremental approach to in-house management, with the need to convince a sceptical Board often mentioned as a restraining influence. The following quote is representative:

> 'Very much organic … logical and incremental … when we actually put up a proposal to introduce a new strategy … the Investment Committee is going to see it as a logical extension of what we are doing'. (FUND)

This caution appears partly related to in-house management being relatively new and unfamiliar to many funds. The possibility exists that wariness might be replaced by hubris at a later stage. Five participants referred to *behavioural pitfalls of success*, including potential for overconfidence, overextending (empire building) and complacency to develop. One participant observes how their own Board had shifted from being wary initially, to pushing the management team to move more aggressively:

> 'At the time, (the Board) were very reluctant because they saw it as being a quite aggressive strategy, and should super funds really be doing this, and couldn't see anybody out there trying to do this sort of stuff. … Now I find myself five years later defending the fact that we're not trying to conquer the world'. (FUND)

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Whether overconfidence develops may depend on initial success. On the converse side, four participants raise issues related to *commitment upon underperformance*, with two alluding to testing of organisational commitment, and two focusing on how commitment may inhibit taking action.

5.2.4. Systems and processes

Fifteen participants (75%) refer to the importance of establishing good *systems and processes* to support in-house management. Aspects include capacity to undertake and settle trades; portfolio and risk management systems; reporting systems; and compliance protocols. Nevertheless, there is stark disagreement on how difficult it is to set up those systems, and how much operational risk is involved. At one extreme is the view that the challenges are meaningful:

> 'Risk around internal management is obviously significantly higher, in our view ... We think it's significant to be honest with you ... you effectively wear the cost internally if your trade goes the wrong way'. (ADVISER)

At the polar extreme are those who consider the establishment of reliable systems as relatively straightforward, on the basis that the required knowledge and capabilities are readily available. This group of participants is dismissive of operational risk as a major issue:

> 'You need to get it right, but you can get people to really help you on that'. (ADVISER)

> 'My view is if I can put the systems in place, and 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. I've got a good middle-office guy. ... All I have to do is convince myself that I'm going to get people that are suitably qualified to do this in-house'. (FUND)

We count seven participants who discuss systems and process as a significant challenge, and four that are largely dismissive of any significant issues. Most of those sitting in-between appear to consider systems as an important but manageable issue.

5.2.5. Other challenges

Of the other challenges, *exposure to errors* receives 11 mentions. This refers to a fund bearing the full cost of any errors, including loss of the ability to recover the cost of operational errors from external managers (seven mentions), or to pass off blame to the manager (six mentions). The notion that *set-up costs are substantial* receives seven mentions, with some referring to a 3-year payoff. Six participants refer to potential intellectual property problems with external managers, although eight did not see any significant issues. Four participants

Table 7
Aspects identified and the four elements

Governance • Board – supportive; clear reasons; realistic expectations • Responsibilities; accountability; delegations • Staff management: evaluation; retention; termination; capture • Risk identification and management • Decision processes		*Structures* • Dedicated internal manager • Hybrid: internal & external managers • Co-investments • Partnerships
Return Impact *Capabilities*	*Costs*	*Alignment*

• Competitive advantage
• Access to skilled staff
• Scalability
• Ability to capture opportunities
  • Access to assets/markets
  • Flexibility/agility
	• Management expenses
	  • Economies of scale
	  • Fixed vs. variable cost (manager fee scales)
	• Establishment costs
	• Diversion of resources
		• Tailoring to goals or objectives
		  • Control and transparency
		  • Liability-driven investing
		  • Liquidity management
		  • Long-term investing
		  • ESG/SRI principles
		  • Tax efficiency

• ESG/SRI engagement
• Market insights
  • Access to information & skill
  • Better manager oversight
	• Management time
	• Distraction to business
	• Ancillary exposures
		• Investment team
		  • Cultural alignment
		  • Incentives and motivations
		  • Team objectives and benchmarks

(continued)

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Table 7 (continued)

• Systems and resources	• Exposure to errors	• Organisational culture
	• Reputational risk	
• Implementation/dealing		• Shared beliefs and purpose
• Portfolio management		• Tension: investment/other staff
• Risk management		
• Tax management		• Board commitment
		• Other behavioural issues
		• Handling success: overconfidence, overextending, complacency
		• Dealing with underperformance

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mention the risk that funds might get ‘captured’ by their in-house teams, although this is counterbalanced by those arguing this is avoidable through appropriate structuring, for example ensuring an external option exists. Minor mentions include the *loss of flexibility* to change the overall strategy and *loss of insights from managers*.

6. Aspects identified and the four elements

Table 7 maps the aspects identified during the analysis to the four elements of ***costs***, ***capabilities***, ***alignment*** and ***governance***. The aspects listed reflect those appearing in Table 4 (success factors), Table 5 (benefits) and Table 6 (challenges). Table 7 thus summarises by collecting the aspects considered by our participants in addressing in-house management, and relating them to the four elements.

7. Conclusion

We draw on interviews with executives from the Australian superannuation fund industry, providing insights into how they approach and view decisions to manage assets in-house. We find that decision frameworks, as well as the perceived benefits and challenges, can be understood in terms of four key elements: ***costs***, ***capabilities***, ***alignment*** and ***governance***. Nevertheless, considerable diversity exists in the weight placed on each element, and the aspects that are emphasised when evaluating the case for managing in-house. Further, we encounter many contrary arguments that the importance of particular aspects is overstated or misinterpreted. In summary, little consistency emerges in how decisions to manage assets in-house are made, what aspects receive the most attention, and how decisions are implemented.

Our research indicates that existing theories of in-sourcing versus outsourcing fall short in providing a complete description of how asset owners approach the choice between managing assets in-house versus using external investment managers. In part, this seems due to the importance placed on governance considerations, which can be viewed in ways that do not always gel with existing theories. However, the prediction that the preference for in-sourcing will vary considerably across organisations is strongly supported by our analysis.

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