THE

Frontier Line

Thought leadership and insights from Frontier Advisors

Issue 114 March 2016

Navigating the Insourcing Trend

The challenges,
benefits and considerations
in moving asset management in-house

FRONTIER
ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $250B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

AUTHOR

Kerrie Williams

Kerrie is Head of Practice at Frontier and has responsibility for a range of business related areas. She is also a member of the governance team and leads the Partners Platform, Frontier's online suite of research and analytical tools. Kerrie's prior experience as a Senior Consultant within the firm saw her managing advisory relationships with a number of clients.

Kerrie holds an MBA, Bachelor of Science and a Graduate Diploma in Applied Finance and Investment. She is a Fellow of Finsia and a Member of the AICD.

AUTHOR

Sarah Cornelius

Sarah is an Analyst at Frontier. As a member of Frontier's governance team, Sarah monitors and reviews regulatory issues, undertakes research, and provides governance and risk advice and support to clients. Sarah also provides general analytical support to a number of clients and oversees liaison with our Global International Research Alliance (GIRA) partners.

Sarah joined Frontier in 2010. She holds a Bachelor of Commerce (Commercial Law) and is currently undertaking a Masters of Applied Finance.

Navigating the Insourcing Trend

Insourcing by institutional asset owners is receiving more and more industry and media attention. In an increasingly competitive environment for superannuation funds in particular, the growing focus on cost reduction and strategies for differentiation mean insourcing has some appeal.

Insourcing has the potential to reduce costs, increase control by the fund and, through this, seeks to provide a better overall outcome for fund members or beneficiaries. It sounds like the obvious next step, particularly for funds with scale. However, there are a range of considerations that require careful thought, including whether your fund has, or can develop, the right team, culture, risk systems and technology to implement, manage and support such a significant change. Much of this report is relevant to the running of a superannuation fund but, at the same time, many of the issues raised are also applicable within a broader investment environment.

Insourcing can be broadly defined and may include insourcing a variety of business functions, such as asset management, accounting, general and member administration, member advice, data management, IT and software platforms, marketing and legal support. However, typically when there is reference to fund "insourcing", the reference is to insourcing asset management by building the internal capabilities required to manage the fund's assets directly, rather than through an external asset manager. This paper focuses on this latter definition of insourcing and the pros and cons of insourcing asset management.

We have observed a number of investors both domestically and globally have insourced, to varying degrees, some component of their asset management function. While the reduction in investment costs some funds are experiencing as a result of lower external asset management fees is one indicator of success, the impact of insourcing will be felt much more broadly and should be considered in this context, specifically the net investment outcome after an appropriate period of review.

We think there are a number of aspects that warrant careful thought, both for funds who are considering moving some proportion of asset management in-house for the first time and also for funds who have already begun the process but may wish to expand the use of insourcing.

Why insource?

Research has shown the high cost of external asset management coupled with poorly aligned performance-based fees are the most commonly cited drivers of the increasing level of internal asset management.

There are however a number of additional drivers cited by fund executives globally, which include the general misalignment of interests between the fund and the external asset managers, capacity issues with external managers for large mandates or in small markets, increased agency risk, lack of transparency, disappointing returns, inability to sufficiently leverage economies of scale to reduce costs, and the desire to support a stronger connection with members and the philosophy of the fund.

"Much of the debate about principal-agency risks has focused on the behaviour of agents – their misaligned incentives, their misrepresentation and graft, their focus on short-term profits at the expense of systemic sustainability, their greed….agents can really only get away with egregious behaviours if principals allow them to."[1]

Ross Barry

On the issue of costs, research by CEM Benchmarking[2] found that for every 10% increase in internal asset management, there is an increase of 0.041% in net value added, for which *"the reason is almost entirely due to the lower cost of internal asset management".* Interestingly, the research also showed there was no significant difference in gross value-added performance between internal and external management at the asset class level. While large investors with tiered management fee structures in place should theoretically benefit from economies of scale when employing external fund managers, we observe the fee benefit is often capped so that investing additional funds above a certain threshold does not always result in any cost benefit to the fund.

Apart from the more obvious potential benefit of cost reductions from reducing external asset management, research suggests managing assets internally can provide the fund with more control by enabling a quicker response to market movements, providing more transparency around what the fund is investing in and greater influence over an invested company on governance issues as a large shareholder, which may be of particular importance to funds who have a heightened focus on environmental, social and governance issues. In other instances, funds simply cannot get the capacity they require with a fund manager, due to the increased business risk the external asset manager would take on should a large investor represent too high a proportion of their business, or if the manager's product is genuinely capacity constrained. Mark Delaney, Chief Investment Officer of AustralianSuper, has stated[3] that *"you cannot get sufficient size with quality managers, which tells you there is excess demand for quality management services in the current marketplace."* Internal asset management is one way to avoid these potential capacity constraints but requires the development of quality asset management services on an internal basis.

As the Australian superannuation industry continues to grow, there will be winners and losers in the superannuation fund space and some funds will experience strong growth in their assets, while others will experience declines. Even as the landscape changes, market commentators predict more and more superannuation funds will likely transition to asset owners rather than investors. Thinking and acting like an asset owner rather than an investor can enable funds to take a differentiated approach to investing, which could be particularly useful for taking into account any fund specific issues or to enhance a fund's brand. This may be increasingly important in both a competitive environment and an environment of lower and slower economic growth, where brand and fees may dominate in the minds of consumers.

Taking a look across the seas

Market research shows that most international pension funds still engage external asset managers to capitalise on the benefits they can offer, such as providing broader insights into global markets and access to niche strategies to which the fund may not otherwise be able to gain exposure. However, a number of the largest international pension and sovereign wealth funds now insource the majority of their asset management functions.

The Institutional Investor's Sovereign Wealth Center reported in September 2013[4] that the top ten largest sovereign wealth funds managed, on average, 62% of their assets internally. Also in 2013, the Pensions & Investments annual survey[5] stated that 26% of the 200 largest defined benefit plans in the US managed some portion of assets internally.

It is interesting to consider some specific examples of large international funds that have embraced insourcing. Chris Ailman, Chief Investment Officer of CalSTRS, commented in 2015[6], *"we have the ability to manage money internally at one tenth of the cost and with more control, so we are constantly looking at it. We've looked at our global peers with more than $200 billion, and they have 58 per cent of assets internally."* To support insourcing, CalSTRS currently has 117 investment staff operating across a range of sectors including private equity, global equity, fixed income and real estate. Across the Atlantic in the UK, we have observed a similar trend, with a number of funds insourcing to varying degrees.

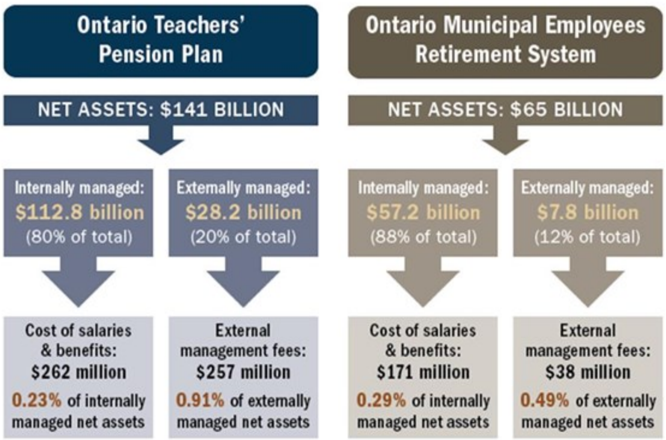
These funds include the Railway Pension Scheme, Tesco Pension Scheme, Pension Protection Fund London, and the recently merged Lancashire County Pension Fund and London Pensions Fund Authority.

While the tendency to insource as pension fund portfolios have grown is evident, many of the large international funds have seen the need to create a hybrid asset management model by combining internal investment expertise with stronger partnerships with external asset managers. We think this is a practical approach to reduce the operational risk of relying solely on an internal team. The Canada Pension Plan Investment Board (CPPIB) is an example of a large, complex pension fund that currently adopts this hybrid asset management model, noting that it will continue to use both internal and external asset management as part of its overall investment strategy. CPPIB currently manages C$282.6 billion in investment assets[7], 64% of which are managed in-house, and has around 400 investment personnel[8] across three investment groups, being public markets, private equity and real estate.

Indeed, Canada is often viewed as the front runner on the global insourcing trend, with most of its largest pension funds now managing a majority of fund assets internally, with two Toronto based pension funds[9] having more than 80% of internally managed assets (Ontario Teachers' Pension Plan (OTPP) at 80% and Ontario Municipal Employees' Retirement System (OMERS) at 88%).

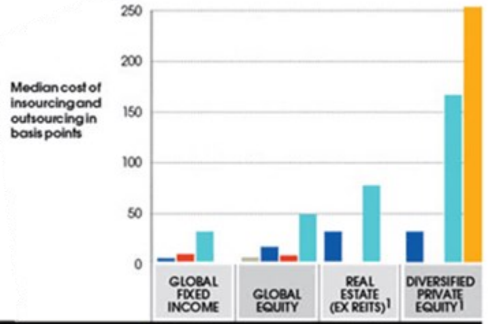
Analysis by Global Governance Advisors in 2015 (Figure 1), highlights that the cost reduction benefit of insourcing is clear for both the Ontario Teachers' Pension Plan and Ontario Municipal Employees Retirement System. While a more extensive study of over 300 pension, endowment and sovereign wealth funds by CEM Benchmarking (Figure 2) shows similar benefits even with staffing and associated costs taken into account.

Figure 1



Source: Global Governance Advisors 2015

Figure 2



	GLOBAL FIXED INCOME	GLOBAL EQUITY	REAL ESTATE (EX REITS)[1]	DIVERSIFIED PRIVATE EQUITY[1]
Internal Passive	–	5.1	–	–
Internal Active	3.1	14.8	29.8	30.0
External Passive[2]	8.0	6.3	–	–
External Active[2]	31.2	47.6	75.5	165.0
Fund-of-Fund[2]	–	–	–	251.9

Data as at 31 December 2012 Source: CEM Benchmarking.

[1] Cost as a percentage of fees in basis points.

[2] Costs include internal oversight on externally managed assets.

Internal investment teams being supported by appropriate investment data management and analytics technology, either internally or via an external provider, has also been an important component of the reported insourcing success experienced by Canadian and US pension funds to date. It is reported that the ten largest Canadian funds have managed to lower annual total fund asset management costs to approximately 0.40%, with OTPP reportedly reducing its total costs, including all investment costs, to 0.28%.

By comparison, one of Australia's largest funds, AustralianSuper, has stated publicly that it is targeting to have between 35-40% of its assets managed internally by 2018 and lowering its total fund asset management costs by 0.15% to 0.45%, a predicted saving of A$150 million per year for its members.

We observe that funds starting an insourcing program often do so in areas such as cash, fixed interest and domestic equities (often passively managed to begin with), where there is less complexity. However, some of the large and more established international funds have instead opted to focus on asset classes where they believe they can generate the most significant cost savings and insourced asset classes requiring more specialised knowledge such as private equity, infrastructure and property. Table 1 provides an overview of the insourcing approach adopted by a number of large international funds, including asset class coverage.

Table 1: What are international funds doing?

	Norges Bank Investment Management (NBIM) (Norway)*	Ontario Teachers Pension Plan (OTPP) (Canada)*	California Public Employees' Retirement System (CalPERS)*	California State Teachers' Retirement System (CalSTRS)*	Canada Pension Plan Investment Board (CPPIB)*	GIC Singapore*
Fund size	**DKK$7,019b** **~A$1.45b**	**C$154.4b** **~A$155.9b**	**US$301b** **~A$405.2b**	**US$191.4b** **~A$257.7b**	**C$282.6b** **~A$285.3b**	**Not disclosed,** **estimated to be A$279b[10]**
Investment staff	**~195**	**Not disclosed**	**Not disclosed**	**~117**	**~400**	**Not disclosed**
Types of investments managed by internal teams	Broad application across the portfolio, with the exception of emerging markets and small cap primarily	• Private Equity • Venture Capital Funds • Real Assets (Real Estate and Infrastructure) • Absolute Return/ Hedge Funds • Renewable Energy • Opportunistic Alternatives	• Global Equities • Fixed Income • Liquidity • Inflation Strategies • Private Equity • Real Estate	• US Equities • Global Equities • Fixed Income • Alternatives (Private Equity and Real Estate)	• US Equities • Global Equities • Government Bonds • Private Debt • Real Estate • Infrastructure	• Equities • Fixed Income • Real Estate • Private Equity • Infrastructure
Total portfolio internally managed	~95.9%*	~80%*	~69%*	*~45% (with plans to increase to 60%)**	~64%*	~80%*

* Based on information supplied in the Fund's annual report

Despite a noticeable trend offshore that as fund size increased so did the amount of internal asset management, there were some exceptions to this rule. In some cases, the large funds who do not insource asset management are prohibited from or limited in doing so by their governing rules or legislation. Australia's own Future Fund, for example, is required under legislation to use external managers for all investment activity[11].

Other funds may not have the structural ability to insource to the degree they prefer, just because they have scale.

CIC, China's US$575 billion sovereign wealth fund, reported in 2012 that it had reduced internal asset management of foreign investments from 43% to 36%. The reason behind this decision was, despite the aspiration by CIC to develop its internal asset management capabilities, during the first six months of 2012, CIC lost eight senior employees. With fewer internal resources, the fund was forced to engage external asset managers. As at 31 December 2014, CIC managed only 32.3% of its total portfolio of assets internally.

What's happening on our own shores?

In Australia, research shows the insourcing trend has developed relatively slowly but has been accelerating in recent years.

In 2015, APRA reported[12] 36% of total superannuation assets were directly held by Registrable Superannuation Entities (RSE's) it regulated in Australia, up from a reported 28.5% of directly held investments in 2010[13]. However, we note that there are some definitional constraints with APRA's reporting of "directly held" and these figures include individually managed mandates. However, in our view, the increase in directly held assets indicates funds taking a more active and controlled approach with the assets they invest in. Reducing costs is again cited as the most common driver of the insourcing decision but strategic benefits that come with managing assets in-house are also a factor.

A number of large Australian superannuation funds have built internal investment teams, with many of these now managing domestic equities in-house, including AustralianSuper, Equipsuper, REST, Telstra Super, UniSuper and QSuper. REST has a team of 30 investing actively in Australian equities, with the strategic need to address capacity issues being the primary driver according to Damian Hill, REST's Chief Executive[14], rather than the reduction in investment management fees. Other asset classes that are insourced are outlined in Table 2, which also shows large Australian funds typically have less than half of total fund assets managed internally in contrast to their international counterparts.

Table 2: What are Australian funds doing?

	AustralianSuper*	QSuper*	UniSuper*	REST*	Sunsuper*	Telstra Super*	MTAA*
Fund size	**A$99.5b**	**A$59b**	**A$49.2b**	**A$37b**	**A$33.5b**	**A$17b**	**A$8.6b**
Investment staff	**~115**	**~20**	**Not disclosed**	**~30**	**~25**	**Not disclosed**	**Not disclosed**
Types of investments managed by internal teams	• Australian Equities • Capital Guaranteed • Currency Overlays • Fixed Interest • Infrastructure • International Equities • Private Equity • Property	• Cash • Global Fixed Interest • Real Estate • Infrastructure • Alternatives • Private Equity	• Australian Equities • Global Equities • Listed Property • Fixed Interest • Cash • Infrastructure	• Australian Equities • Bonds • Cash • Growth Alternatives • Infrastructure • Property	• Infrastructure • Fixed Interest • Cash	• Property • Australian Fixed Interest • Infrastructure • Cash • Currency Overlay • Asset Allocation Overlays • Private Equity	• Infrastructure • Private Equity • Property
Total portfolio internally managed	~19.0%*	Not disclosed	~47.6%*	~16.4%*	~5.9%	~30%*	~18.6%*

* Based on information supplied in the Fund's annual report

Issues to consider

"Never test the depth of the river with both the feet"

Warren Buffet

Figure 3: Potential positive and negative insourcing outcomes

Positive	Negative
• Potential for lower costs, due to reduced external asset management fees • More control over investments • Reduced agency risk • Fewer external manager relationships allow the fund to monitor more closely • Greater alignment with internal fund philosophy • Greater ability to tailor the portfolio to achieve the fund's objectives • Greater alignment with members	• Challenge to attract and retain high quality investment staff in the competitive financial sector and implications for organisational culture • Higher operating costs due to an increased number of staff and associated infrastructure • Significant set-up cost of systems to support the internal investment team • Increased operational risk as the fund shifts more towards being an "asset owner" • More governance and risk management oversight and resources required • External asset managers may be less willing to share market intelligence as internal teams "compete" • Implications of an underperforming internal investment and/or investment team

Insourcing is a complex matter, with a number of issues and challenges to be considered.

Governance

An essential element for effective internal asset management is a strong governance framework. The structure and composition of the Board will generally dictate how the investment governance framework is configured to meet business objectives and governance obligations. Bringing asset management in-house adds further complexity and ensuring all involved have clarity about their delegations and authority is critical.

Legislation in Australia has not yet caught up with the rapidly developing insourcing trend, which is something for superannuation funds in particular to bear in mind. In Australia, although there are standards of recommended governance practices there are no legislated governance standards for managing assets internally. In 2013, APRA noted its concern that *"most Australian (superannuation) funds don't have the required scale or expertise to effectively undertake in-house asset management"*[15], warning Trustees to take a very measured approach, address all of the risks and issues involved and not to solely focus on the potential cost reduction.

The Board is ultimately responsible for the sound and prudent management of the fund irrespective of the fund type and cannot abrogate its responsibility for any functions it delegates to management. However, appropriate delegation of specific decision making components is an important part of the efficient running of a fund as long as all processes and policies are appropriately documented to ensure the correct process is consistently followed.

There is a big difference in the level of governance required when selecting external investment managers compared to running internal investment strategies. The introduction of a sub-committee for oversight of the investment team that is completely independent to the investment team, yet still contains adequate investment knowledge is recommended. We recommend an independent risk management sub-committee be established to provide oversight and ensure that the risks taken by the internal investment team are consistent with the overall risk appetite of the fund.

The internal investment team should also be monitored as an external asset manager would, using the same performance benchmarks and being reviewed periodically by an independent third party. The method of assessment and expectations of the internal team should be set prior to its establishment, including rules and processes to identify when an underperforming internal strategy needs to be addressed, including the ultimate decision to terminate the arrangement.

People

Perhaps the most critical issue to consider when insourcing is the appointment of investment personnel and the implications of this for the culture of the organisation.

This includes the ability to recruit and retain skilled investment staff, particularly when competing with external managers and other organisations for talent. Fund reporting shows the remuneration structure in Australia is very different to that of large external asset managers both domestically and overseas. It also differs significantly from many global pension funds.

Australian superannuation funds report a range of different remuneration structures[16], including benchmarking against industry standards for base salaries using databases such as the Financial Industry Remuneration Group which measures against similar funds. Some also use key performance indicators for incentive payments, relating to absolute and/or relative fund performance and individual contribution. There are also funds who have noted their objection to incentives linked to fund performance, in particular, short-term performance based incentives. Some funds link an individual's performance to key business targets, such as meeting business strategy objectives, adherence to internal processes, demonstrating appropriate risk behaviour, and alignment with the fund's culture, including transparency, demonstrating corporate standards and values, and participation in corporate initiatives. It is important for compensation and governance structures to align in order to reduce excessive risk taking and keep individuals accountable for their behaviour, both good and bad.

Of course, introducing changes to remuneration structures in order to compete with other financial institutions requires careful thought to ensure there is alignment with the fund's longer term objectives and consideration of broader cultural change that may result. This has the potential to be particularly challenging for funds with an all profit to members philosophy. Managing assets will often require a different mindset to that typically seen in a fund's existing staff, so how the two are integrated in the most effective way to deliver positive outcomes will require planning and strong management. Non-financial incentives, clear goals and purpose, a positive and flexible work environment and opportunities for contribution, professional development and progression are additional levers that can all play a part in attracting and retaining talent. Getting the balance right, whatever that may be, will enable internal teams to have a stronger alignment to the fund's philosophy than external managers have. This has the potential to be quite powerful.

The set up costs and infrastructure requirements involved with insourcing can be significant (including recruitment, IT, trading and back office functions), while the ongoing operational costs (salaries for the investment team and support staff, training and management) are also substantial. It has been estimated that on average, six front-office investment staff are needed for every US$10 billion of internally managed assets[17]. We have observed internal team sizes ranging from 20-400 people, depending on the amount of assets under management. Funds need to be mindful any real benefit may not be seen for a number of years in some cases, so patience is required. Management, operational and legal personnel who can manage the change and maintain a focus on the fund's objectives and philosophy are considered critical, as is ongoing and transparent communication with employees.

Managing key person risk and succession planning are also important considerations with insourcing. Under Prudential Practice Guide CPG 233 Pandemic Planning (which requires formal business continuity planning and its formal incorporation into strategic and business plans), is a mandated requirement for all APRA regulated superannuation funds to identify key personnel and develop an explicit succession plan that includes clear oversight and reporting procedures and the cross-training of key operational roles that are critical to ensure the continuity of the fund. As a best practice approach, funds should consider these issues with investment personnel to ensure that inadequate oversight of staff or staff absences or departures do not place the fund at risk.

Organisational structure

Before introducing or increasing the level of internal asset management, it is essential to consider the organisational structure to ensure it is fit for purpose for both the size of the fund and the anticipated degree of insourcing. Business functions such as compliance, business continuity, internal controls and ethics should also receive more attention as the fund insources its asset management. Operational independence between asset management and investment implementation is important and is observed at large funds who already have large internal teams in operation.

Larger internal capabilities can allow the Board to concentrate on its high level role of establishing and overseeing the fund's mission, goals, values and beliefs. The CIO and executive team can then focus on strategic investment decisions, with oversight provided by the Board and/or Investment Committee. Establishing a clear framework of responsibilities and accountabilities is critical, while flexibility and agility in decision making within this framework to adjust for unexpected internal and/or external changes is beneficial and one way to capitalise on an insourcing approach. It is important to have appropriate segregation of duties between the internal investment team and those who oversee the appointment and monitoring of external asset managers. One of the most important reasons to have segregation between the internal investment team and external asset managers is to maintain the confidentiality of the external managers' intellectual property, such as their portfolio positioning.

Under Prudential Standard SPS 521 Conflicts of Interest, it is a mandated requirement for all APRA regulated superannuation funds to have a clear policy for how the fund identifies, assesses, mitigates, manages and monitors potential and actual conflicts of interest. Separate investment committees at the fund level and at the internal investment team level help to address the potential risk of conflicts of interest, and membership should include those with an understanding of the issues and challenges in managing money. This is a best practice approach and critical for any institutional investor.

Behavioural biases in decision making

As with all decision making bodies, internal investment teams have the potential to exhibit behavioural biases such as groupthink, which can result in less robust decision making. We think it is important for the Board and senior management to actively manage this by being aware of the risks, testing whether biases are evident, encouraging a range of different ideas and approaches, and ensuring diversity in personnel. Strategies that can help to combat typical behavioural biases include employing a rotating internal committee member structure, encouraging contrarian views, embracing regular self and external assessment, and being clear about and properly managing any conflicts of interest.

Access to broader industry/market views

One of the perceived weaknesses of a fund increasing its internal asset management is that industry relationships may be compromised or lost, cutting off the possibility of access to particular investments or ideas in the future. Reducing the number of external asset managers can however result in fewer but stronger relationships if this is still considered desirable. The ability to create more dynamic partnerships can be achieved through co-investments and other strategic partnerships so as to not "lose" the industry and market views that might otherwise have come with using external asset managers as a key source of investment ideas.

Risk management

Risk management oversight and controls are critical and will have implications for governance structures, staffing and technology requirements. Risk management in the context of managing assets is significantly different to risk management as an investor. For superannuation funds, under Prudential Standard SPS 220 Risk Management, the fund needs to identify what risks need to be monitored using risk management tools such as stress testing and scenario analysis, with limits set based on a risk factor framework that specifies the fund's tolerance for each of the risks and consideration of which asset classes may be impacted as a result. This is a prudent approach for any institutional investor. Operational risk considerations include monitoring the adherence to internal guidelines, limits, procedures and policies, as well as maintaining data and technology security and integrity. Risk management should be supported by the availability of appropriate data and analytics and consideration will need to be given to what is required in this regard. It is expected funds use a combination of both quantitative and qualitative measures when making risk assessments.

Monitoring performance outcomes is also important, and, as noted earlier, thought should be given in advance to how a failure to meet objectives, particularly if persistent, will be addressed. Terminating an internal team when it underperforms is a lot harder than terminating an underperforming external fund manager, particularly when sunk costs incurred in establishing that capability are factored in, let alone the impact on the organisational culture. Decisions to reduce or remove an allocation to an asset class may also have implications for internal investment teams, but it is important this does not become the driver of asset allocation decisions.

Approach

“Invest a few moments in thinking. It will pay good interest.”

Unknown

We have observed a range of different approaches within the industry in relation to insourcing. Some funds have established a separate entity to manage the fund’s assets, whilst others manage assets within the fund and employ staff alongside existing fund staff. Some funds use a combination of the two approaches. Funds who have a smaller proportion of internally managed assets may decide to establish or build on an existing internal investment team as well as engaging with specialist external asset managers in areas where they do not have, or cannot add, the appropriate level of skill and expertise. Research indicates most funds, regardless of their size, will however maintain some level of external asset management.

We think it is good practice, as the fund brings more control (and risk) in-house, that regular independent reviews of the internal investment team are conducted by an appropriately qualified firm.

Setting up a separate business entity to manage the investments can have mixed outcomes and ultimately, it will depend on the end result the fund wants to achieve as to whether this is a suitable option. By establishing a separate entity, the fund can confine any cultural issues that may arise due to the different remuneration and organisational structures to that entity. In the longer term, it is also possible that the entity is successful in its own right and can take on external clients at more traditional money management fees and this can be a profitable outcome for the fund as an owner of that business. However, having a separate business also has the potential to negate some of the benefits that can accrue to insourcing such as the benefit of alignment of interest, a reduction in flexibility and in the ability to apply cross-asset class team solutions to problems. It also has the potential to cause cultural disconnect and can introduce added agency risk. The investment management business may start to lose touch with its parent company (the fund), becoming less likely to collaborate and instead prioritise self-interest.

When insourcing, it is important funds should play to their individual strengths by internally managing assets in areas where it makes most sense to do so, either because the strategies are not overly complex or because the fund can readily appoint staff that have expertise in a particular area.

Initially focusing on one asset class where there is existing internal knowledge and skill is a good starting point. One approach may be to begin with passively managed strategies and evolve to managing active strategies as the structure and resources of the investment team evolve. However, this needs to be weighed up against the cost at which passive management can be accessed externally and the totality of the pros and cons.

In turn, funds should then delegate asset management in areas where specialist skills and expertise do not exist internally and cannot readily be obtained. Additionally, funds should consider the relationship with the external manager or provider and whether it adds value to the fund via excess returns, added diversification or some other form of benefit that cannot readily be duplicated.

Whether to insource the management of offshore assets is another important consideration, with the location of investment staff a potential factor in some asset classes or strategies. There is an added complexity in managing staff and maintaining a corporate culture when expanding an internal team across multiple offices and locations that will require careful planning and management.

In all cases, the goal should be to find the best way to meet the objectives of the beneficiaries for any specific investor or fund.

Under Prudential Standard SPS 530 Investment Governance, it is a requirement for all APRA-regulated superannuation funds to have clear investment objectives and a detailed plan of how they will achieve their investment objectives, including an investment policy that clearly establishes and documents the boundaries in which the internal investment team can operate, as well as clear oversight and reporting procedures. We believe this is also a best practice approach for any institutional investor.

The potential benefits of insourcing may outweigh the negative impacts for some funds. However, for other funds, if it is a focus on cost reductions that is driving the decision, alternatives to insourcing, such as co-investments, restructuring the asset allocation (e.g. excluding certain high-fee asset classes), and/or consolidating existing mandates may be preferred.

Framework

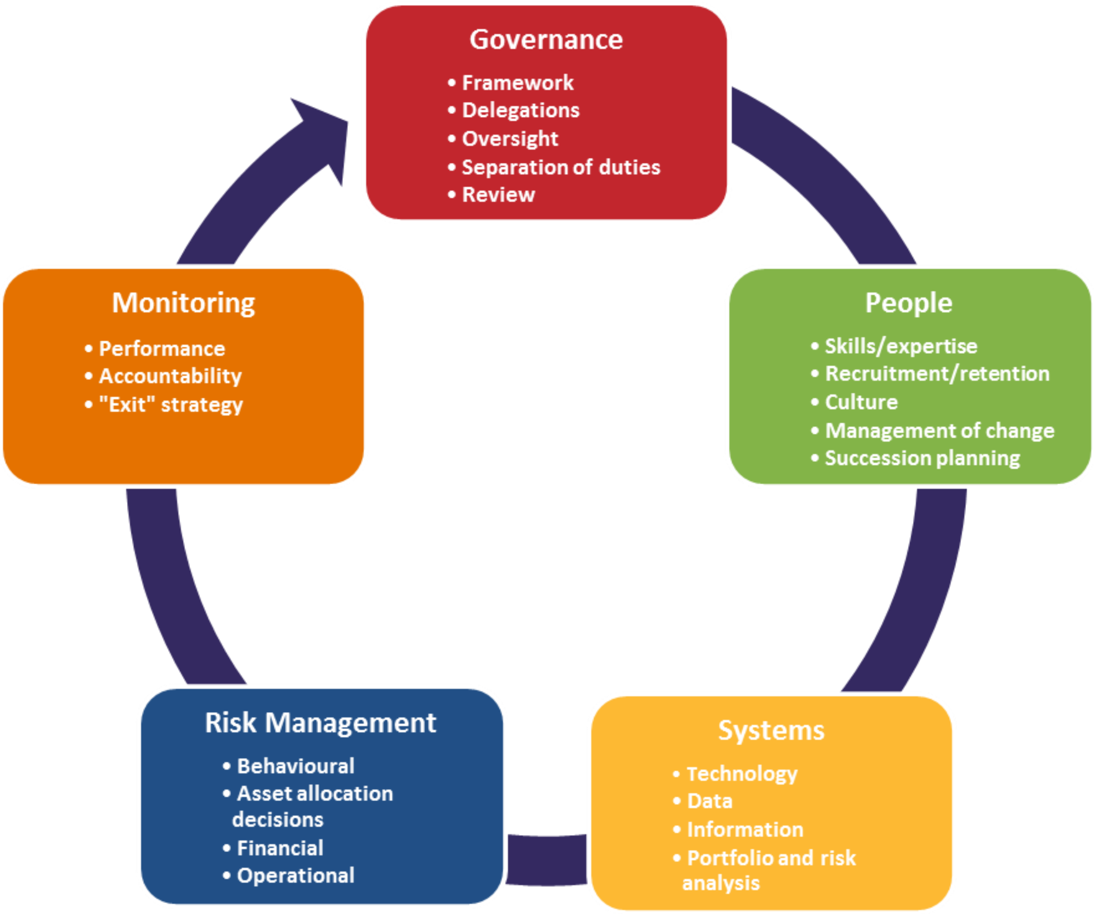
We do not believe there is one universal "best practice" approach. What works for one fund won't necessarily work for another fund, regardless of how similar they appear to be either by assets under management, internal staff or by variables like member demographics in the case of superannuation funds.

The strategy adopted for any investor needs to be developed on a bespoke basis and should consider the long-term projected outlook and objectives for the fund, particularly when deciding which assets to manage internally. A decision by a Board to manage assets internally is also a longer term business strategy that may take a number of years to show results, so needs to be carefully considered and the internal foundation to support it needs to be carefully crafted before any such change is implemented.

Developing interim and longer term milestones and measures for success should also be undertaken.

While we do not believe there is one universal "best practice", we do believe there are a number of items that need to be considered for each investor as part of thinking (a) whether to insource, (b) what to insource, and (c) how to insource. These are shown in Figure 4.

Figure 4: Insourcing considerations



The final word

The decision to insource part or all of a fund's asset management function should not be made with haste. It is not a decision that is a necessary step for funds that have reached a particular size, nor is it one that will always achieve a reduction in costs. It is a complex issue and one that needs to be carefully and thoroughly considered in relation to the objectives, size, business mix and complexity of the individual fund. Ultimately, there is no "one size fits all" approach to insourcing.

Insourcing asset management needs to be adequately supported by appropriate organisational structures, internal governance, people, culture, formally documented processes and policies and risk management and systems, in order to capitalise on its full potential. Recognition and consideration of the broad challenges and issues associated with insourcing is critical and funds should seek advice as needed when making this important decision.

While cost reductions can be achieved by insourcing if there are sufficient economies of scale, these can be easily eroded by the losses incurred by a poorly executed strategy. However, a considered and well executed insourcing approach has the potential to reduce costs, facilitate a stronger connection between the philosophy of the fund and the way it is invested, and help a fund improve net outcomes for its members and beneficiaries.

Sources:

1. Ross Barry (2015) "Crisis and Complexity: An inquiry into the nature and causes of economic and financial crisis"
2. Terrie Miller, Chris Flynn (October 2010) "Internal management does better after costs", CEM Insights
3. David Rowley (April 2015) "Mark Delaney's new frontier: CIO of the year finalist", Investment Magazine
4. Loch Anderson (September 2013) "Sovereign Wealth Funds Look For Inside Edge by Managing Money In-House", Institutional Investor Magazine
5. Christine Williamson (May 2013) "Insourcing trend growing among big institutional investors", Pensions and Investments online
6. Amanda White (December 2015) "We don't have to be friends", Fiduciary Investors Symposium Chicago, top1000funds.com
7. CPPIB Annual Report December 2015
8. State Street (2014) "Pension Funds DIY: A hands-on future for asset owners"
9. Christine Williamson (29 June 2015) "More pension funds ponder going in-house", Pensions and Investments online
10. Loch Anderson (September 2013) "Sovereign Wealth Funds Look For Inside Edge by Managing Money In-House", Institutional Investor Magazine
11. Future Fund Investment Model and Process, 2014
12. APRA Insight, Issue One 2015
13. APRA Insights, Issue One 2010
14. Sally Patten (January 2014) "REST Super starts internal equities team", The Australian Financial Review
15. Helen Rowley from APRA - November 2013
16. Dan Purves (February 2015) "Super Salary: Difference in Disclosure", Investment Magazine
17. Jody MacIntosh and Tom Scheibelhut (2012) "How Large Pension Funds Organize Themselves: Findings from a Unique 19-Fund Survey", Rotman International Journal of Pension Management

FRONTIER ADVISORS

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266