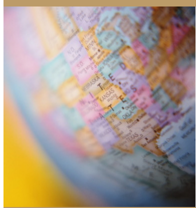

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INTERNAL VS. EXTERNAL MANAGEMENT FOR STATE AND LOCAL PENSION PLANS

*By Jean-Pierre Aubry and Kevin Wandrei**

Introduction

As the types of assets in which state and local pension plans invest has expanded, so have the number of external asset managers that plans use. However, due to concerns about fees and recent questions about the value of active management, some large public plans have begun to reevaluate the size of their external management teams. CalPERS, Wisconsin RS, and Nevada PERS are examples of large plans that have recently consolidated their external management team as part of an overall commitment to reduce investment fees, which cut into their after-fee returns.[1]

This *brief* documents the trends in the number of external asset managers used by public pension plans and examines the relationship between external management and fees. The aim is to assess how the recent commitment by some plans to rely on fewer external managers might impact investment performance going forward.

Trends in Internal Vs. External Asset Management

Before the 1980s, it was not uncommon for plans to manage a significant portion of their assets internally.[2] But, the shift in allocation toward equities and more complex investment strategies – along with some notable cases of mismanagement by in-house investors – encouraged a steady shift to external management during the 1980s and 1990s.

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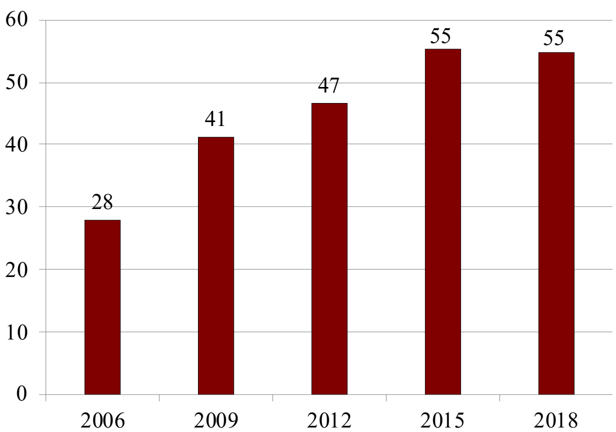
Tracking the number of external asset managers employed by public plans suggests that this growth continued in the 2000s. While average assets held by public plans increased by about 50 percent since 2006, the average size of their external management teams nearly doubled (see Figure 1).

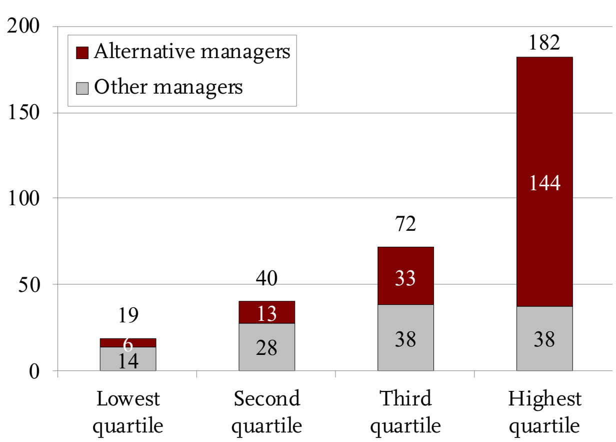
Figure 1. Average Number of External Asset Managers Used by Public Plans, 2006-2018



Sources: Plan CAFRs, Investment Reports, websites, and authors' email contacts.

This recent increase in external managers has coincided with steady growth in plan allocation to alternative investments, such as private equity and hedge funds. And, as shown in Figure 2, it seems this shift in asset allocation is driving the increase in external managers: the plans with the most external managers have a greater proportion of alternative asset managers.[3]

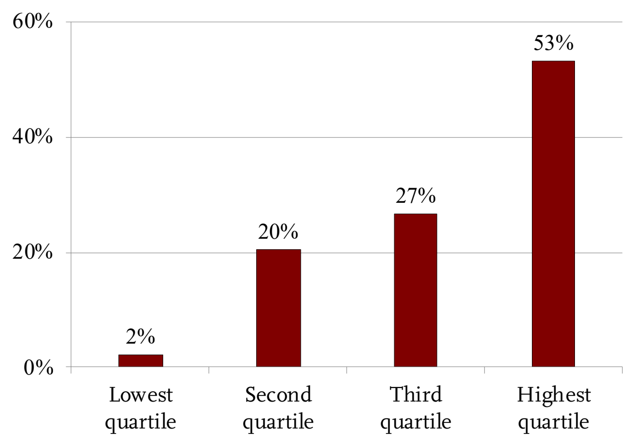
Figure 2. Total Number of External Managers, by Quartile of External Managers, 2018



Sources: Plan CAFRs, Investment Reports, websites, and authors' email contacts.

Although the general trend over time has been toward external management, it is important to note that some plans still continue to manage some assets in-house – mostly public equities and fixed income, because they can be managed passively more easily than alternative assets.[4] In the *Public Plans Database* (PPD), about one-quarter of plans were managing some assets internally in 2018.[5] Unsurprisingly, these plans tend to be larger (see Figure 3).

Figure 3. Share of Plans that Manage Some Assets Internally, by Quartile of Market Assets, 2018



Note: See endnote 6.
Sources: Plan CAFRs, Investment Reports, websites, and authors' email contacts.

Is the Number of Asset Managers Related to Plan Performance?

The main concern regarding external asset management is that the fees paid to these managers cut into after-fee returns. Indeed, prior research by the Center found that plans that paid higher fees experienced lower after-fee returns relative to their benchmarks, particularly for alternative asset classes such as private equity and hedge funds.[7]

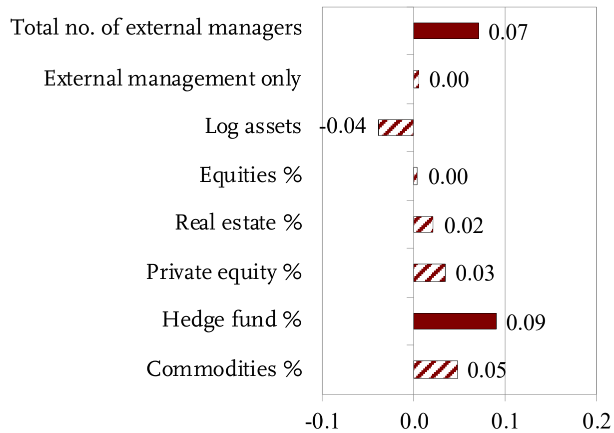
Prior studies of public and private pension plans in the United States and abroad have found a negative relationship between external management and investment performance – primarily due to the fees associated with external management.[8] While these studies have focused on the share of assets managed externally, the issue under investigation for this *brief* is whether the *number* of external asset managers impacts performance. This distinction is relevant because most plans today are considering whether to change their number of managers, rather than the percentage of assets managed externally.[9]

The analysis begins by investigating the assumption that the number of external asset managers is related to fees. For this purpose, the analysis relies on a linear regression in which the dependent variable is the plan's reported investment fee rate (total fees paid as a percentage of total pension assets) and the key independent variable is the number of external asset managers.[10] The regression also includes controls for plan size (total assets) and asset allocation (especially, the allocation to alternatives), and a variable meant to capture the extent of external asset management: whether the plan administrator indicates having a meaningful internal investing program. Together, these three control variables help ensure that the coefficient on the number of external asset managers captures only the relationship between the fee rate and the number of external asset managers – as opposed to the share of assets managed externally.

The results show that the relationship between the number of external managers and the fee rate is positive and statistically significant (see Figure 4). Specifically, a one-standard deviation difference in the number of external asset managers (roughly 65 managers) relates to a 7-basis-point difference in the fee rate (see Appendix for full results). Given that the standard deviation for the fee rate is about 28 basis points, the number of external asset managers explains roughly one-fourth of the variation in fees. Fees could be related to the number of asset managers for two reasons. First, using fewer asset managers translates to more assets under management for each manager, which may give managers an incentive to negotiate reduced fee rates. Second, using fewer asset managers may increase competition between them for the reduced asset management opportunities, which could also lower fee rates offered by managers.

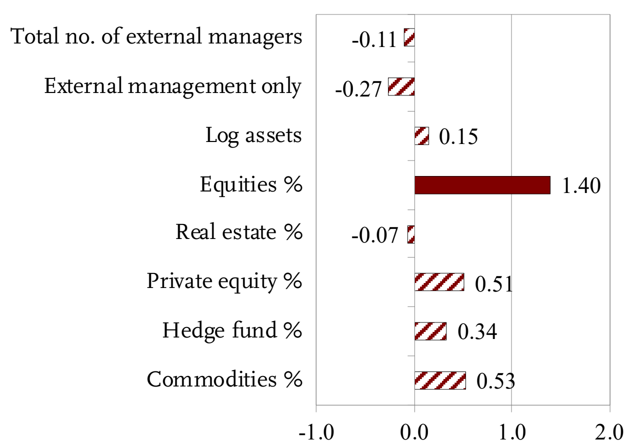
Having confirmed that the number of external managers is related to fees, the analysis employs a similar regression to test the relationship between the number of external managers and after-fee returns. The results of this second regression show that the relationship between the number of external managers and after-fee returns is not statistically significant (see Figure 5).[11] A possible reason for this result is that plans with fewer external managers miss out on some out-performing managers.

Figure 4. Effect of External Management on Investment Fee Rate, 2006-2018



Notes: Values represent the effect of a one-standard-deviation change. Solid bars are significant at the 5-percent level.
Sources: Authors' calculations using plan CAFRs, Investment Reports, websites, and authors' email contacts.

Figure 5. Effect of External Management on After-Fee Return, 2006-2018



Notes: See notes for Figure 4.
Sources: Authors' calculations using plan CAFRs, Investment Reports, websites, and authors' email contacts.

Conclusion

As the asset allocations of public pension plans have expanded to include alternative investments, so have the number of external asset managers used by the plans. In fact, the plans with the most external managers stand out primarily by having a higher proportion of these managers devoted to alternatives.

However, due to concerns about fees and recent questions about the value of active asset management, some large public plans have started to reevaluate the size of their external management team, with an eye to improving their after-fee returns.

This *brief* finds that their concerns about external managers do have some merit. A simple regression suggests that having more external managers is related to higher investment fees. However, a similar regression relating the number of external managers to after-fee returns found no relationship. Together, these findings suggest that public plans could reduce their fees by consolidating their external asset management team, but, in terms of after-fee returns, it matters which managers get cut.

Endnotes

1 Diamond (2019); Denmark (2016); and Martin (2016).

2 The 1978 Pension Task Force Report on Public Employee Retirement Systems states, "The frequent placement of plan asset management and investment authority in non-expert plan officials often produces investment policies and practices that are significantly less valuable than that expected from professional investment advisors and managers, and generally found in private sector plans (U.S. House of Representatives 1978).

3 One reason for this relationship between the allocation to alternatives and more external asset managers may be that good private investment opportunities require more niche expertise to: 1) identify; and 2) perform due diligence.

4 CEM Benchmarking (2019) finds that 51 percent of the large cap equities held by private and public U.S. pension plans are managed internally.

5 The Center emailed plan administrators from each PPD plan about their use of internal asset management. Respondents that characterized their fund as totally externally managed or downplayed the assets they did manage internally as insignificant to the overall investment strategy were flagged as "not managing some assets internally." Respondents that presented their internal asset management as a meaningful component of their overall investment strategy were flagged as "managing some assets internally." Most respondents indicated that their current approach to internal and external asset management had been in place since before 2001. Those that did not respond to the email were classified as "not managing some assets internally" unless internal investing was explicitly mentioned in the plan's financial reports, investment documents, or on the plan's website.

6 The use of internal management is based on the practices of the investment entity or retirement system that manages each plan's assets. For example, because the North Dakota Retirement and Investment Office (NDRIO) manages all its assets externally, all pension plans invested with the NDRIO – North Dakota PERS, Teachers, and Bismarck Employees plans – are reported to manage all their assets externally.

7 Aubry and Crawford (2018).

8 Using the CEM Benchmarking Inc. database that includes public and private pension plans in the United States and abroad, Dyck and Pomorsky (2011) find that between one-third and one-half of a 43-50 basis-point difference in annual returns between large and small plans arises from the cost savings to large plans from increased internal management – where costs are at least three times lower than under external management. CEM Benchmarking (2015) finds that a 100-percent increase in internal management is associated with a 22.1-basis-point increase in net value added, but only a 7.3-basis-point increase in gross value added, suggesting that two-thirds of the increase in net value added is due to lower investment costs.

9 Both CalPERS and Nevada PERS chose to reduce the number of external managers without moving more assets internally. Interestingly, Wisconsin RS steadily reduced its external managers while also increasing the share of assets managed internally from 20 percent in 2006 to 64 percent by 2016.

10 A common concern with the fees reported for alternative assets is that they often understate the total fees paid. Fees for private equity and hedge funds contain several components – the primary two are management fees and performance fees. While the fee data reported by plans rarely specify what types of fees are included, the data suggest that the fees reported for private equity and hedge funds are likely a lower bound. Importantly, the reported fee data are often incomplete because pension funds do not have access to full information – investors can be contractually prohibited from obtaining details about fees from their investment managers.

11 As a robustness check, the analysis also included a third regression that related the number of external managers to a plan's investment performance relative to its benchmark. The results also show this relationship to be negative, but not statistically significant.

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APPENDIX

Table A1. Effect of External Management on the Investment Fee Rate, After-Fee Return, and Return-to-Benchmark, 2006-2018

Variable name	Fee rate	After-fee return	Return-to-benchmark
Number of external managers (per 10 mgrs)	0.0101***	-0.0162	-0.0053
	(0.0035)	(0.0318)	(0.0215)
External management only (1-0)	0.0049	-0.2724	-0.1547
	(0.0627)	(0.3808)	(0.3336)
Log market assets in 2006	-0.026*	0.0982	-0.0949
	(0.0154)	(0.1505)	(0.0857)
Equities %	0.03437	12.505**	3.2611*
	(0.2834)	(5.8778)	(1.9116)
Real estate %	0.4593	-1.423838	-7.877251
	(0.5468)	(5.8586)	(4.8491)
Private equity %	0.5566	8.5037	1.9814
	(0.3889)	(6.6146)	(2.6207)
Hedge fund %	1.2237***	4.6353	3.6061*
	(0.3648)	(6.0201)	(2.1526)
Commodities %	1.3005*	14.8143*	3.92049
	(0.7130)	(8.5690)	(6.3947)
R-squared	0.2891	0.6022	0.1585
Number of plan-years	524	537	334

Notes: The regression includes controls for the fiscal year and the fiscal year end. The return-to-benchmark dependent variable is equal to the difference between the plan's benchmark rate of return and the plan's after-fee rate of return. Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1.
Sources: Authors' calculations using plan CAFRs, Investment Reports, websites, and authors' email contacts.

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