

Research Working Paper

In-House Investment Management: Making and Implementing the Decision

An Internal CIFR Research Project

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Synopsis

We propose a framework that asset owners can use for making and implementing any decision to manage investments in-house. It involves addressing four elements: capabilities, costs, alignment and governance; with key aspects identified for consideration within each element. The framework draws on guidance from the literature, and insights from interviews with executives from the Australian superannuation fund industry. We also report on the interviews, where we uncover striking diversity in the approaches to deciding whether to manage in-house, and the emphasis placed on various aspects related to the perceived benefits, challenges and success factors. Our framework encompasses and unifies the wide range of viewpoints we heard from industry executives. We are supportive of in-house management, provided that the conditions are right and it is implemented appropriately.

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1. Introduction

In-house investment management is a hot topic in the Australian superannuation industry, where increasingly funds are attaining a size at which managing in-house becomes feasible, if not desirable. Pressure to reduce fees provides additional encouragement to ‘have a look’ at in-house management as a possible way of cutting costs. In this report, we examine the decision to bring in-house the management of assets, as compared to the alternative of exclusively out-sourcing to external investment managers. In doing so, we draw on insights from both the literature and interviews with executives from 20 organisations in the Australian superannuation industry. Our contribution is two-fold:

1. A **framework** is presented to assist asset owners to make and implement decisions to manage in-house.
2. An **account** is provided of the approaches and views towards in-house management within the Australian superannuation industry.

Our Framework

The framework that we propose is effectively an organising structure that encompasses both the main concepts appearing from the literature, and the range of approaches and aspects being considered by the industry as revealed during the interviews. The framework involves addressing four elements: **capabilities**, **costs**, **alignment** and **governance**. Identifying the **capabilities** associated with in-house teams provides a sense for the marginal impact on gross returns, which when coupled with estimates of potential **cost** savings, allows the effect on **net returns** to be gauged. **Alignment** is addressed with the intention of forming a judgement on whether in-house management sits comfortably within the organisation, and thus whether it should enhance or impair the probability of the fund achieving its objectives. **Governance** entails considering the structures and processes required to support successful in-house management, and their feasibility for the organisation. All four elements are evaluated and weighed up with the assistance of a checklist of aspects to consider. The checklists are indicative: we make no claim that they are comprehensive, and encourage users to adjust them to their needs and preferences. Further detail on the framework is found in Section 2.

Interview Findings – Diversity in Approach and Points of Emphasis

Our interviews uncover striking diversity across the Australian superannuation industry in the approach to deciding whether to manage in-house, and the emphasis that is placed on various aspects. On the surface, there is a reasonable amount of agreement around the main areas to be addressed. At least 75% of participants place some importance on the following areas:

- **Impact on returns** – most focus on net returns, but some are primarily focused on costs;
- **Alignment issues** – tailoring investments, and Board support are key considerations for many;
- **Governance** – the importance of a supportive governance structure is well-recognised;
- **Staffing** – most see the main issue as attracting and retaining staff that are both skilled and aligned with the organisation, within any constraints on remuneration;
- **Culture** – bringing in highly-paid investment teams is seen as culturally challenging to organisations that have traditionally been used to out-sourcing and implementing; and,
- **Systems and processes** – it is broadly acknowledged that appropriate systems are needed for functions such as trading, portfolio and risk management, reporting and compliance.

While agreement exists over the main focus areas, there is considerable diversity of opinion over how much each area matters, and in what way. Everybody we spoke with seems to have a different approach to deciding whether assets should be managed in-house, both in terms of how they conceptualise the problem and the aspects deemed as most important. Figure 6 on page 21 gives a sense for the breadth of approaches. We also encounter a wide range of views on many facets of the issue. For instance, some thought that in-house management can provide access to competitive advantages that support higher returns; while others expect returns to fall, but costs to potentially fall even further. Some consider the ability to tailor investments of prime importance; while others argue that tailoring can be effectively achieved using external managers. Some perceive staff management and culture as major challenges; while others think that the related problems can be readily solved by targeting culturally-aligned staff in the first instance. Some view systems as critical to get right, and a significant source of risk; while others trivialise the difficulty of establishing reliable systems. In short, we find no industry consensus when we look beneath the surface. Recognising this, we design our framework as general so it can accommodate a broad range of views and preferences about what aspects need to be considered.

Interview Findings – The Process of Considering and Implementing In-House Management

Some common elements are evident in the process of considering in-house management of assets. All participants address the decision on an asset-class-by-asset-class basis; and typically approach it in a measured, forward-looking and incremental fashion. This makes sense. It recognises that in-house management may work well only for some assets or strategies; takes time to implement; and that learning can help limit the implementation risk. Cash is often the first candidate for managing in-house, given that investing in cash is relatively straightforward, can be implemented with modest resources, and has complementarities with fund liquidity management. Beyond that, there is only limited consistency across Australian superannuation funds on what assets they prefer to manage in-house.

Bringing assets in-house necessitates a choice about how an in-house management capability should be structured. We encounter four broad structures during our interviews, with the degree and manner in which the in-house capability is blended with input from external managers being a key point of distinction. These include: (i) a *dedicated internal structure*, whereby an asset class is managed entirely in-house; (ii) *hybrid external/internal models*, under which the in-house team is responsible for a slice of the assets within a multi-manager structure; (iii) *co-investments*, where the fund piggy-backs on the ability of an external manager to identify and source assets through taking a ‘slice on the side’; and (iv) *partnerships*, either between funds or with an external manager, involving the fund providing capital while some management functions are performed externally. The hybrid model appears popular in Australia, especially in core listed assets like equities and fixed income. Within the hybrid model, there is a further choice of the degree to which the in-house capability is *segmented* and treated as just another manager, versus *integrated* and used to ‘complete’ the portfolio in some way. Here the issue of the intellectual property rights of external managers is encountered: again there is a variety of views.

Our View – When Funds Should Look to Manage Assets In-House

We are generally supportive of in-house management, on the proviso that the conditions are right and it is implemented appropriately. Done properly, in-house management is capable of generating *improved net returns*, plus increased control allows assets to be managed in a way that is *better directed to member needs* and *delivered with higher confidence*. A further advantage of establishing an in-house capability is that it provides a *platform for the future*, especially if designed as scalable and flexible. Nevertheless, we wholeheartedly agree with our participants that in-house management should be approached in a measured and incremental fashion; and that it is unlikely to be suitable for all funds or in all asset classes. It all depends on the circumstances. With this in mind, the following conditions may signal that in-house management is worthy of close consideration:

- **Large funds** – As assets grow, funds increasingly encounter capacity constraints with external managers, and the potential cost savings are greater. Larger funds also have access to the resources required to build in-house teams and the structures required to support them. Indications are that superannuation funds need to be at least A\$5-\$10 billion to justify managing any assets in-house; that some in-house management is probably inevitable when assets are above A\$50 billion; and that funds with assets of A\$10-\$50 billion sit in a grey area where it all depends on the circumstances.
- **Alignment and tailoring matters** – In-house management will be more beneficial in situations where it is valuable to have those responsible for managing the assets to be keenly focused on overall fund outcomes, or where there is call for some form of tailoring that cannot be satisfied by external managers. Examples include where there is a defined benefit fund, a need to access illiquid assets in ways that complement fund objectives, or the requirement to design an asset class portfolio for a particular purpose.
- **The organisation is accommodating** – Managing in-house is more likely to be successful if it sits comfortably within the organisation. This requires in-house management to be digestible within the fund’s culture, a supportive Trustee Board, and the required capabilities to be readily available or accessible, especially in terms of staff with appropriate skills. Indeed, without these aspects, it is arguable whether in-house management should even be considered.
- **A competitive advantage exists** – Some funds may see potential to exploit opportunities to enhance returns that are best accessed via an in-house team. For instance, an in-house capability may be able to leverage the benefits of size in unlisted assets, invest with a longer time horizon, or reap benefits by exercising control. The ‘term deposit trade’ that was available after the Global Financial Crisis is a good example of how in-house teams have been used to access a specific opportunity to increase the return on cash portfolios.

The best way to structure an in-house capability will depend on the particular situation and the objective. Nevertheless, we are attracted to *integrated hybrid models* under which investment is undertaken by both the in-house team and external managers, but the portfolio is managed on a fully integrated basis. This model is best capable of enhancing returns in a way that supports tailoring and flexibility. One issue is a lessening in the ability to apply competitive discipline to an in-house team that is expected to perform a different function to external managers. Nevertheless, the risk of capture that arises from being completely reliant on an in-house team is curbed, as external managers remain within the mix. Any lessening in competitive tension can be a reasonable price to pay for the alignment benefits that arise from having an in-house capability that is focused entirely on overall fund outcomes.

But What About The Risks?

There is no doubt that some mistakes will inevitably be made with in-house management. However, fear of error should not prevent in-house management from being embraced where benefits are evident. In-house management is rarely of sufficient size to ‘sink a fund’ in its own right, as it typically occurs as discrete strategies across a range of asset classes, and often as one component of a hybrid structure. Rather, it is investment functions that cut across the entire portfolio – such as asset allocation and currency management – that carry more inherent risk. Moreover, the prime task is to identify and mitigate the risks. For example, we concur that many of the challenges around staffing and alignment can be addressed by targeting employees that are culturally aligned. Here the true risk is that the pool of potential employees that are *both* culturally aligned *and* skilled is too small. Another technique is obtaining assurance around governance, systems and team capability through independent review. Some funds commission asset consultants for this purpose. In summary, the risks associated with in-house management should be seen as something to manage, rather than avoid.

Research Scope

The scope of this research is restricted by certain practical considerations. First, we examine in-sourcing only with regard to direct investment in assets in order to make the analysis manageable. We do not consider in-sourcing of other investment tasks such as asset allocation, manager selection or currency management; or non-investment functions like legal or systems. Second, our interview sample comprises 13 not-for-profit superannuation funds and 7 ‘advisers’, with the latter including asset consultants and research houses. For-profit (i.e. retail) superannuation funds are excluded as most are managed by diversified organisations where investment management is an integral component of their business model. Hence they do not face a decision of whether to set up an in-house investment management capability. Third, all interview participants are based in Australia. While interviewing overseas participants might have enhanced the research, it was not possible due to resource and time constraints. Nevertheless, we consider our sample as conducive to exposing the key issues and themes, especially as all participants have recently been grappling with the decision to manage assets in-house.

This Report

This report proceeds as follows. Section 2 details our framework for making and implementing any decision to manage assets in-house. Section 3 provides background, including the definition of in-house management, a review of the literature, and a brief overview of the history and status of in-house management in Australia. We then report on the interviews. Section 4 deals with the method; Section 5 gives an account of how the decision to manage assets in-house is being approached in the industry; and Sections 6, 7 and 8 report what was said about the benefits, challenges and success factors, respectively. Section 9 offers some concluding comments.

2. The Framework

We commence by presenting our framework for making and implementing any decision to pursue in-house management. The framework is based around four key elements to address: *capabilities*, *costs*, *alignment* and *governance*; along with a list of aspects to consider within each element. Our framework draws on a combination of guidance from the literature on the concepts (see Section 3), and insights from our interviews with superannuation fund executives (Sections 4 to 8). As the framework is a key output from our research, we are positioning it upfront as Section 2. Some readers may prefer to skip this section initially to go on and read the following sections where the foundations are established, then returning thereafter to examine the framework.

Together the four elements provide an **organising structure** that encompasses and unifies the insights arising from both the literature and the interviews; and accommodates the wide range of decision approaches and aspects mentioned by our interview participants. The first three elements – *costs*, *capabilities* and *alignment* – reflect core concepts raised in the related academic literature, most notably that on in-sourcing versus out-sourcing and the scope of the firm. *Governance* is included as an overarching element that addresses the structure under which in-house management is undertaken.

Figure 1 arranges the four elements into a **decision flowchart** that operates along the following lines. An estimate of the marginal *costs* saved through managing in-house relative to using external managers is formed; and coupled with an (probably indicative) attempt to gauge how the *capabilities* associated with an in-house team might impact on returns. Together these generate a sense for the potential impact on **net return**. The latter plays to one of the focal points for our interview participants, all of whom place importance on potential return impacts in some manner (even if only through the prism of cost effects in isolation). *Alignment* is considered in parallel. The intention is to form a judgement on the

extent to which in-house management sits comfortably within the organisation, such that the probability of the fund achieving its objectives is enhanced rather than impaired. The concern here is whether the in-house capability can be harnessed effectively, rather than acting as a drag. At issue is whether various agency and behavioural influences – such as motivation, culture, and exposure to cognitive errors – are more problematic under in-house management than with external managers. Taken together, these three elements support an evaluation of the magnitude and tenor of the potential advantage from in-house management. The fourth element – **governance** – is then brought into play. This involves considering the structures and processes required to support successful in-house management, and their feasibility for the organisation. As governance may influence not only the feasibility of in-house management, but also how it is structured and hence the nature of the other elements, we draw some dashed arrows in Figure 1 that loop back. After evaluating and weighing up all four elements, a decision would be made and implemented as appropriate.

Figure 1: Decision Flowchart for In-House Management

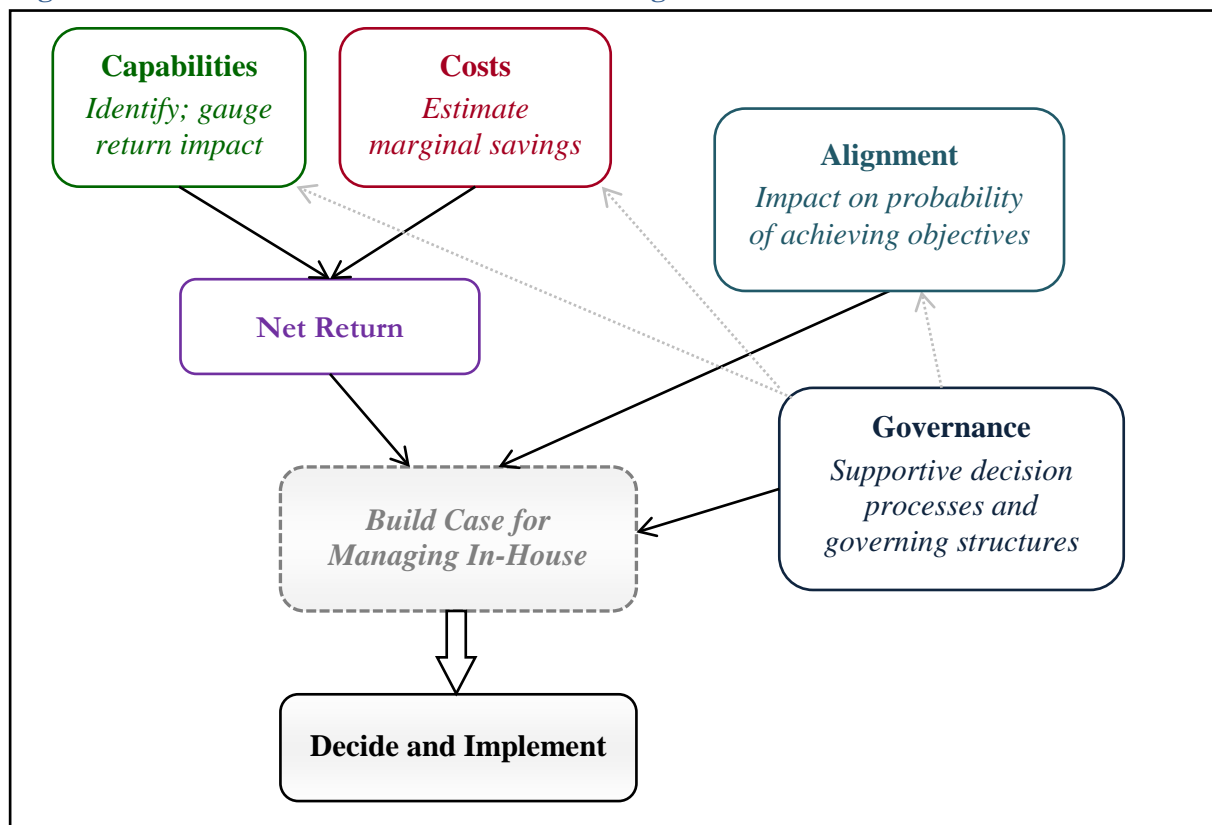


Figure 2 expands on each of the four elements by listing the **aspects to consider** when making and implementing any decision to pursue in-house asset management. In effect, Figure 2 is a checklist. The aspects listed are mainly drawn from the interviews, reflecting items identified by participants as potentially important to take into account and/or manage. Detailed descriptions of the various aspects are peppered throughout the reporting and discussion of the interview findings, most notably in Section 5 (decision), Section 6 (benefits) and Section 7 (challenges). In addition, our interview participants identify 12 success factors for in-house management, which are presented in Section 8. Seven of these are identified by more than one-third of participants, including (in order of mentions): governance; staff selection and management; systems and resourcing; culture and alignment; clear reasons for managing in-house; Board commitment; and evidence of some competitive advantage. Components of Figure 2 that relate to these seven success factors are underlined.

Figure 2: Aspects to Consider in Evaluating and Implementing In-House Management

<u>Governance</u>	
<ul style="list-style-type: none"> • Board – <u>supportive</u>; <u>clear reasons</u>; realistic expectations • Responsibility and accountability <ul style="list-style-type: none"> – Delegations – Definition of success or failure • Monitoring and performance evaluation • Risk identification and management • Compliance protocols 	<p>Structures</p> <ul style="list-style-type: none"> • Dedicated internal • Hybrid internal/external model <ul style="list-style-type: none"> – Segmented vs. integrated – Intellectual property protocol • Co-investment • Partnerships
Net Return	
<p style="text-align: center;">Capabilities</p> <ul style="list-style-type: none"> • <u>Competitive advantage?</u> • Access to skilled <u>staff</u> • Scalability of active investing • Ability to capture opportunities <ul style="list-style-type: none"> – Access to assets / markets – Flexibility / agility • ESG / SRI engagement • Market intelligence <ul style="list-style-type: none"> – Insight from being in market – Better manager monitoring • <u>Systems and resources</u> <ul style="list-style-type: none"> – Implementation / dealing – Portfolio management – Risk management – Tax management 	<p style="text-align: center;">Relative Cost</p> <ul style="list-style-type: none"> • Expense ratio <ul style="list-style-type: none"> – Economies of scale – Fixed vs. variable cost (manager fee scales) • Establishment costs • Diversion of resources <ul style="list-style-type: none"> – Management time – Reporting needs • Ancillary exposures <ul style="list-style-type: none"> – Operational risk – Reputational risk
<p style="text-align: center;">Agency and <u>Alignment</u></p> <ul style="list-style-type: none"> • <u>Board commitment</u> • Tailoring to objectives <ul style="list-style-type: none"> – Control / transparency – Liability-driven investing – Liquidity management – Long-term investing – ESG / SRI principles – Tax efficiency • <u>Investment team</u> <ul style="list-style-type: none"> – Culturally aligned to organisation – Motivation and incentives – Team objectives and benchmarks • <u>Organisational culture</u> <ul style="list-style-type: none"> – Shared beliefs and purpose – Tension: investment/other staff • Other behavioural issues <ul style="list-style-type: none"> – Dealing with underperformance – Handling success: overconfidence, overextending, complacency 	

Note: Items underlined relate to success factors identified by more than one-third of interview participants.

Choice of Structure for In-House Management

Positioned within the Governance element at the top right of Figure 2 is a list of four potential structures under which in-house management might be undertaken. The structures are distinguished by the degree to which in-house management is blended with inputs from external managers. All four structures are encountered during the interviews, and are described and discussed in Section 5.4. Here we offer some observations about the *choice of structure*. The overarching message is that the appropriate structure will depend on the circumstances – there is no one universally optimal structure across organisations or asset classes.

The *dedicated internal structure* represents the extreme whereby an asset class is managed entirely in-house. This structure seems relatively rare in the Australian market, except perhaps for management of

cash. A more popular structure, especially in core listed assets like equities and fixed income, appears to be the *hybrid external/internal model* under which the in-house management team is responsible for a slice of the assets within a multi-manager structure. The advantage of a hybrid structure is that the co-existence of internal and external capabilities creates competitive tension and maintains discipline around the in-house team, thus avoiding capture. It also provides an element of flexibility, to the extent that internal and external capabilities are fungible and can be rebalanced or reconfigured as required. However, the hybrid model requires determining the degree to which the in-house team is *segmented* and treated as a discrete manager with an explicit mandate; versus managing the portfolio on a (fully, or partially) *integrated* basis where it is ‘completed’ by the in-house capability. Choosing between segmented and integrated hybrid structures involves a trade-off. A segmented structure supports comparability and fungibility between the in-house team and external managers, and thus maintains competitive tension. An integrated structure improves alignment with overall fund objectives, as it enhances the capacity to tailor the portfolio, and treats in-house investment staff as part of the wider team rather than as ‘hired guns’. The relative importance placed on such aspects will influence where a fund might position itself on the segmented versus integrated spectrum.

The other two structures – *co-investment* and *partnerships* – are more prevalent in alternative asset classes (although not exclusively¹). Both are ‘half-pregnant’ forms of in-house management, in that some meaningful management tasks are undertaken externally. Their main advantage is that they provide the means for small-medium sized funds² to directly invest in large-ticket unlisted assets such as property or infrastructure, with the benefit of external management input, and without requiring a full in-house capability. Their chief disadvantages relate to limits on liquidity and control over the underlying investments, which in turn hampers the capacity to tailor towards objectives (i.e. reduced alignment). These limits can be more evident for co-investments, to the extent that purchases are restricted to what the external manager offers, and there exists a greater need to follow the manager’s lead in exiting. The suitability of these structures depends on the circumstances, including the willingness to trade-off control for other advantages of direct investment such as costs savings.

3. Background

This section addresses three matters. Section 3.1 discusses the difficulty of defining in-house management, and the absence of a widely-accepted definition. Section 3.2 reviews the related literature, and draws out the implications for our research. Section 3.3 provides a brief overview of in-house management in Australia, including its history, current usage and the regulatory environment.

3.1. Defining In-House Asset Management

There appears to be no widely-accepted definition of in-house asset management. For instance, we commenced the interviews by defining in-house management as “*situations where assets are selected directly and then managed by the fund, rather than out-sourcing to external managers*”. We quickly discovered that this definition was insufficient; and that a meaningful grey area exists where the responsibility for selection of assets and their day-to-day management can be shared between the fund and an external manager. This is particularly the case with alternative assets. For instance, we heard about the following structures during our interviews:

¹ We also encounter partnerships in listed assets, under which the fund works closely with external investment managers as a skill exchange in a relationship-building context.

² The use of co-investment and partnership structures in Australia can be seen as a consequence of having a number of funds that are below the scale required for a dedicated internal in-house capability in alternative assets, as observed for instance among some of the ultra-large global funds.

- the fund makes the asset selection decision, which is implemented by an external manager;
- co-investments, where an external manager selects and sources the assets, but the fund takes an additional slice which they own directly after performing their own due diligence;
- partnership structures, where responsibility for asset selection and management is effectively shared by the partners, perhaps under a dedicated vehicle with its own staff; and,
- investment management organisations that are fully-owned yet operate as if they are an external manager, so that the fund effectively acts only as an owner and funding source.

To add to the complexity, our interview participants hold varying perceptions of what it means to manage in-house. Two notable alternative definitions from ‘advisers’ in our sample appear below, both of which differ from the definition that we offered initially:

“the true definition of in-house is they only manage money for you, and that’s all they do ... they’re not seeking external money”

“control over the investment of the underlying assets ... it’s effectively the ability to make a decision as to whether to invest or redeem the underlying asset”

The question arises regarding whether it matters that there is no widely-accepted definition. We suspect not. Of more concern is what funds actually do in order to meet their members’ needs, rather than the label that is applied. Nevertheless, the absence of a clear definition does make it more difficult to interpret the interviews, as participants may have different things in mind when they discuss “in-house management”. This should be borne in mind when considering the interview findings as reported later.

3.2. Literature

In this section we extract key theories and concepts from the literature, which in turn underpin the framework presented in Section 2. We commence by reviewing the academic literature on in-sourcing versus out-sourcing in general, before discussing the research on fund management specifically. We then summarise the findings from two global surveys, and raise some of the limitations of the literature. The section concludes by discussing the implications for our research.

General Literature on In-sourcing versus Out-sourcing

An extensive body of literature exists on in-sourcing versus out-sourcing, and its relation to the nature and boundaries of the firm. Much of the research is theoretical in nature, although there is some empirical support available. The body of literature can be described as comprising a number of conceptual frames that are complementary rather than competing.

Transaction cost theory focuses on the relative cost of procuring goods and services through the market (i.e. out-sourcing) versus from within the firm (see Coase, 1937; Klein, Crawford and Alchain, 1978; Williamson, 1985; Grossman and Hart, 1986; Hart and Moore, 1990; Grossman and Helpman, 2002). Differences in costs can arise from the relative difficulty of identifying prices, negotiating and concluding contracts, and dealing with unforeseen contingencies under uncertainty. The relative cost of in-sourcing versus out-sourcing can be influenced by aspects such as: asset specificity; the extent to which those controlling the assets are able to extract rents during the process of negotiating over ‘revealed surplus’ (i.e. the value created), or in response to unexpected contingencies; incentives to invest in or maintain assets; and technology. 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, and external providers have high bargaining power. Transaction cost theory broadly aligns with the *costs* element of our in-house asset management framework.

A second conceptual frame emphasises *incomplete contracts* and related issues such as agency, monitoring, incentives and governance; arguing that the property rights focus adopted by transaction cost theory is too narrow (see Alchain 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 due the nature of the asset or specific task. Ownership also allows firms to coherently direct and incentivise workers. An aligned notion is that of *formal versus relational contracts* (see Baker, Gibbons and Murphy, 2002). Relational contracts involve informal agreements and unwritten codes of conduct. They are often ongoing in nature, and more likely to be effective in the context of in-sourcing, such as through employment contracts. In-sourcing is likely to be more beneficial where high uncertainty makes it difficult to design formal contracts and measure performance for external parties. This might arise under situations involving team work, or where agents are required to perform multiple tasks. The incomplete contracts frame mainly accords with the *alignment* element of our in-house asset management framework; but also touches on *governance*.

A third conceptual frame relates to *value creation*, and has received more limited 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. The first is dynamic creation and capture of value through combining resources and innovation, i.e. capabilities. The second is meeting the objectives of principals, i.e. purpose. They advocate linking the nature of the firm and the choice between in-sourcing and out-sourcing to capabilities and purpose, which they see as reflecting the essence of entrepreneurial and managerial activity. Pitelis and Teece’s approach aligns with both the *capabilities* and *alignment* elements of our framework.

Overall, the literature generally supports the idea that the choice between in-sourcing and out-sourcing is subject to multiple influences, and should depend on the circumstances. Leiblein, Reuer and Dalsace (2002) make such a case. These authors examine data from the semi-conductor industry. They find that the relation between performance and in-sourcing versus out-sourcing is not straightforward, and is better characterised as endogeneous. They also summarise the range of claims made in the management literature with regard to in-sourcing versus out-sourcing. They note that in-sourcing has been viewed as enhancing performance through accumulating resources that lead to competitive advantage, as well as improving co-ordination by utilising information flows or interdependencies. However, in-sourcing requires committing resources and may be costly to reverse, and foregoes various advantages of operating in the market place. Conversely, they note that out-sourcing has been viewed as enhancing flexibility, shifting costs to external suppliers, enabling firms to tap into specialised capabilities, shortening product development cycles, and avoiding decision making complexities arising in corporate hierarchies. However, out-sourcing can potentially hollow out organisational capabilities, and lead to failure to seize opportunities. Leiblein, Reuer and Dalsace (2002) conclude that the relative efficacy of in-sourcing versus out-sourcing depends on the situation, in particular whether the most valuable characteristics reside within or outside the firm, and the significance of problems associated with appropriating from external providers.

Fund Management Literature – Clark and Monk

Within a limited literature considering in-sourcing versus out-sourcing from a fund management perspective, perhaps the most directly relevant is the research undertaken by Gordon Clark and Ashby Monk, which we summarise here in some depth. In Clark and Monk (2013a, 2013b), these authors discuss the ‘geographical reach’ of investment management organisations, including the decision to manage in-house versus through external investment managers. They observe how size and economies of scale matter. Small funds that lack the resources required for in-house management are more likely to out-source asset management, and focus on investment strategy and selecting and monitoring external managers. Large funds are more likely to pursue in-house management for its complementarity with fund objectives, emphasising those tasks that are cost-effective to perform internally. In this respect, the key decision variables are: (i) relative cost of conducting the task in question; (ii) access to the requisite human capital; and (iii) possessing appropriate governance procedures, complemented by information infrastructure. Further, proximity to the market for acquiring talent may impact on the decision: in-sourcing is more likely in the domestic market. The decision variables they emphasise align with the *costs*, *capabilities* and *governance* elements of our framework. In addition, they contrast selected benefits and challenges of in-house versus external asset management, most of which relate to the *alignment* element. They suggest a major advantage of in-house management is that it facilitates writing relational contracts, which can better deal with shifts in market conditions and the development of distinct investment strategies. However, they consider in-house management to be potentially less flexible to the extent that it brings exposure to capture and entrenchment by internal managers, and could be associated with bureaucratic inertia and/or confusion.³

In Clarke and Monk (2012), they provide a list of benefits and success factors associated with in-house management. The five benefits they identify are: (i) access to certain assets or markets; (2) better alignment (i.e. lower agency costs); (iii) improved internal capabilities; (iv) better performance, largely due to lower cost; and, (v) ‘sustainability’, which equates to better tailoring of portfolios to meet needs. Their success factors are arranged into a notional hierarchy, which we reproduce in Figure 3. Many of the benefits and success factors identified by Clark and Monk emerge from our interviews.⁴ The aspects that Clark and Monk raise are accommodated within our own framework, although with differences in broad structure, manner of presentation and emphasis.

Fund Management Literature – Other

MacIntosh and Sheibelhut (2012) consider in-house management as part of an examination of the organisation and compensational structures of 19 large pension funds. They confirm that the use of in-house management is a function of fund size: funds with assets below US\$10 billion manage only 8% of their assets internally, while those with assets of over US\$50 billion manage 51%, on average. They also find that funds making greater use of in-house management perform better, with net value add rising by 3.6 basis points for every 10% managed internally. (Their regression contains no controls for other factors that might contribute to performance and are correlated with in-house management, such as size.) Rozanov (2015) observes that Canadian pension funds have a strong preference for in-house management, which is driven by two investment beliefs: ability to add value in less liquid assets due to inefficiencies in private markets, and enormous cost savings for large institutions due to scale.

³ Clark and Monk suggest three ways to mitigate some of the alignment-related problems they raise: (i) establishing a shadow market for the services; (ii) building an internal unit dedicated to facilitating efficient co-ordination of activities; and, (iii) instituting a compensation regime that rewards cooperation and shared responsibility for achieving organisational objectives.

⁴ Some interview participants would not agree with Clarke and Monk’s application of certain components of Figure 3, for instance the manner in which mandates are designed or the type of culture that is implied.

Figure 3 Clark and Monk's Success Factors for In-House Management



Source: Adapted from Clark and Monk (2012)

Fang, Ivashina and Lerner (2015) identify benefits and pitfalls of in-house management, as a prelude to an analysis of direct investment and co-investment in private equity. They see the trade-off between cost and investment quality as central: external management is higher cost, but may offer higher quality. They list the benefits of in-house management as cost savings (significant in private equity); improved control and flexibility; ability to pick deals; ability to time the market; avoidance of various agency problems associated with external management (e.g. pressure to invest regardless, desire to attract investors and/or assets); and capacity to customise risk exposures. The main challenge is viewed as the need to build capabilities that are not traditionally possessed by asset owners, such as investment skill, ability to implement deals and to monitor investments; and to do so without suffering a return loss that outweighs the cost savings. Fang, Ivashina and Lerner (2015) find the direct investments in their private equity sample outperform public markets, but not private equity benchmarks. However co-investments significantly underperform, which they attribute to a 'lemons problem' whereby general partners offer up only the poorer deals. Andonov (2014) also finds funds that invest in-house in alternative assets perform better than those that use external managers or fund-of-funds.

Most of the other fund management academic research is tangentially relevant. Some authors examine the choice between in-house management and use of external managers in the mutual fund industry (e.g. Chen *et al.*, 2013; Chuprinin, Massa and Schumacher, 2015). However, this work focuses on the impact of agency issues and incentives on relative performance in a mutual fund context, and is not directly transferable to in-sourcing versus out-sourcing by asset owners such as superannuation funds. The literature on delegated investment management contains a thread addressing the agency problems that arise with external managers (e.g. Elton and Gruber, 2004; Stracca, 2006; van Binsbergen, Brandt and Kojien, 2008; Blake *et al.*, 2013). This work focuses on issues with external management, rather than a comparison with the alternative of managing in-house. Nevertheless, this literature suggests that in-house management might assist in overcoming some of the alignment, information asymmetry and co-ordination issues associated with external managers by implication.

Global Industry Surveys

Two international surveys provide insight into global trends for in-house management. State Street (2015)⁵ sponsored a survey conducted by the Economist Intelligence Unit of 134 pension funds from 15 countries in August 2014. This survey found that 81% of respondents intended to increase the proportion of assets managed in-house over the coming three years. The two key drivers are reported as cost savings and improved oversight over the portfolio. It is noted that executives indicated that they want to decrease agency risk, become more agile investors, and attain a more aligned investment process. State Street observes that pension funds are at differing stages on the in-sourcing journey (also observed in our interview sample); and that larger funds have the resources to pursue more ambitious in-sourcing strategies. The major challenges with managing in-house are seen as related to attracting and retaining investment talent, and building the advanced tools and capabilities required.

Similar findings emerge from a global survey of Chief Investment Officers (CIOs) undertaken by www.top1000funds.com and Casey Quirk in 2014.⁶ The key drivers of greater in-house management are identified as cost savings and greater control. The survey quotes average costs of 5 bps for internal mandates versus 53.4 bps for external mandates. Nevertheless, control is identified as the primary reason for bringing assets in-house. This is seen as stemming from an increasing focus on risk and absolute return investment, and an associated desire for better transparency, understanding and control of assets in the portfolio. The survey found that large funds manage around 36% of their assets in-house, with 60% of respondents planning to increase in-house management. The largest shifts are occurring for core equity and fixed income, where assets managed in-house stand at 40% for fixed income (22% in 2013) and 23% for domestic equity (9% in 2013). One interesting finding (contrary to our interviews) is that the use of passive management is heaviest among funds that manage in-house, where it seems to be employed for core portfolios.

Finally, it is worth noting that the global asset owner landscape contains some very large-scale funds that are in another league to Australian superannuation funds. The largest Australian fund, AustralianSuper, had assets of A\$92 billion (~US\$70 billion) at June 2015, and was ranked 43rd by assets on Towers Watson's list of the Top 300 pension funds for 2014.⁷ Managing funds with well over US\$100 billion (of which there were 24 on the Towers Watson list) gives rise to some distinctive

⁵ http://www.statestreet.com/content/dam/statestreet/documents/Articles/Pensions/AssetOwners_FullReport.pdf

⁶ *Investors Need to Rethink Operating Model*, Top1000 Funds, March 25, 2015, media report available at: <http://www.top1000funds.com/analysis/2015/03/25/investors-need-to-rethink-operating-model/>

⁷ *P&I/TW 300 Analysis: Year End 2014*, Towers Watson, September 2015, available at:

<https://www.towerswatson.com/en-AU/Insights/IC-Types/Survey-Research-Results/2015/09/The-worlds-300-largest-pension-funds-year-end-2014>

opportunities and challenges. The imperative and approach with respect to in-house management is likely to be entirely different for these mega-funds compared to Australian funds. This was explicitly recognised by a couple of our participants, as illustrated by the following quote:

“Those big funds, they’re a very different beast. And the sort of strategies that they can pursue are completely different to what an AustralianSuper could pursue or what we can pursue. So you have to be mindful that the size you are means that your focus and effort needs to change according to that size.”

Some Limitations of the Literature

The literature is subject to two limitations related to scope. First, the discrete choice between in-house (in-sourcing) and external management (out-sourcing) is addressed as if it were a ‘one-or-the-other’ decision. This overlooks the possibility of hybrid structures involving a combination of internal and external management, which is a popular model among our interview sample. The implication is that one needs to be wary when interpreting some of the benefits and challenges touted in the literature, to the extent that they presume commitment to one model or the other. For instance, issues around loss of flexibility and entrenchment by the internal team may be diluted if not nullified under a hybrid model.

A second limitation relates to the evolving manner of engagement between asset owners and external managers. Increasingly, these relationships are taking the form of partnerships, rather than clearly-specified, arms-length mandates. Effectively this shifts the arrangement away from a discrete contract towards a relational contract (see Clark and Monk, 2014; Monk and Sharma, 2015). Such arrangements may help to address some of the agency and alignment issues that can arise under traditional mandates. They also blur the distinction between managing in-house versus through external managers.

Common Threads and our Framework

No clear consensus on the theories and concepts emerges from the literature, with various authors investigating and emphasising different components of the problem. Nevertheless, it is possible to identify some common threads, which in turn support our framework as presented in Section 2. In particular, most of the relevant factors for the choice between in-sourcing versus out-sourcing are captured by our first three elements:

- (a) **Costs** – Not only does the issue of relative cost sit at the foundation of the transaction costs view; but relative cost is widely mentioned in the fund management literature, where it is often equated with fund scale. Further, costs are highlighted as a key concern within the global pension fund industry, according to the two international surveys we report.
- (b) **Alignment** – Issues of alignment figure prominently in the incomplete contracts view of the in-sourcing versus out-sourcing decision, where the main concern is agency problems and the importance of being able to determine the rules of engagement and to structure incentives. Related themes emerge in the fund management context, in the form of concern over agency risks associated with external managers, and the extent to which portfolios can be designed to best meet the objectives of the fund through exercising greater control, transparency, flexibility and relational contracting. Worries over the possible loss of flexibility due to bureaucracy or entrenchment under in-house management also relate to agency and alignment, and whether it is better secured through managing in-house. The two international surveys highlight control and oversight as important, consistent with alignment being a key concern within the global pension fund industry.

- (c) **Capabilities** – Although the general literature on in-sourcing versus out-sourcing has paid only limited attention to the notion that in-sourcing may allow an organisation to build capabilities that could create value, the fund management literature itself mentions a number of aspects that relate to capabilities that might enhance returns. These include the improved ability to access and identify certain attractive assets, and the scope and agility to exploit opportunities that may be less accessible to external managers who are anchored to benchmarks by their mandates. There is also acknowledgment that certain capabilities need to be built to support in-house management, including processes and operational systems.

The above three elements capture most aspects of the decision to in-source, and the benefits and challenges of doing so. However, the importance of **governance** needs to be recognised. Appropriate governance arrangements are a foundational element for successful in-house management. Clark and Monk (2012) appear to hold this view, placing governance at the base of their pyramid as reproduced in Figure 3. Adding governance gives rise to the four broad elements underpinning our framework.

3.3. In-House Management in Australia

We now provide a brief account of the history of in-house management in Australia; the current status; and the regulations.

Historical Perspective

Here we draw on commentary that was offered by a few of our interview participants. Putting aside the insurance companies, in-house management by Australian superannuation funds extends back over 30 years. The initial phase involved a small number of funds – including Equisuper, REST and Telstra Super – embracing in-house management due to a belief by those involved that it offered a better solution. We expand on the role of personal experience and beliefs in Section 5.3.

Subsequent to this initial phase, some structural influences have provided the motivation and foundation for a broadening in those funds pursuing in-house management, especially over the course of the last decade. The main influence has been the *emergence of larger funds* due to system growth and fund consolidation. An increasing number of Australian funds are attaining the size that makes in-house management feasible if not inevitable, or are anticipating doing so in the foreseeable future. We discuss the influence of scale in Section 5.2.

A second influence is the *building of internal management teams*, as an increasing number of functions are taken in-house. Traditionally, many funds either out-sourced the entire investment process to a balanced manager (the 1980s model), or the Trustee Board was advised and led by an asset consultant (the 1990s model). The industry has since been transitioning away from out-sourcing. Investment functions that have initially been taken in-house include construction of multi-manager asset portfolios comprising specialist external managers, oversight of cash and currency management, and active asset allocation. All of these functions require the building of internal investment management teams. Once established, these teams provide a foundation for extending into in-house asset management. Indeed, in-house asset management might be viewed as a natural extension on other investment functions.

A third influence is *technology*, which improves the ability to access or establish the required systems.

Current Status

SuperRatings kindly provided us with data from their 2015 survey of Australian superannuation funds. The survey finds that 59% of funds manage some assets in-house (63% in 2014; 57% in 2013), with reference to the supplied definition of in-house management as ‘having control over the purchase or

sale of the underlying assets’. Figure 4 details the self-reported percentage of assets (Panel A) and asset classes (Panel B) that are managed in-house. Nearly one-fifth (18%) of funds report a substantial commitment (20% or more) to assets being managed in-house. Panel B indicates that cash is the asset most likely to be managed in-house, and is done so for 97% of those managing internally, and 57% of all funds. In other asset classes, in-house management is practiced by between 10% and 31% of survey respondents that are managing assets in-house. The spread of moderate percentages indicates that there is considerable variation in *which assets* funds are managed in-house. This aligns with the wide range of perspectives and approaches to in-house management we encounter during the interviews. Further detail on how asset classes are selected for in-house management appears in Section 5.4.

Figure 4: Assets Managed In-House

PANEL A Percentage of Assets Internally Managed			PANEL B Asset Classes Internally Managed		
<i>% of Assets In-House</i>	<i>% of Funds Managing In-House</i>	<i>% of All Funds (scaled by 59% and rounded)</i>	<i>Asset Class</i>	<i>% of Funds Managing In-House</i>	<i>% of All Funds (scaled by 59% and rounded)</i>
<5%	16%	9%	<i>Core Assets</i>		
5% to <10%	30%	18%	Cash	97%	57%
10% to <15%	14%	8%	Fixed interest	31%	18%
15% to <20%	19%	11%	Australian equities, passive	18%	11%
20% to <30%	5%	3%	Australian equities, active	26%	15%
30% or more	26%	15%	International equities	13%	8%
			<i>Other Assets</i>		
			Infrastructure	23%	14%
			Property	26%	15%
			Private Equity	10%	6%
			Alternatives	15%	9%

Source: SuperRatings

In some areas, the SuperRatings survey results seem at odds with what we heard during the interviews. The 18% report that in-house management of passive Australian equities does not square with a near-consensus view from our participants that there is little point to passively managing equities in-house, given that indexed funds are so cheap to purchase and involve no operating risk. Also, the reported percentages of 13% for international equities and 10% for private equity seem high, given that pursuit of in-house management is reported by only one fund in our sample of 13 (mostly large) funds for each of these asset classes. The differences for passive Australian equities and international equities may be largely explained by the fact that the SuperRatings survey also covers retail funds, which provide a broad range of products which can include in-house passive and international equities options. In contrast, our sample reflects not-for-profits funds only. In the case of private equity, we wonder whether some funds in the SuperRatings survey might be conflating in-house selection of external managers with direct in-house management of the assets. In any event, the broad indication from the SuperRatings survey that between 5% and 20% of funds are practicing in-house management in many of the major asset classes seems broadly consistent with our interview findings.

Regulatory Environment

In-house management is not explicitly regulated in Australia. Nevertheless, in-house management is covered by APRA’s *Investment Governance* standards under Prudential Standard SPS 530 and Prudential Practice Guide SPG 530. These standards require funds to establish specific and measurable investment objectives; effective due diligence processes; monitoring and risk management systems; and segregation of duties. The implication is that funds are expected to develop governance processes and systems around in-house management to the standard required for its effective implementation, as appropriate given the nature and complexity of the business operations. Another notable feature is operational risk reserves (ORR), which are addressed by SPG 114 *Operational Risk Financial Requirement*. Funds are required to maintain an ORR of at least 0.25% of funds under management (FUM); but should consider holding larger reserves if circumstances require. A few interview participants express the view that in-house management should be supported by greater ORRs. However, as we encounter disagreement over whether in-house management increases exposure to operational losses, it is likely that this view is not commonly held.

4. Interview Method and Sample

This section details the research design for the interviews we conducted with executives from the Australian superannuation industry. We outline the topics covered in Section 4.1; discuss the interview sample in Section 4.2; address ‘data’ collection in Section 4.3; set out the interview analysis method in Section 4.4; and describe how the findings are reported in Section 4.5.

4.1. Topics Covered

Six topics were covered during the interview: background information; decision framework; benefits; pitfalls; influence of scale; and success factors. Refer Figure 5 for brief descriptions. Participants were initially invited to comment “off the top of their heads”, with a view to extracting their opinions without leading them in any direction. This was followed by discussion and queries from the interviewers, with a view to ensuring all aspects of interest were covered.

Figure 5: Interview Topics

Topic	What participants were asked about
<i>1. Background information</i>	<ul style="list-style-type: none"> • Experience with in-house management • Percentage of assets • Structure – asset classes, team, etc. • Plans
<i>2. Decision framework</i>	How in-house management is viewed from a philosophical, or decision framework, perspective
<i>3. Benefits</i>	Perceived benefits of in-house management
<i>4. Pitfalls</i>	Costs, risks and challenges of in-house management
<i>5. Influence of scale</i>	How in-house management relates to FUM, and the thresholds at which it might be contemplated
<i>6. Critical elements</i>	Success factors for in-house management

4.2. Sample

We conducted in-person interviews with executives from 20 organisations within the Australian superannuation industry during October and November 2015. The sample includes 13 medium-large not-for-profit superannuation funds, and 7 representatives from asset consultants or research houses, which we denote collectively as “advisers”. Our aim was to interview a substantial portion of the Australian superannuation funds that are either pursuing in-house management or have been considering the possibility; as well as industry advisers or observers whose position requires them to form a viewpoint on the relative efficacy of in-house management and/or provide implementation recommendations to their clients. We refrain from providing granular detail on the sample (such as a FUM breakdown) in order to limit the potential for participants being identified, given that we made promises to preserve anonymity. The population of large non-for-profit funds and advisers from which we were drawing is limited. Here we attain incomplete but substantial coverage, such that the findings should be highly representative for these groups. The area where we have thinner coverage is the medium-sized not-for-profit funds that may be on the fringe of considering in-house management.

The restriction of the superannuation fund sample to medium-large not-for-profit funds requires explanation. We targeted the larger superannuation funds (around A\$20 billion and above) because these were highly likely to have addressed in-house management by virtue of their size. In addition, we attempted to speak to medium-size funds (~A\$5-20 billion) where we had information that they were either undertaking in-house management, or had considered it. For-profit (i.e. retail) funds were excluded due to their different business models and status. Most retail funds are diversified investment management organisations where investment management is a core offering, if not the legacy product. Accordingly, such organisations are not faced with the decision of whether to set up an in-house asset management capability, given that it forms an integral component of their business. By contrast, superannuation is the core business activity in the not-for-profit sector, where most funds come from a position of traditionally having out-sourced the management of asset class portfolios. In-house management of assets is thus a matter of choice, not pre-determined under the business model. Interviewing not-for-profit funds allows us to evaluate the factors that influence the decision of whether and how to build a capability to manage assets directly, versus maintaining an out-sourcing model.

Our sample contains funds from the industry, public and corporate sectors. Nine of the 13 funds managed superannuation assets in excess of A\$20 billion in 2014; the other four sat in the A\$5-\$20 billion range. All funds are either currently managing assets in-house, or are considering the possibility. Five funds in the sample manage 20% or more of their assets in-house. The period over which some assets have been managed in-house is widely spread, ranging from multiple decades to recently. We mainly interview CIOs or equivalent, although the sample contains two Chief Executive Officers (CEOs). At the advisory houses, we spoke to either senior consultants or senior researchers, many of whom were in management positions within their organisations.

4.3. Data Collection

Our qualitative ‘data’ largely derives from the in-person interviews, but also includes some written documents and media reports. Interviews were of a planned duration of one hour, with most running approximately to time. Two researchers attended each interview, one of whom attended all of the sessions. One researcher conducted the interview, with the other taking notes and asking supplementary questions as appropriate. Interviews were recorded, and verbatim transcripts prepared for analysis. Interviews were semi-structured. Participants were sent an abridged Interview Guide prior to the interview (reflected in Figure 5, so that they were aware of the topics to be discussed. Interviewers worked from an extended version of the Interview Guide, containing a checklist of drill-down issues, which acted as a prompt to ensure all items of interest were addressed. A number of the participants

provided internal documents, including analysis and presentations on the structures and decision criteria pertaining to in-house management. Finally, we collect media reports of statements made by representatives of the organisations in the sample, as well as other industry participants. These written documents and media reports provided confirming evidence and additional insights.

4.4. Analysis

The analysis of interviews 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 appearing in the data; but without specifying the categories in advance. The process was evolutionary and iterative, in the sense that the number of categories and allocation of statements was reviewed and updated on an ongoing basis. The number of categories continued to expand throughout the analysis of transcripts as different perspectives were discovered – a notable finding in itself, as it indicated a high diversity in views. Once categorisation was finalised, the findings were written-up.

Various techniques exist to ensure that qualitative research is trustworthy and consistent. Our report ensures integrity by referring to the literature described in Section 3.2 for conceptual framing, drawing on multiple data sources, and analysing data from differing perspectives. More specifically, the following three methods are used:

- *Researcher checking* – Formal coding was undertaken by one researcher. An independent check on the coding was provided by another researcher reviewing the transcripts and extracting key themes, which were then cross-referenced to ensure all major items and perspectives were captured. During the write-up of results, the structure by which the findings were collated, presented and interpreted was further rationalised and checked by other researchers.
- *Participant checking* – Participants were given the opportunity to review their transcript, with a number suggesting changes where the text did not reflect their intent or contained typographical errors. Participants were also given an opportunity to review the draft report and comment.
- *Data triangulation* – Where possible, interview data was crossed-checked against behaviour, as reported in written documents or media reports. Data triangulation was limited in scope, but highly beneficial where alternative sources of data were available.

4.5. Reporting of Findings

Interview findings are reported through a combination of summaries capturing the general tenor of conversations, counts of the number of participants that mention particular items, and illustrative quotes. The counts reflect where participants mention an item in a way that indicates they attach a degree of importance to the aspect in question. These counts provide an indication of the breadth of concern with the item, but not the intensity of the views. In addition, there could be two reasons for a count not being recorded. The first is a participant failing to mention the item, which could indicate either it is attached no importance, or merely an oversight. The second reason is that a participant might disagree that the item is relevant. We attempt to draw out the intensity and range of views about selected items in summarising the discussion. With respect to the quotes, these are selected to be illustrative rather than comprehensive; and are lightly edited to improve flow without altering the meaning. We also identify whether the quotes are sourced from a ‘fund’ or an ‘adviser’.⁹

⁸ NVivo 10 software was used in the analysis.

⁹ We also estimated the item counts between funds and advisers, but decided not to report the breakdown as no clear distinction is apparent.

5. Interview Findings: The Decision to Bring Funds In-House

We commence our reporting of the interviews by detailing how our participants are tackling the decision to bring funds in-house. Section 5.1 gives an account of the general approaches described by our participants. Section 5.2 discusses key aspects that are taken into account. Section 5.3 focuses on the role of personal experience and beliefs in the decision. Section 5.4 examines how the decision to manage assets in-house is being implemented, including the structures being adopted.

5.1. Wide Variety of General Approaches

The most striking finding from our interviews is the diversity of views across the sample. Every participant has their own particular approach to in-house management. We also encounter differing emphasis and viewpoints regarding the various aspects that might be considered. During analysis, we found it necessary to continually add new categories (nodes) right to the very last transcript as new perspectives or views emerged that we had not heard previously. Figure 6 provides an initial sense of the extent of this diversity. In this figure, we attempt to capture in 2-3 lines the essence of each participant's broad approach, and the aspects they emphasise most.¹⁰ Although there is a sizeable element of overlap, for most part the points of emphasis and the manner in which they discuss the issues differ considerably. *Hence the Australian industry is addressing in-house management through a wide variety of frameworks.* There is no consensus on how the decision should be made and what aspects matter most. Nevertheless, certain subjects receive mention across a range of participants, even if discussed in differing terms. We drill down on the most discussed aspects in Section 5.2.

5.2. Key Aspects Considered

This section discusses six aspects that are widely mentioned by our participants as key considerations in the decision to bring funds in-house: net returns; scale as an influence; competitive advantage; capacity to implement; alignment; and risk.

Net Returns

A majority of participants allude to the importance of considering net returns, which is the balance between any change in gross return (or alpha, implicitly after-tax), and the potential cost effects arising from in-house management. Net return encapsulates the two key elements of *capabilities* and *cost*. Net return is the primary focal point for seven participants, although it is either explicitly or implicitly referred to by most. The broad emphasis placed on net returns encourages us to include it as a separate checkpoint under the framework appearing in Section 2.

¹⁰ Participants were sent the summaries, and asked to confirm that they accurately reflected their stance.

Figure 6: Key Decision Influences for Each Interview Participant

Net return as the focal point (7 participants)	
Fund	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.
Fund	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.
Fund	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, e.g. tailoring, access to opportunities, cost (but not cost alone). Any big bang shift must flow from overall fund strategy.
Adviser	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.
Adviser	Value-chain framework can be used, focusing on assessing comparative risk-adjusted return in each component of the chain. Economies of scale, and the value of fund differentiation, are considerations.
Adviser	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.
Adviser	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.
Exploiting competitive advantages (1 participant)	
Fund	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.
Flows from objectives (1 participant)	
Fund	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.
Two primary criteria (4 participants)	
Fund	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.
Fund	Prime considerations are ability to tailor and then leveraging competitive advantages , especially those related to scale and execution. Bias is toward in-house management where these are evident.
Adviser	Two focal points are: 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, e.g. control over assets; ESG; tailoring to objectives. In-sourcing is a strategic decision.
Adviser	Net returns can be improved by reducing costs at certain scale; plus can better tailor to objectives . Additional alpha shouldn't be expected; and governance and alignment issues need to be sorted.
Three or more key criteria (7 participants)	
Fund	Three key criteria are: (1) do-ability ; (2) capacity constraints ; (3) cost savings . Also, other synergy benefits can matter. Trading off these criteria leads to a hierarchy of which assets to manage in-house.
Fund	In-house management can help solve three problems related to size : (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.
Fund	Key issues are: (1) capacity ; (2) control ; (3) costs . In-house management of alternatives can reduce fees where they are highest; and might be accessed using co-investment or partnership structures.
Fund	Three criteria: (1) no taking of active risk ; (2) ability to manage the operational risks ; (3) clear and compelling cost advantage . Taking active risk requires a step up in governance, systems, culture, etc.
Fund	Our reasons for moving in-house have varied across assets and over time. They have included: enhanced ability to add value after costs , supported by a competitive advantage; better alignment and pursuit of long-term investing; access to capacity ; and duration management .
Fund	Key criteria are: (1) possessing a core competency ; (2) alignment with objectives; (3) scale efficiencies . Resource constraints can be influential in limiting what might be pursued internally.
Adviser	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 toward in-house management.

Notwithstanding the broad attention on the potential implications for returns, the perception of how in-house management impacts on net returns varies considerably. At one end of the spectrum is the view that shifting to in-house management may lead to lower gross returns, but could lead to a meaningful increase in net returns due to substantial decreases in management expenses (discussed next). At the other end of the spectrum are those who see in-house management as offering the potential to enhance gross returns as well as reducing costs, usually because it leverages a competitive advantage (discussed below) or provides other ancillary benefits, such as access to opportunities, synergies or market insights (see Section 6). Others have no prior expectation, but just consider it important to evaluate the potential net return impact. The following quotes highlight the range of positions on this issue:

“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)

“... you should be managing for total return after fees and taxes ... it comes down to fee reduction without unduly impairing the performance of the portfolio.” (ADVISER)

“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)

“... over time we’ve delivered (a large amount) of active return on the big flagship funds against the benchmark. And so while that’s working for us ... it’s the most efficient way of keeping risk under control, but to give yourself an extra layer of return.” (FUND)

Analysis of the transcripts provides a sense for the extent to which cost is emphasised as the primary driver of expected improvements in net return. While all 20 participants comment that in-house management could potentially lead to increased returns, 14 (70%) explicitly adopt a net return focus in doing so; while 5 (25%) talk about cost reduction as driver in isolation.¹¹ Counterbalancing this, some participants went out of their way to explicitly state that cost was not, and should not, be the primary factor. When asked where reducing cost is ranked among the reasons for managing in-house, the answers range from second to fourth. The quotes below reflect the tenor of the debate:

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

“Partly they can be motivated by MySuper ... just going away from active management and bunkering it all down and going a bit more plain vanilla to save money.” (ADVISER)

“Cost is [ranked] about number four. Cost is a very positive outcome. If you’re doing it for cost, you’re doing it for the wrong reasons.” (FUND)

“If done purely for cost, mediocrity might be the only sustainable goal.” (FUND)

¹¹ One participant talked about cost savings combined with a variety of other possible benefits, but did not refer to net returns *per se*.

Scale as an Influence

Scale is an important driver in the decision to bring funds in-house. The larger the fund, the greater is the imperative to at least consider in-house management, and the higher the likelihood that it might be considered inevitable. The links with scale are manifold, but may be arranged into three broad groups:

- (i) **Management expenses** – The scope to reduce the management expense ratio (MER) through in-house management increases with FUM. This is mentioned by 9 participants, and relates to the *cost* element.
- (ii) **Capacity constraints with external managers** – 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 the *capabilities* element.
- (iii) **Return benefits** – Certain competitive advantages associated with larger size might be better captured through in-house management and thus lead to higher returns. Examples include improved ability to capture certain opportunities, or invest more effectively in unlisted assets. Six participants allude to such benefits, which relate to the *capabilities* element.

After accounting for the overlap, scale effects are explicitly mentioned by 16 participants, and otherwise implicitly referred to when discussing the potential for cost reduction. Here we expand on the first two of the above aspects. Competitive advantages related to scale are discussed in Section 6.2.

Management Expenses

The following quote points toward the mechanism by which the potential to reduce the MER with in-house management is linked to scale:

“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)

A number of participants cited their own version of the calculation of the dollar magnitude of fees paid to external managers at selected levels of FUM, coupled with contemplation of what this amount might buy in terms of in-house management capability. These sorts of calculations not only serve to gauge the cost savings that could become available through in-house management. They also highlight how the potential savings vary with scale, and suggest the lower bound at which in-house management might be considered. For instance, a participant from a smaller fund shared these thoughts:

“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 underlying source of the problem and opportunity is that external managers charge a basis point fee, which converts management fees to a variable cost for the asset owner.¹² Meanwhile, an in-house

¹² 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.

management team approximates a fixed cost. At high FUM, the variable costs associated with external managers amount to a much larger MER than the fixed cost of establishing an in-house capability. Another way of describing this situation is that in-house management allows the fund to retain the economies of scale for their members, rather than have them captured by external managers.

While we do not dispute that in-house management offers the potential to reduce MERs, two additional considerations should be taken into account. First, the calculations should be applied only to that portion of the assets brought in-house. For instance, bringing 25% of a \$10 billion equities portfolio in-house would release \$7.5 million in external manager fees at 30 bps to be spent on in-house management. While helpful, these numbers are not overly large, and might amount to less than 2 bps at the total fund level. Second, it is possible that the available MER savings from moving assets in-house could be reduced if external managers reduce their fees. One participant offered the opinion that it might prove unnecessary to bring funds in-house to save fees, as external managers are likely to respond to the threat of losing business by reducing fees closer to the marginal costs of in-house management. There are indications that investment management fees are currently under pressure, as reflected in these quotes:

“A perverse thing is happening, and that is that we are getting unsolicited offers from funds management firms that are saying: ‘we’re offering you a fee discount’. And we haven’t even talked to them yet. It is pre-empting.” (FUND)

“Every manager we’re talking to at the moment is offering cost reductions. Virtually they’re asking for them. They all know it’s sort of out there.” (FUND)

Capacity Constraints

The link between scale and the capacity constraints encountered with external active managers can be understood by considering the limits to feasible mandate size, and then contemplating the problems that this creates as FUM rises. This issue 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; and the best managers are often at capacity. 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 (which is what you would probably get anyway from over-diversifying managers in the portfolio), or 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.

This parable broadly extends to many other asset classes, although the numbers and discourse will vary.

Not everyone agreed that in-house management solves capacity issues. Here is a contrary view:

“I’ve heard the arguments. I’m not so sure. If capacity is a problem, I’m not sure that internalising it solves the problem. You’re trying to access some sort of market inefficiency, some sort of market process ... [with] capacity, it’s going to be the size of the sort of inefficiency you’re trying to target. Depending on what you’re trying to do, you will have different capacity constraints in the market, rather than in the investment management commitments ... we’ve gone to great lengths to get global so we’re not constrained by any market.” (FUND)

Competitive Advantage

The concept that in-house management offers competitive advantages that may enhance returns over those available from external managers falls under the *capabilities* element. Leveraging some competitive advantage or generating alpha was directly cited by five participants (25%) as a *key* reason for in-house management. In addition, the idea that managing in-house might generate additional returns manifested in a number of forms across the discussions. We heard mention of: exploiting existing skills; enhanced ability to capture investment opportunities, often via the flexibility afforded by an in-house capability; pursuing strategies that are not readily accessible through external managers (e.g. long-term investing); and synergies that might generate returns across the portfolio, such as insights gained through operating in the markets. We expand on some of these advantages in Section 6, where the benefits are examined in detail.

In any event, a meaningful portion of our sample consider in-house management as giving access to some form of competitive advantage, even if they did not identify the advantage as a key consideration in the decision. On the other hand, three participants made a statement indicating they perceive in-house management to have no real advantages over external managers, so that the choice has to rest entirely on other advantages such as lower cost or tailoring.

The quotes below provide a sense for how this issue was approached by those who saw identification of some competitive advantage as important. Typically this involves linking the circumstances of the fund – its intent, governance framework, size and resources, skills, culture, etc. – to some kind of an advantage from operating in the market:

“We started to reflect on what are our core competitive advantages, and what capabilities make more sense within the governance framework and culture of an asset owner.” (FUND)

”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 be sustainably accessed via control.” (FUND)

“We come from the point of view in starting of: ‘would we have a competitive edge’? For example, Aussie equities was considered twice before and rejected, that we couldn’t work out where we’d have a competitive edge, or how would we fit it into our current portfolio. ... we look for aspects where there’s some dislocation, like going into direct debt recently, to say okay, there’s change here, the banks are leaving this particular field. So there’s a structural change.” (FUND)

“... what asset classes we do in-house depends on where we think we’ve got skill and where we add value ... [for instance] we can negotiate better rates in many types of instruments because we’re a different sort of entity, a different counterparty, compared to just putting it in a cash management trust. So we use that as sort of a competitive advantage. ... The equity strategy that we’re looking at [is] more of a long-term hold, not trying to compete with the traditional alpha generation because I just don’t think it is easy to have a competitive advantage ... again, this is about playing to your strengths, not to trying to compete directly. ... If you’re able to 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.” (FUND)

Capacity to Implement

A majority of participants emphasise the importance of effective implementation of in-house strategies through appropriate governance processes, people, systems, and the like. We expand on these areas in Section 7. For some, the capacity to implement was sufficiently important to be treated as a key flash point for the decision itself, i.e. confidence in capacity to implement is required before managing in-house is contemplated. Capacity to implement is mainly associated with the **capabilities** element; although at times the issue is whether in-house management is consistent with the **governance** structures or in **alignment** with the organisational culture. The quotes below give a sense for the ways in which capacity to implement could enter the decision. Note these are typically minority views. The majority view is that implementation hurdles can be overcome for the most part. That is, the fund should first decide what to do, and then work out how to do it.

For some participants, capacity to implement stood as an important criterion for deciding whether in-house management should be attempted:

“...[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], given that we could easily access whatever skills we wanted outside. ... we certainly haven’t bitten off more than we can chew” (FUND)

“... if we can do it in a low risk way internally ... do it in a competent way, and we can get the people with the skills at the right price ... 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)

Capacity to implement can also play a role in deciding which asset classes are most suitable for managing in-house:

“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. So some things we thought would be more do-able; and we biased ourselves toward the more do-able ones.” (FUND)

“It’s [also] a matter of geography. People are generally more familiar with home markets than they are with overseas markets. And then it has to do with the complexity of the asset class.” (ADVISER)

Some funds see themselves as resource-constrained, either due to their size, or the nature of their budgeting process. This could either influence the decision to manage in-house, or limit the scope of what is considered feasible:

“I really couldn’t convince myself that running a lot of active stuff internally makes sense with a small team. It just doesn’t add up.” (FUND)

“... we’re only going to have a limited number of resources ... lots of analysts running around ... we’re not going to be able to fund that” (FUND)

“... to try and internalise absolutely everything, I think you’re going to have to have a very, very large team. And that may be somewhat unmanageable with the scale of the funds that [many Australian funds] have got at the moment.” (ADVISER)

Alignment

The question of whether managing assets in-house supports better *alignment* figures prominently in the interviews. All 20 of our participants identify at least one benefit that amounts to some improvement in alignment (see Section 6 for details). For approximately half of the sample, securing better alignment is more than an ancillary benefit and represents a key consideration in the decision. While the point of emphasis varies considerably, funds are looking for in-house management to improve alignment in two broad, related ways. The first is via *improved tailoring* towards objectives. This includes aspects such as: designing strategies to specifically meet objectives; how assets are sourced and held in the portfolio; complementing external managers, and hence ‘completing’ the portfolio; managing overall fund liquidity via the cash portfolio; and liability-driven investing in the case of a defined benefit (DB) fund. The second avenue is *avoiding agency risks* associated with external managers.

Nevertheless, we also encounter considerable dispute over the relative importance of alignment, particularly with regard to the ability to tailor. The main opposing view is that external managers offer sufficient breadth and flexibility to support the pursuit of tailored strategies without needing to resort to in-house management. The series of quotes below capture the breadth of views around this topic.

Some participants see 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 instigating the approach that allows the fund to best achieve the desired outcome:

“What’s the purpose of the organisation and its role? You’ve got to start with that, plus the values of the organisation” (FUND)

“Strategies for each asset class will vary with investment option, depending on its objectives – including whether an internal strategy is appropriate.” (FUND)

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

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

“It’s not to try and duplicate what external managers are doing ... it was to find niches that make sense for us to run, such as lower risk and enhanced beta strategies. ... 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 out there in the marketplace.” (FUND)

“A number of our clients build equity portfolios in a different manner. For some, it’s about downside protection, and it’s not just about outperforming the market by say 2% per annum. It’s about trying to get 4% or 5% outperformance in weak markets; and they’re happy to give up a bit of that in strong markets. It’s always been a challenge to find those managers; and you might be able to build that capability in-house if that’s the particular philosophy you’ve got.” (ADVISER)

Some note that managing in-house can assist with *cash flow management*:

“I’m actually getting some cash flow characteristics that I want to give to my members”
(FUND)

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

Where there is a *defined benefit fund*, some see the potential for in-house management to enhance the implementation of liability-driven investing (LDI). There is a general view that the case for in-house management differs under defined benefit versus defined contribution:

“In-house management was absolutely fundamental to manage that defined benefit portfolio. ... Once you’re in that LDI world, I’m not going to out-source this to a whole bunch of different parties, because how do you actually get this fund managed as you look after this part of 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 DB they can tailor things a lot more. But for accumulation, I don’t think that’s the case. For a start, the in-house portfolio is one part of a bigger portfolio. So it’s one manager, it’s one of several managers, so to get the entire portfolio you’ve got to bundle all that in together. So they’re just a part of it.” (ADVISER)

Some *question the need to manage in-house in order to tailor*. Four participants argue that external mandates can be designed to meet nearly any purpose. Another three suggest that external managers cover a meaningful portion of the range of requirements. For instance:

“... 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)

“So it does help the management and oversight of cash flows and risk management, but I don’t regard that as a really major advantage. I think we could out-source and still achieve that with properly drafted mandates and oversight. ... [And with defined benefit] I’ve got no doubt that we could retain managers to do that.” (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 7,000 managers.” (ADVISER)

“I’d say it’s sporadically true [that managers can tailor effectively]. It’s pretty true ... on, for example, the smart beta spectrum or an income-investing spectrum. There’s a whole line of products available for sort of 5 or 10 basis points where it’s going to be cheaper, but is tailored. ... I’d say it’s half true for things like ESG and SRI and that sort of thing, where you can sort of get something with that label, but it may not be exactly what you meant by ESG and SRI.” (ADVISER)

For a handful of participants, in-house management is seen as helping to *overcome the agency risks* inherent with external managers. The concerns relate to the fact that managers are incentivised in ways that may lead to return leakage, or to take 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 they can be driven to make ill-advised investments as they are anchored to benchmarks, or expected to invest in assets within their specified universe regardless of attractiveness:

“... agency risk ... the ultimate objectives of the members is distorted the further you appoint agents within the chain” (FUND)

“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)

“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 that everyone comes in the door with, which they're selling. ... The offer to tailor is always there; but to get that tailoring actually happening for you, 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. ... They can't do it is the short answer.” (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)

Risk

The potential risks associated with in-house management did not feature prominently in the decision for the majority. Some perceive the risks as limited (e.g. managing a slice of Australian equities in-house “*won't sink the fund*”); and/or take the stance that the risks need to be understood and managed. The majority appear confident in their capability to deal with the risks, which we discuss in more detail in Section 7. Thus risk concerns are not a barrier to adopting in-house management for most.

Nevertheless, a minority of participants appear to place sufficient weight on the risks of managing in-house that it might just swing the balance. Operational risk was most commonly mentioned, which is closely related to capacity to implement (discussed above) and hence *capabilities*. We also heard mention of reputational risk, peer group risk, and the need for a higher return hurdle on managing in-house in recognition of the greater risks involved.

5.3. Role of Personal Experience and Beliefs

The personal experiences and beliefs of key decision makers appear quite influential, not only in the decision to manage in-house, but also for the manner in which it is done. This notion is evident from both the interview transcripts, and an appreciation of the background of the people involved. It is also to be expected, and not necessarily a bad thing, to the extent that venturing into areas where there is competency and comfort makes sense. Below we provide some evidence for our contentions.

In Section 3.3, we mention that the initial phase of in-house asset management in Australia entailed a small number of funds, such as Equisuper, REST and Telstra Super, embracing in-house management due to a belief by those involved that it offered a better solution. A number of our interview participants elaborated on this background. We heard that the key people involved in this early phase came out of the investment operations of the State Electricity Commission of Victoria (SECV), which became Equisuper when SECV was privatised in the late-1990s. They include (in alphabetical order) industry notaries such as John Coombe, Ken Marshman, Terry McCredden, John Nolan and George Zielinski, all of whom were money managers with both the capability and a predilection to manage assets in-house. This group of people has been influential in the subsequent development of in-house management at a number of Australian superannuation funds, driven by the confidence and belief that managing in-house can drive better member outcomes if done properly.

In addition, we note that the format pursued for in-house management often reflects the background of the people involved. For instance, the in-house management effort might be concentrated on (or commence with) listed markets where this aligns with the experience of the investment team.

Our interview transcripts contain some comments confirming the influence of personal experience and beliefs. For instance, two participants express their predilection towards managing in-house:

“The question should be why should you out-source? 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 out-source.” (FUND)

“I think in-house management is both viable, practical and if you can you should do it, and there are a lot of reasons for it.” (ADVISER)

There is also 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, but I didn’t have a strong view one way or another.” (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 and so on, we’d be stuck with that model.” (FUND)

The influence of personal experience and belief links to one of the structural trends identified earlier: the expansion of internal management teams. When staff members are employed who have a history of market involvement, such as former investment managers, they bring the skills and confidence to manage assets directly. Some may also come with a predilection to do so. Nevertheless, we emphasise that this is not necessarily a bad thing, provided that in-house management is pursued for the right reasons. Indeed, focusing the in-house management efforts on areas where experience and skill exists

plays to the *capabilities* element. However, exposure to behavioural issues, such as over-confidence or complacency, may need to be watched (see Section 7.3) to ensure that *alignment* is not compromised.

5.4. How the Decision Is Being Implemented

We now discuss the process and structures under which decisions are being implemented. We observe how the majority of participants describe an approach that is measured, incremental and forward-looking; and how the decision is being applied on an asset class-by-asset class basis. We relay comments on the indicative size of FUM at which our participants believe in-house management might be appropriate. The section concludes by examining the variety of structures that are being used.

Measured, Incremental and Forward -Looking

Our participants are largely taking a measured and incremental approach to in-house management, with nobody describing or recommending a comprehensive, ‘big-bang’ implementation across a fund:

“... not in a big-bang sort of way. It was basically just ‘are there things where we can have more internal involvement?’... an incremental evolutionary type thing. You’re just adding stuff on as you go.” (FUND)

“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)

“We didn’t want to do everything at once ... built a three-stage approach” (FUND)

“All these things are evolutionary. This is a very young industry.” (ADVISER)

Some participants emphasise the forward-looking nature of the decision, recognising that an in-house capability may take some years to build. We heard about how strongly-growing funds should give consideration to their FUM and capacity constraints down the track; and how the situation might differ for defined benefit funds entering a rundown phase:

“You could take a \$50 billion fund that’s growing rapidly and a \$50 billion fund that’s shrinking, like a couple of closed defined benefit schemes. It may not make much sense for the \$50 billion defined benefit closed scheme to go through all the expense of setting up in-house asset management in say, Aussie equities, if [it’s] declining. For the \$50 billion fund that’s growing with SG contributions, it probably makes abundant sense. It’s not just about scale today, but it’s about scale tomorrow.” (ADVISER)

“... [it’s a] process of reviewing how do we invest now, what’s our growth profile, what’s the scalability of our current approach, and where are the areas where we should be focusing resources on, if at all – [being] forward -looking.” (FUND)

“Funds have got to say, how big will I be in five years’ time and 10 years’ time? And that time passes very quickly. So you’ve got to be preparing yourself.” (ADVISER)

Asset Class-by-Asset Class

Aligned with the incremental nature of the process, the decision to manage in-house is universally addressed on an asset class-by-asset class basis. The following quote captures the sentiment at large:

“We tend to go through asset class by asset class ... [ask] what’s the best model? And we revisit that regularly. And so there hasn’t been a strategic forum [at our fund] where we say let’s become an internal asset manager.” (FUND)

Beyond the position that going in-house is essentially an asset class-by-asset class decision, any commonality in approach starts to break down. The series of quotes below provides a sense for the variation in which asset classes are targeted for managing in-house, and the reasons why. We intentionally report a large number of quotes (nine), to further underline the wide disparity in approaches encountered:

“When we initially started, it was more about particular asset classes and where we felt that it was hard for external managers to add value ... As we’ve added other asset classes over time, the drivers have been different. ... It depends on what you’re trying to achieve out of those asset classes.” (FUND)

“So what asset classes we do in-house depend on where we think we’ve got skill and where we add value. At the moment we don’t do global equities in-house, for example. And one of the reasons we don’t is that I think the operational risks attached to doing global are much greater than they are doing domestic. ” (FUND)

“Asset management is a whole set of functions that are internal to the asset management entity. If you break each of those up, and then for each asset class put a tick or a cross as to whether it’s ever a candidate for internalisation, and if it is, where does it sit in the spectrum, you’ll find that some asset classes you can’t pick.” (FUND)

“... depends a lot on the resourcing required and the degree of the direct management. So you could do co-investments in property or infrastructure or private equity - two good, capable people per asset class could run a decent little co-investment program. So the scale for that might be as low as \$5 billion or \$10 billion. To build a full active management, say, Australian equities capability would probably require 10 to 20 people, particularly when you include back office people. So therefore, the scale for that is probably around the \$40 / \$50 / \$60 billion dollar range, or at least predicted to get there in the near term. Global equities is probably bigger still...” (ADVISER)

“All the generic asset classes are managed in-house ... Australian equities, global equities, basically anything Australian to start with in terms of mainstream. Where we draw the line is anything which requires ... large teams involved in bottom-up fundamental analysis.” (FUND)

“I think it makes sense for elements within an asset class, or strategies within an asset class, and maybe not for other strategies within an asset class. So it’s all horses for courses. But clearly in the illiquid alternative space, the agency risk is very high and the cost is very high, so it’s a more logical place to start.” (FUND)

“Not on our horizon are the internal management of any unlisted assets like infrastructure or real estate or private equity ... because of our size, we will always need to have global footprints. So if we’re going to run a successful program, we’ve got to get that sort of

management done in multiple jurisdictions in multiple countries. We've got to source pipelines of assets. We've got to get all of that framework in place, and that's an amazingly difficult thing to do. If we were small, and we were only going to buy assets in one location, like in Australia, or we were only going to buy less complex assets, then it may be different.” (FUND)

“... first answer is it depends on the asset class; it depends on the area you're going to play in. So it's pretty easy to do cash.” (FUND)

“You generally start off with cash and short-term fixed interest because to a certain extent you've got to do that anyway to manage liquidity, so you probably have some in-house skills in that respect. Then it's a matter of geography; people are generally more familiar with home markets than they are with overseas markets, and then it has to do with the complexity of the asset class.” (ADVISER)

Notwithstanding the wide variation in approaches, it is possible to identify some common **themes** with respect to which assets are more likely to be selected for in-house management:

- **Cash is the asset with the greatest propensity to be managed in-house** – This notion is confirmed by the SuperRatings data appearing in Figure 4. Our interviews indicate that the propensity to manage cash internally reflects three influences: (i) the relative ease and low cost of establishing a cash management capability at modest FUM; (ii) the synergy benefits between liquidity management and cash investment; and (iii) the opportunity to take advantage of the ‘term deposit trade’, where banks were offering attractive rates for direct deposits post the Global Financial Crisis.
- **The influence of scale varies across assets** – Scale requirements ranked from lowest to highest appears to be cash, then fixed income (differentiating sovereign and credit), then local listed equities and alternatives through co-investment or partnership, and finally overseas equities and alternatives involving direct sourcing and management of the assets.
- **Overseas assets** – These are generally harder to manage in-house, as the capability hurdle is higher.
- **Investment process** – Assets may be more amenable to being managed in-house where more mechanical processes can be used, rather than complex strategies that require professional teams.

Scale Indications

We asked interview participants to give a rough indication of the FUM at which in-house management is worth contemplating. Our aim was not to extract exact estimates, but rather to provide a sense for the broad thinking in the industry. At the lower end, some thought that consideration might be given to adopting in-house management at FUM levels as low as A\$5-\$10 billion, at least in a limited form such as management of cash, or in special situations. At the upper end, A\$50 billion was mentioned a few times as a FUM level at which in-house management becomes almost inevitable due to the potential cost savings and the capacity implications of investing through external managers. This number was often driven by indicative calculations with respect to Australian equities. Hence the A\$10-\$50 billion range appears to be the ‘grey area’ where some form of in-house management might be contemplated, but is not considered as imperative.

Finally, the quote below arises from an advisory house where our participant canvassed a broad range of views from colleagues, one of whom had undertaken some detailed analysis. The numbers quoted relate to the size of the book in the asset class. They fall in the \$10-\$20 billion range, consistent with a fund of around the \$50 billion mark.

“Aussie equities, maybe the size of that book needs to be \$10 billion to \$20 billion; private markets, direct investment, \$20 billion; internal cash, trading and capital market functions, maybe currency hedging, \$10 billion. ... Credit, I guess given the sort of systems, is probably pretty large as well. ... Cash is sort of different because at the moment we’ve got this term deposit trade.” (ADVISER)

Structures

In-house management can be undertaken within a range of structures, which we position in our framework as a component of the **governance** element. Below we identify four models, and draw out some observations about the efficacy of each arising from the interviews. We then discuss two related structuring issues: whether a separate legal entity might be set up; and potential intellectual property (IP) issues within hybrid models.

Four Structures

1. Dedicated internal manager

Under this model, 100% of the asset class is managed in-house. With the notable exception of cash, we heard about only two other instances where an asset class portfolio is fully-managed internally (although there may have been others that were not directly declared).

2. Hybrid: internal and external managers

Many participants express a strong preference for a hybrid approach, under which an in-house management capability is combined with external managers to form a multi-manager portfolio. It is typical for the in-house team to manage something like 20%-30% of the portfolio, at least in Australian equities. Benefits of a hybrid approach mentioned by our participants include: greater flexibility to tailor the portfolio and adjust weightings to various strategies (more levers); creating competitive tension between internal and external managers; avoiding capture by the in-house team; establishing a benchmark for in-house performance; providing more bargaining power in fee negotiations; and extracting insights from external managers. The quotes below capture these themes.

“My sort of starting point would be open architecture ... that makes the exit strategy a whole lot more do-able. So if I’ve given 30% to my internal manager and 70% to external[s], and my internal manager starts screwing up, I say; ‘Well, okay, you’re down to 20%, I’m shifting 10%.’ It’s going to start pressuring my fixed cost argument, and the whole reason for doing it. But at least it gives me a way of getting out; it gives me a way of benchmarking what they’re doing.” (ADVISER)

“... part of the assets, not the whole. There would be competitive tension with other people; there’d always be a backup, so that if it didn’t quite work out internally you weren’t totally reliant on your internal staff. ...[Totally internal] is crazy ... you’re captured by your internal people.” (ADVISER)

“I think it’s really, really important to have an external manager in every asset class. ... Our in-house guy actually likes having an external manager to bounce ideas off, etcetera. I, as the boss, I like to have an external manager so I’ve got a redundancy ... external managers know, in fee discussions for example, we’ve got an alternative and the alternative is sitting on my floor. So there’s that competitive tension. There’s obviously a benchmark there.” (FUND)

Within the hybrid approach itself, we identify three models, distinguished by the extent to which the in-house capability is integrated, as opposed to being treated as a discrete manager in its own right:

- *Fully integrated* – The portfolio is managed as an integrated unit, with the in-house management capability used as a ‘portfolio completion’ facility. This entails the internal team having complete visibility on the positions of external managers, which they attempt to complement. Responsibility for the overall portfolio would likely reside within the in-house team.
- *Partially integrated* – The in-house capability is established as a discrete manager in a multi-manager structure, but may be managed or directed in line with overall portfolio objectives. This could entail the in-house team being involved in the construction and delivery of strategies that accord with the needs of the portfolio; or given specific objectives or tasks. Responsibility for the overall portfolio would likely reside with higher management, such as a portfolio manager or the CIO, or be shared with the in-house team. The in-house team might have line-of-sight through to the portfolios of external managers.
- *Segmented* – The in-house capability is treated as just another manager within a multi-manager structure, with its own distinct mandate. The in-house manager is expected to do no more than deliver on its mandate; and there would probably be no line-of-sight through to the portfolios of other managers. Responsibility for the overall portfolio would reside with higher management, such as a portfolio manager or the CIO.

The three structures vary in the degree and type of benefits that are accessed. For instance, a fully integrated model is better for alignment, tailoring and leveraging any insights from external managers. However, it erodes the potential to create competitive tension and benchmarking between the external and internal teams as they are no longer performing comparable functions. The appropriate structure will depend on the circumstances, in particular the overall portfolio objectives. One challenge with a hybrid approach relates to IP, which is discussed at the end of this sub-section.

3. *Co-investments*

Co-investment is used by some funds in alternative assets. It involves piggy-backing on the ability of an external manager to identify and source assets through taking a ‘slice on the side’. One advantage of co-investing is that it provides access to assets at a lower cost, as it avoids paying the full management fee (which is often substantial in alternatives). Another advantage is that co-investment can be executed by medium-sized funds through a small in-house team. The main disadvantage identified by our participants is that co-investments can be difficult to exit in isolation of the manager, and can thus be relatively illiquid. Also, investment is driven by availability – the fund can only take what is offered. Furthermore, assets offered up for co-investment may suffer from a ‘lemons’ problem, as documented by Fang, Ivashina and Lerner (2015) for private equity (not mentioned by any participants). Some of these themes are drawn out in the two quotes below:

“We co-invested alongside [the manager] ... you need to do your own verification, and look at the due diligence work and read it yourself ... You do need some in-house resources in order to undertake that function, or you’re basically just blindly investing alongside. The fees are less for co-investment. ... It’s opportunity driven. ... It sits in a special purpose vehicle attached to each asset class. We’re not actively managing that asset. It has tag-along rights with the manager. If the manager chooses to divest, we divest alongside it.” (FUND)

“One of the big challenges with co-investment is that you’ve got very, very small slices when you’re little. Very small slices that are sometimes really hard to get rid of. You’ve

got weird pre-emptives often that sit in these things. ... It's actually a big disadvantage of co-investing at any stage, that you've got [no] exit strategy." (FUND)

4. Partnerships

We encountered two partnership models during the interviews. The first involves a partnership between funds: a structure that is prevalent in alternative assets, such as direct infrastructure or property. This model has similar benefits to co-investments in terms of providing access to assets at low cost in situations where internal resources are constrained. Further, fund partnerships can provide greater influence over asset purchase decisions than under co-investment, and are less exposed to any 'lemons' problems. However, fund partnerships may face their own constraints on control over exit; and alignment between partners is crucial. The second model involves a one-on-one partnership with an external manager or other operator, under which the external party provides the expertise and the fund supplies the capital. Key challenges under both models include selecting the right partner(s) and structuring. The quotes draw out some of the issues:

"... collective internalisation of property management by the big industry funds ... I would call all of that internalised. And I would call IFM, up until it started getting external from the original core investors, that it had been an internalisation process of managing infrastructure. It was a means of getting the costs down and having a group of investors with a collective view about the way they wanted to invest. ... In a collective, you're reliant on other people sometimes in terms of what they want that collective to do, and whether they've got funds to put into the collective. Whereas when you're running your own internal [operation], you might be happy to keep funding a little bit of that, but you can then go and buy a billion-dollar shopping centre." (ADVISER)

"So in terms of expanding into offshore markets in both those asset classes, it's not somewhere where we have the expertise. So what we're doing is looking to establish partnerships with key knowledgeable, experienced people in that space. It might be another fund manager, or it might be an operator." (FUND)

"Partner selection in these things is everything. So there are different dynamics. So who are the five other investors who are co-investing in this thing with you? How do you get on? Do you have an independent director? Have they got lots of fund managers on the Board who all want to play around with spreadsheets, but not govern very well? You've got to actually select your partners and have a philosophical alignment with them. The operator - who's going to actually run the port? Who's going to run the tollway? What's the arrangement? How does the Board make decisions? What happens if one wants to sell and one wants to buy? The pre-emptive arrangements. All that sort of stuff. This deal-structuring piece is not trivial." (FUND)

Separate Business Entity?

One issue to consider is whether in-house management should be set up as a distinct business entity in its own right, i.e. an investment manager that is fully owned by the fund. Feelings among our interview participants were decidedly mixed on this point. Some hold the view that establishing a separate business is desirable, and possibly unavoidable, as it accommodates differences in culture and remuneration structures between investment and non-investment staff. Further, it creates a business that could ultimately further enhance **returns** by eventually accepting external funds and possibly being on-sold. Some referred to precedents in the form of the Axiom operation set up by State Super (which was ultimately sold to Deutsche Bank), and the ownership of Hermes Investment Management by the BT

Pension Fund. Detractors typically point out that structuring an in-house capability as an external manager for all intents and purposes does not solve the **alignment** and agency-related problems that arise with external management. Further, it may dilute some of the synergy benefits of having an in-house team. The quotes below convey the *contrary* viewpoints. We comment that the gravity of these views partly depends on the extent to which the management operations are integrated with the fund, which may be influenced by whether the management company is dedicated or accepts external money.

“I don’t see the benefit in having a separate legal structure. From a cultural point of view, you want to be part of the fund, share the ethos of the fund. ... [One issue is what] mitigates the risk of there being two separate classes of people in the organisation? If you put them in a separate legal structure and really treat them differently, it probably makes the situation worse.” (ADVISER)

“We wanted to keep the investment team as part of the trustee company, because when you start to manage an external entity, you create further agency risk. We also wanted to have that cross-pollination of ideas.” (FUND)

“It’s probably not the best model because it introduces agency issues and your decision to redeem from the manager ... has direct impact on the equity value of that business. ... We actually sometimes buy equity in hedge funds, but we may not necessarily give them the money to go with it. It doesn’t have to be a connected decision. ... it’s just the way the two come together, you lose the flexibility. ... I’ve seen some bad case studies.” (FUND)

“I like the idea that a super fund is a mutual social fabric self-help in retirement kind of set-up, and that corporate and economically rational and commercially modular structures are not that appropriate.” (ADVISER)

Intellectual Property (IP)

Feelings are similarly mixed regarding the IP problems that may arise under a hybrid model, where in-house management is combined with external managers. Of the 14 participants that comment on the IP issue, three perceive it as a real problem and an inevitable source of conflict; three regard it as a surmountable problem if properly managed; and eight do not consider it a significant issue. With respect to the latter, four arguments as to why IP problems are insignificant are summarised below:

- We are not trying to copy managers, but rather to complement them. The entire aim is to do something different, rather than mimic managers and generate redundancy. *(6 mentions)*
- We structure our operation so that the in-house manager cannot view the positions of external managers. *(5 mentions)*
- We are entirely open with our external managers. Indeed, we are paying them for their IP, which they are happy to provide as part of the relationship. *(3 mentions)*
- We do not compete with external managers as we are a closed fund. *(1 mention)*

Another view is that the real field of competition is capacity, not investment process or insight. From this perspective, a problem only arises if the in-house team attempts to front-run external managers.

We will leave it to the reader to decide whether this is an issue that needs addressing. Nevertheless, the sensitivity of external managers to IP issues is one aspect that may be worthy of consideration when structuring an in-house capability.

6. Executive Views: Benefits

Section 5 described the approaches used and key aspects emphasised by our interview participants in deciding to manage assets in-house. We now provide more detail on their perceptions of the potential benefits. While the reasons for managing assets in-house are ultimately related to the expected benefits, the overlap is not complete as some benefits may be considered ancillary rather than germane to the decision. Here we both pick up on some of these incidental benefits, and take the opportunity to expand on the nature of the benefits and the debate surrounding them.

Figure 7: Benefits Mentioned by Interview Participants

BENEFIT IDENTIFIED	Number of Mentions	Portion of Participants	Notes
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
RETURN ENHANCEMENT			
<i>Broad focus:</i>			
Net return benefit (<i>return net of costs</i>)	14	70%	Majority see potential to increase gross returns <i>less</i> cost
Cost reduction in isolation	5	25%	Minority refer to lower costs without referring to net return
<i>Return sources:</i>			
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 from adopting long-term view, or 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
ALIGNMENT			
<i>Related to Tailoring:</i>			
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
<i>Other Alignment Benefits:</i>			
Mitigating agency problems	7	35%	Avoiding agency issues with external managers
Member perceptions	4	20%	Improves visibility and credibility with members
ESG / SRI policy embeded	3	15%	Improved ability to align portfolio with ESG / SRI policy
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
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

Figure 7 lists the various benefits that are mentioned during the interviews, as well as the number of participants mentioning each. It is arranged in four categories: (i) *scale-related benefits*, (ii) *return enhancement*, (iii) *alignment*, broken down into *tailoring* and *other benefits*, and (iv) *market insights*. At the base of each category is reported the intersection or overlap of the listed benefits. This captures the extent to which participants mention at least one item in each category. The intersections are high, standing 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*. The counts drop away for the individual benefit items, with many being mentioned by only a minority of participants. This indicates that there is some agreement around the broad categories of benefits, but limited consistency around what are the most important aspects within each category. Individual benefit items that are mentioned by over 50% of participants include *tailoring to strategic goals or objectives* (90%); *access to opportunities* (65%); *access to information and skills* from operating in the markets (65%); *addressing capacity constraints* (55%); and *control* (55%). In addition, 70% view the benefits (and the decision to manage in-house) through the lens of the potential for a positive impact on *net returns*. We now discuss selected benefit items in detail.

6.1. Scale-Related Benefits

The first two items listed under scale-related benefits – *addressing capacity constraints*, and *lower MER* – were discussed in Section 5.2. The third item – *additional returns related to scale* – refers to the notion that an in-house capability may facilitate the leveraging of size to gain access to opportunities. For example, it could permit the fund to participate directly in corporate re-capitalisations, or capture opportunities in unlisted assets where a combination of an in-house team and the ability to commit sizable capital provides an advantage. Six participants refer to benefits of this type, which overlap with the ‘access to opportunities’ item listed under the ‘return enhancement’ category.

6.2. Enhancing Returns

The tendency to view the potential to enhance returns through the lens of *net return benefit* versus *cost reduction in isolation* was discussed in Section 5.2. Hence we discuss here the items listed under the *return sources* sub-heading in Figure 7. *Access to opportunities* is mentioned by 13 participants. This relates to improved capacity to identify and capture opportunities from being present in the market. In addition to the ability to leverage scale (as discussed above), another major component is possessing the flexibility and agility to respond quickly when opportunities arise (5 mentions). In addition, some participants refer to how skilled in-house teams are better able to distinguish good and poor opportunities, i.e. sort the wheat from the chaff.

Six participants explicitly talk about in-house management providing access to *competitive advantages* that may lead to superior return generation. Of these six, two state that any competitive advantage is likely to exist in alternative assets only. Three other participants take a contrary view, expressly disagreeing that in-house teams offer any meaningful advantages, and stating that they see no reason to think that they can do better than external managers. Of those suggesting that in-house teams could build a competitive advantage, this mostly relates to exploiting a unique position that arises from being an asset owner that can bring to bear its 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)

“... strategic investing ... far more aligned with the traditional asset owner than the search for alpha.” (FUND)

“... 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*¹³ function, specifically *engagement* (mainly with companies). A further four allude to the possibility that returns could be enhanced by applying a *long-term investing* philosophy to the way that assets are managed:

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

When asked about whether managing assets in-house might enhance after-tax returns through improved *tax efficiencies*, participants offer a variety of views. Three participants agree that tax management is an important benefit of in-house management, although in one of these cases the comment applied only to an overseas property portfolio. A further four suggest that in-house tax management might make some marginal difference, but do not consider it as significant. Others think that internal tax management neither matters, nor is necessary. Indeed, the majority view is that the bulk of tax benefits can be delivered by external managers under an appropriately designed mandate with an after-tax benchmark, i.e. that in-house management is not a ‘killer app’ in the tax space.

6.3. Alignment

Alignment considerations figure prominently among the recognised potential benefits from in-house management, even if they are not always a key decision driver. Most prevalent is the *tailoring benefits* group, which relate to capacity to tailor the portfolio in some fashion. This group includes the ability to *tailor to goals or investment objectives* (18 mentions); *control* (11 mentions); and *transparency* (8 mentions). While the ability to tailor is referred to as a major consideration for the decision to manage in-house for around half the sample, all 20 participants nevertheless acknowledge some form of tailoring benefit.

Below we list the types of *tailoring benefits* that are mentioned during the interviews, together with the number of mentions. The various items reflect how the participants talk about the tailoring possibilities. It is possible that some of the items listed are of a similar nature, and it is just that different language is being used to describe the same thing. Nevertheless, the modest counts for each item reveal that the participants had quite differing views on the specific nature of the key tailoring benefits:

¹³ 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 programs, given these two terms appear in the quotes.

- Building bespoke products or strategies (8 mentions, 4 related to income products)
- Liability-driven investing (6 mentions)
- Liquidity management (5 mentions)
- Risk or exposure management (5 mentions)
- General mention of tailoring benefits, no specifics given (3 participants)
- Investing to a time horizon (3 mentions; 2 referring to long-term investing)
- Downside protection (2 mentions)
- Inflation hedging (2 mentions)
- Thematic investing (2 mentions)
- Selection and sizing in alternative assets (2 mentions, plus 1 disagreeing this was feasible)
- Portfolio completion (1 mention).

Control is an advantage that is closely related to tailoring in the sense that it enhances the ability to ‘work’ assets towards achieving fund or portfolio objectives. Nevertheless, many participants make a point of specifically referring to ‘control’ in its own right. Comments regarding control are typically made in relation to direct investments or large stakes that bring influence through a seat on the Board or the like. Nevertheless, there is considerable variation in the control benefits that participants highlight. 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 (akin to *ESG / SRI engagement*, although possibly for a different purpose); and better risk management.

Transparency might be seen as supporting the tailoring and control benefits of in-house management. Transparency refers to ability to build a clearer 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.

Another aspect related to alignment is the extent to which in-house management can assist in *mitigating agency problems* that can arise with external managers. This is mentioned by seven participants.¹⁴ The main agency advantages are that an in-house team 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.

Four participants recognise the potential for in-house management to improve *member perceptions* of the fund. This could arise from the enhanced visibility that comes from directly holding, and engaging with, the investments in the portfolio, e.g. being reported in the media as a major owner, or taking a public stand on a corporate issue. Alternatively, an in-house capability might support the offering of unique investment options that members may appreciate.

Some also view *ESG / SRI* through an alignment lens, where the issue is how to best have an *ESG / SRI policy embedded* in the portfolio so that it is imbued with certain sustainability principles. Three participants thought this could be more effectively achieved through in-house management, all of whom were advisers. A few beg to differ, viewing the *ESG / SRI* function as capable of being effectively implemented through out-sourcing solutions, such as the appointment of specialist advisers, or working with external managers.

¹⁴ This seems low, given the attention that agency risk often receives. For instance, agency risk is a central element to the incomplete contracts perspective from the in-sourcing versus out-sourcing literature; and tends to be prominent in discussions of problems in the investment management industry.

Finally, while most participants view the *culture* issues associated with employing professional investment staff as a problem to be managed (see Section 7.3), two participants also see some cultural benefits from sharpening the focus of the organisation. The following quote does a good job of contrasting the potential pluses related to culture against the minuses:

“Culturally, I’m not sure if it’s a plus or a minus. ... if you’re just implementing and just executing ... what the Investment Committee or the Board or the asset consultant have told you to do ... what you tend to do is you get implementers as opposed to people who truly understand investment markets. ... Culturally, it’s very different to run investment people. They tend to have egos. If they don’t have an ego, they’re generally not good at what they do, because you are putting yourself on the line every day and you’re very measurable. So it changes the culture of the organisation quite substantially. I think that can be a plus and it can be a minus. Outside of the investment team, some of super is a little sleepy. And so therefore having a culture that is more along the investment lines helps more broadly, because you are thinking potentially more quickly. But you do then need to make sure that you don’t create silos and fiefdoms and all of those sorts of things within the organisation.” (FUND)

6.4. Market Insights

Fifteen participants refer to *market insights* that can arise from in-house investment teams which are present in the markets on an ongoing basis. Two types of benefit are mentioned. 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 in general. Second, in-house teams can support *better oversight of external managers* (6 mentions) by either improving monitoring and evaluation skills, and/or enhancing the ability to negotiate mandates. The quotes below provide a sense of these benefits, which relate to the *capabilities* and *alignment* elements:

“You get access to information from the market that you wouldn’t otherwise get. You can see what’s happening on a more timely basis” (FUND)

“... having employees who were on the ground, bottom up, seeing what they’re seeing. It’s just another input into the asset allocation process.” (ADVISER)

“You’re actually trading in that market as opposed to just being an asset owner investing with managers. You have so much more information about the availability, the liquidity, what you really should be paying, etcetera, etcetera. ... can also learn a lot and develop expertise within the actual markets themselves.” (FUND)

“If we have got experienced fund managers, we’re going to be better at out-sourcing ... the nature of the meetings [with external managers], now they’re completely different. It’s a two-way discussion.” (FUND)

7. Executive Views: Challenges

We now report on the challenges or pitfalls associated with in-house management that are identified by the interview participants – the potential problems, costs and risks. For most part, the challenges are viewed as aspects to be recognised and managed. Figure 8 lists the various challenges we heard about during the interviews, as well as counts of times they were mentioned. The counts reflect either an expression of concern that the aspect in question involves some potential downside, and/or acknowledgement that there is a meaningful issue to address. For certain items, some participants dispute whether there is any meaningful issue, either because they see the perceived problem as being overstated, or relatively straightforward to avoid. We draw out these contrary views in the discussion.

Figure 8: Challenges Mentioned by Interview Participants

CHALLENGE IDENTIFIED	Number of Mentions	Portion of Participants	Notes
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
<i>Staff Issues Mentioned</i>	19	95%	95% saw staff management as a challenge (varying degrees)
GOVERNANCE			
General recognition	14	70%	Importance of governance structure recognised in general
<i>Specific aspects mentioned:</i>			
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
<i>Governance Issues Mentioned</i>	19	95%	95% attach importance to governance around in-house teams
BEHAVIOURAL			
Culture clashes	19	95%	Remuneration/jealousy; managing change & 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
<i>Behavioural Issues Mentioned</i>	19	95%	95% saw need to manage behaviors, particularly culture
SYSTEMS & PROCESSES			
	15	75%	75% viewed systems as important (others dismissed as trivial)
OTHER			
Exposure to errors	11	55%	External managers can take blame, or make good certain losses
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

Figure 8 arranges the challenges into five categories: *staff*, *governance*, *behavioural*, *systems and processes*; and *other*. The intersection or overlap for the listed challenges is reported for the first three categories, capturing the number participants that mention at least one item. The intersection is 19 participants (95%) in these three categories. This indicates that nearly all participants agree that in-house management gives rise to meaningful challenges relating to *staff*, *governance* and *behaviours*,

with the latter category largely reflecting concern over the *cultural clashes* that can occur with in-house investment teams. In all three categories, there was one participant who either saw no significant issues, or gave no indication of concern. The *systems and processes* category is mentioned by 75% of participants as a meaningful challenge; although there is a minority contrary view that establishing the required systems is straightforward or even trivial. The most notable item in the *other* category is *exposure to errors* (11 mentions). This relates to the idea that the blame and cost of errors becomes borne entirely by the fund, and can no longer be passed on to external managers.

There is a tendency for counts to drop away for individual items, albeit to a lesser degree than for the benefits list. High counts are evident for *attracting skilled and aligned staff* (95%) and *culture clashes* (95%), indicating that nearly all participants view these as important aspects. Reasonably high counts are observed for all items listed under *staff* (the lowest is 55% for *terminating if required*), suggesting a moderate-high level of agreement over the key challenges around staffing. Reasonably high counts are also observed for the *governance* items, suggesting some agreement over the key issues in this category. With the exception of *cultural clashes* and *exposure to errors*, all other items listed under the *behavioural* and *other* categories are mentioned by only a handful of participants. In addition, many of the listed challenges are subject to dispute by a notable minority, such that even moderately high counts cannot be interpreted as representing a consensus view. In summary, while we detect more agreement on the key challenges than we did for the benefits of in-house management, there is nevertheless a significant degree of variance across the sample on the importance placed on many aspects. The following discussions flesh out the intensity and breadth of views on individual items.

7.1. Staff

The *staff* challenge associated with in-house management is multi-faceted and somewhat complex. Key aspects include: *attracting skilled and aligned staff* (i.e. employing the ‘right’ people; 19 mentions); *remuneration* (16 mentions); *retention* (12 mentions); and *terminating if required* (11 mentions). *Performance evaluation* is a related issue that is addressed under *governance* in Section 7.2. We encounter a wide range of views on the gravity of the staff-related challenges. At one end of the spectrum are those who see staff issues as substantial; and almost insurmountable on some dimensions, such as the difficulty of attracting and retaining quality staff given pay constraints. At the other end of the spectrum, one participant didn’t seem to perceive any significant staff-related issues, dismissing all the major concerns expressed by others. The majority of participants sit somewhere along this spectrum, admitting that staff management is an important challenge, but considering the problems to be surmountable if dealt with appropriately. All up, 19 participants view some component of staff management as a meaningful challenge with in-house management.

Attracting and Retaining the ‘Right’ Staff: Remuneration vs. Culture

Most participants want to *attract staff* possessing two characteristics: (i) the required *skills*, and (ii) cultural *alignment* with the organisation. These two characteristics relate to the *capabilities* and *alignment* elements respectively. Many participants consider the skill characteristic to be pitched against constraints on the fund’s ability to remunerate staff competitively, relative to what investment managers might be paid in the market. Cultural affinity comes into play as not only a desirable characteristic in its own right; but there is also a widely-held view that targeting culturally-aligned candidates can help to counterbalance the limitations on remuneration. Below we elaborate on these themes with the help of a series of quotes.

These first two quotes, both from advisers, reflect genuine concern that constraints on remuneration will inevitably lead to ‘B-team’ appointments to the detriment of performance:

“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)

“I would be a little concerned that the types of people you'd get are the leftovers from funds management after the funds management industry sort of downsized ... you might also get leftover investment bank people that can't find jobs ... it's not clear to me that: (a) you're getting the best and brightest, and (b) you're getting the youngest and the hungriest. ... Often you see people hiring from the sell side, and I'm not sure the people come with the right expertise ... You've got to be careful of repurposing internal staff ... you're likely to adversely select. You're going to get the people that are prepared to work for the amount of money you're prepared to pay them. And remember that active asset management is, roughly speaking, a zero sum gain. So you don't want to be hiring the patsies.” (ADVISER)

The opposing view, put forward by 13 participants, was that it is a matter of targeting skilled people who are content working for less than they might be paid elsewhere due to other perceived benefits. Cultural affinity is seen as pivotal in this respect; although we might have encountered a particularly high concern with culture because our sample is biased to the not-for-profit sector. Focusing on cultural affinity offers a way of enhancing alignment; and is consistent with the notion of culture as a sorting mechanism as raised in the academic literature (see Van den Steen, 2005; Kosfeld and von Siemens, 2011). Apart from cultural affinity, various other benefits of managing investments for a superannuation fund versus an investment manager are mentioned as having the potential to attract skilled staff. These include: the ability to concentrate on investing without having to undertake marketing activities; the potential to make a difference; the opportunity to learn, especially for less senior staff; and the prestige of being responsible for managing large sums of money. A key question is whether the pool of skilled people who are willing to trade off a lower salary for cultural affinity and other related benefits is sufficiently large. Many participants implied that this is indeed the case, with some observing they are not constrained in their ability to access skilled staff. The quotes below capture this line of argument:

“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)

“You can appeal to different things, right? That's what I used to say to people coming to [our fund]: ‘It's a profit-for-members organisation’ ... If they don't get that, then they're not going to be happy in a profit-for-members organisation ... it's not just money that people work for ... some people want to feel as if they're doing something for someone else. And it's a different motivation, so you're actually sort of pulling a different heart string really. ... Having said that, if you don't keep them up to date with the money level, the heart string will only play so long, right?” (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, as well as an investor. Firstly, you don't live and die by your last call. You've got time, generally. ... You don't have to raise capital. No marketing. ... 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. And I don't work in a global firm. I'm not asking people to sit up and do conference calls at 2:30am ... So there's a lifestyle benefit from working in a super fund in an investment team. ” (FUND)

“We know that we can't pay the same remuneration. When you look at our equities team ... they've taken a pay cut to join ... and similar with fixed interest ... It represents a great deal for a junior that comes in – you think about the exposure they're going to have ... A great number of people in my generation are sick of the corporate life, and all they want to do is manage money ... they don't have to go around cap-in-hand to advisors and consultants and all that, in funds-gathering mode. They can do what they love doing. That is a huge attraction to these people; and that's why they're happy to take a cut.” (FUND)

“... the guys that are here now like their autonomy... [in some areas] we are the market leader, so they like that. They like to be the big swinging dick.” (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. They don't have to worry about a P&L, they don't have to worry about selling their wares, they don't have to worry about losing money ... Probably the word plenty is too strong, but there's enough of them around – you know, it's competitive to get these jobs.” (ADVISER)

“I would have said 90% of people who have been recruited by all profit-to-members super funds believe in that ethos ... thinking you can go and hire a dozen people in an equities team that all adhere to that ethos is ambitious. It's not impossible. There are people in funds management who want to feel some connection to the end user and don't want to make millions of dollars in profit for a parent company ... but it's certainly not everyone.” (ADVISER)

Remuneration Constraints (Culture again raises its head)

Remuneration constraints are central to the perceived staffing issues. The majority view among our participants is that superannuation funds by and large offer lower remuneration to quality candidates than they might earn elsewhere, especially in terms of lesser bonus potential and lack of scope for equity incentives. This is notwithstanding the fact that paying market rates should be financially well within reach for large funds, given that it would have an almost undetectable impact on MERs. Rather, the chief constraint on remuneration appears to be concern over the potential impact on organisational culture, harmony and alignment; with jealousy receiving an occasional mention. These issues are raised by 11 participants, with the following quotes providing a sense for the concerns:

“You've got to be able to countenance an incentive and recruitment model which is the same as what the industry does, because that's going to be your reference point. So you've got to buy into that. You have to philosophically be able to handle all of that, and certain organisations can't.” (FUND)

“They had internal professional investment management people picking shares ... there was a real tension on salary. They were getting meaningfully more than everybody else in their organisation, which caused grief. And they were getting meaningfully less than if

they worked for Goldman Sachs, which was also causing grief. And it was a lose-lose situation.” (ADVISER)

“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 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. Alternatively, if you’re remunerating internal investment execution on fund level outcomes ... how do you sustainably retain high sub-sector performers?” (FUND)

“The remuneration side of things is also very different. You want to keep some of the good elements around people working holistically, because it doesn’t work if you’ve got individual stars. The strategy only works if those people see themselves as part of a bigger portfolio that we’re managing. But you do need to align them, and traditional sort of metrics around incentives and things are a factor.” (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)

One of our central themes is the wide variety of views we heard from the industry, and remuneration issues are symptomatic. Below we convey some of the contrary views regarding remuneration. For example, the quote below comes from one participant doesn’t view remuneration as a constraint at all. Another made the comment during feedback that remuneration surveys show CIOs are already paid more than CEOs in many funds; and that any resistance on pay is more likely to come from the Board.

“The big funds now, we’re able to pay market. I’ve had no problem attracting talent. The general thing is that they give up a bit on the upside, they don’t get that extreme bonus in the amazing years, but they’re generally on better bases and more stable packages.” (FUND)

A couple of participants allude to placing the in-house team in an external structure as a way around the remuneration and cultural constraints (although, as discussed previously, this might come at the potential cost of inhibiting alignment and the ability to tailor):

“But part of that solution ... is to structure an [external] arrangement that provides you with aligned, sometimes exclusive services, but also enables third-party fund management to deliver business economics.” (FUND)

One participant argues that the industry should change its mindset on its aversion to matching the employment market for skilled investment staff:

“You’re only choosing from the B-team if you structure it wrong. ... For some industry funds that may well become quite a challenge from a philosophical point of view because you will have people on your payroll, in your teams, that could well be earning more than your chief executive and things like that, if they’re getting a part of the performance getting paid to them as a bonus. ... But is that a bad thing if the members have been rewarded with higher returns? It’s not. At the end of the day, you pay for it one way or another. If you go external, you’re going to pay for talent. If you go internal, you should have a mindset that you should pay for talent.” (ADVISER)

Retention

A further issue that is intertwined with the remuneration/culture nexus is staff *retention*, particularly with regard to highly skilled staff that outperform. Again we heard a number of alternative views on the notion that superannuation funds are going to struggle to retain skilled staff. One participant acknowledges the issue, but suggests that the problem might be mitigated by focusing on strategies that are not reliant 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. I think [this] is probably the key thing. Again, that’s why to 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 not the senior investment staff, nor the junior investment staff (who gain a great opportunity to learn), but rather the middle tier who are keen to advance their careers:

“Where we are potentially going to struggle – and it hasn’t been [the case] to date – is that middle tier. Clearly we’re giving them a sensational grounding. But until their bosses move on – and if their bosses are really happy, they’re not moving on – I think that’s where we’re going to be exposed to poaching.” (FUND)

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 not focused on who is actually managing their money:

“People who run money in an asset management business are always the revenue generator. But they’re not a revenue generator in a super fund, they’re a service provider. 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

Another issue over which we encounter a variety of views is whether *terminating if required* is more problematic for in-house investment staff, with the implication that performance might be inhibited if the internal team is subject to lower scrutiny and accountability. Six participants express a genuine concern along the following lines:

“Psychologically it’s a lot harder to terminate somebody you work with every day who is part of your team, than it is to terminate an external manager whose business and livelihood continues without you.” (FUND)

“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. You’ve incurred probably millions of dollars in set up costs and ongoing costs.” (ADVISER)

“How do you terminate what you chose? ... We don’t know the answer yet, so I think it is the great dilemma. What would a Board of Trustees do if they had perennial underperformance? If they take the members’ point of view, they have to act and they have to terminate. But they might restructure in the sense that they terminate the person they had managing it, and they get someone else in new.” (ADVISER)

Three participants advance a contrary view that there is no real difference between an in-house team and external managers, as both are placed under an equivalent level of scrutiny. Two supporting reasons receive mention. First, close relationships that inhibit termination are evident for both internal and external management. Second, the structures under which in-house teams are evaluated are robust and provide multiple points of review, such that individual relationships are unlikely to dominate.¹⁵

“What I’m saying is you get equally attached to friends and colleagues and peers in asset management firms, and it’s hard to terminate them when things go badly. ... 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)

“People ask me about that with internal management: ‘What are you going to do when they underperform, and you won’t get rid of them?’ If you think about relative risk ... we were already taking manager risk. So when we don’t perform, we change. So you’d have to say are you going to be any worse off in firing your internal team than firing your external team? And 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 in between the extremes. Six participants admit that there may be 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 abets 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 actually offers more control as it affords the opportunity to terminate underperforming people; whereas with external managers you can only sack the organisation:

“What people sort of miss is you can sack individuals, which you can’t do in an out-sourced arrangement. If your equities team is doing badly, maybe it’s because you’ve got a bad analyst rather than we need to terminate in-house. So you’ve got more control,

¹⁵ The countervailing argument to the idea that the influences from individual relationships are diffuse is that the organisation as a whole might become vested in their in-house team.

which is the point of doing it. I guess what I'm saying is I think the issues of how you treat your internal team versus your external [managers] can be managed.” (FUND)

7.2. Governance

The challenges associated with establishing an appropriate *governance* structure around in-house management are referred to by 19 out of 20 participants.¹⁶ Fourteen acknowledge the importance of governance in a general sense. The following quote from an adviser is representative:

“We look at the fund's governance processes, we look at the risk management compliance and oversight of an internal team ... at the Investment Committee level it's probably some additional monitoring that's required to make sure that those ranges and tolerances that are set are being worked within for the investment team; and maybe some structure around decision making, and also around that decision making process of which assets to buy and which to redeem.” (ADVISER)

In addition, certain aspects of the governance landscape are singled out for attention, including: *performance evaluation*; having a *supportive Board*; the difficulties associated with *managing in-house teams*; and the importance of establishing *delegations*. We now drill down on each of these aspects.

Performance Evaluation

The issue of *performance evaluation* for an in-house team is vexed. Thirteen of our participants comment on the challenges involved, focusing on two related problems: (i) what benchmark to use, and (ii) how to attribute responsibility for performance. Both problems are compounded when in-house management is structured as integrated within a hybrid structure, rather than operated as a segmented activity. Benchmarking performance against external managers is viewed by many participants as desirable; and understandably so, given that external management is often the alternative option. However, when the in-house team is expected to perform particular functions under an integrated structure, and thus is not set up as a discrete manager with a clear mandate, the comparability with external managers breaks down. It then becomes less clear how performance should be benchmarked and attributed. Further, focusing purely on peer relativities could create perverse incentives that undermine the ability to successfully tailor:

“How do you objectively measure the value-add of the team in a holistic sense? ... The other thing about the integration ... it also then comes back to how you're measuring your value adds. It just becomes a lot murkier.” (ADVISER)

“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. That's another level of quantification.” (FUND)

“If you're going to treat it like a third party manager ... which is what we say we do ... we do measure performance; we do measure relatively. But if they are changing the risk

¹⁶ One participant didn't focus on governance, apart from making a comment that any Board constraint is “*more perceived than real*”.

factors to offset a position, then we make note of that so that we know what the impact is.” (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 opportunities that are suitable given fund objectives, as by the skill of the manager:

“... 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 and you’re having to put 10 cents in the dollar out to him every year anyway, so he’s got to buy new assets all the time?” (ADVISER)

The above raises the challenge under an integrated approach of how to best evaluate an in-house team when investment returns are not fully revealing of their contribution. This issue is closely related to the performance evaluation problems associated with long-term investing, where the success of strategies may not be revealed for some time. For a discussion of this issue, refer Neal and Warren (2015). One solution to the problem that investment performance can be an unreliable measure of contribution is to include subjective or team-based components in the evaluation, with the intent of identifying and rewarding behaviour that is consistent with diligently working toward fund objectives. In this vein, a few participants refer to including subjective or team components in the bonus calculations, or augmenting the evaluation with an external review by asset consultants:

“[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 of that is [based] on the investment performance of the portfolio itself ... and then a component of that STI 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. ... For a period of time there in the property portfolio there were five years where we didn’t do a deal. At least five years. ... performance wasn’t deteriorating because we [bought] expensive assets. And it’s again getting into the softer skills: was the shoe leather being worn out, but still being attached to the market to know where the opportunities were.” (FUND)

“... a variable reward which has got a large chunk of team element binds the team together ... we’ve anchored things more to medium to longer-term outcomes” (FUND)

“... you really have to assess were they bad or were they unlucky?” (ADVISER)

Supportive Board

The manner in which the Trustee Board embraces and engages with in-house management is emphasised by 12 participants. Two key issues raised are the Board’s commitment, and its willingness to delegate; although there are occasional hints of concern with Board capability arising from some participants. A *supportive Board* is seen as critical for success. This needs to be secured and managed

through engagement and transparency (and resilient to changes in Board members or the CEO). Some participants refer to reassuring the Board through external reviews:

“It’s dead in the water if you have not got a sponsor on the Board. ... I had some strong sponsors, but even then you’ve still got a big Board and they’re very professional, they’re not going to basically decree it ... There’s people there that have never been involved with in-house, and they think that this is just adding to risk, etcetera. So you’ve got to bring them on for the journey.” (FUND)

“It’s taking the Board from being used to signing off on every single manager on hire and fire, and having to be involved in the beauty parade process, to having established an internal Investment Committee, getting that to a stage where they understand what its operation is ... and then getting those delegations clearly articulated, and then also being able to report back and making sure that they are comfortable with the caliber of the people ... and the accountability.” (FUND)

“If you hire smart people you should allow them to do things. That’s not the way Trustee Boards necessarily operate. Trustee Boards need to come along on the ride. They need to agree to delegation.” (FUND)

“I thought we needed to be able to demonstrate that there’d be no surprises. So communication with the Trustee and bringing them along on this sort of journey is just vitally important, because their particular position and their fiduciary obligation to the members ... getting them across the line, because if you introduce in-house investment management, that’s a big step for some of these Boards.” (FUND)

“It’s transparency. ... No surprises, keep them informed.” (FUND)

“You’ve got to bring your Board and [Investment] Committee along ... you just need to convince yourself and your Committee if the right strategy is there, and then we’ve got the guys that can execute the strategy ... So 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 ... we had a few goes at getting the Committee across the line, and then the Board. So once we do that, then we need to demonstrate that all of the compliance works, all the trading processes work as well ... there’s certainly a lot more transparency around the internal stuff, and probably a lot more angst than what there is around the external stuff.” (FUND)

“The other challenge is the Board and the broader executive and their ability to manage risk and understand and fulfill their role of governance above a genuinely asset management style function. I think that’s challenging. Not impossible, but challenging.” (FUND)

“One of the challenges in super funds is that the people who are on the Board and who are the CEOs ... often don’t have an awful lot of investment experience” (FUND)

Managing In-House Teams is Difficult (and a Distraction)

As well as the potential for culture clashes associated with investment teams (to be discussed in Section 7.3), 11 participants explicitly refer to various difficulties associated with *managing in-house teams*.

The majority of these focus on how it might absorb management time, and potentially distract the broader business from its mission. One participant highlights how this problem becomes most poignant during the inevitable periods when the in-house team underperforms (see second last quote below). Another refers to greatly increased reporting requirements (see last quote).

“Management time and the leadership around managing internal investment professionals are demanding. It is a major cost.” (FUND)

“... going to have to get used to dealing with prima donnas, let’s be honest, and introverts, and all the things that go with funds and different people.” (ADVISER)

“Potentially it’s going to be a distraction from the main game, unless you see that investment management is your main game. It can take up a lot of management time ... any active management process has periods of underperformance. How is the business going to react to that? ... So it’s a distraction for the business.” (FUND)

“It’s very onerous in terms of reporting requirements. We are far more granular in our reporting of in-house. ... But that’s necessary for the governance.” (FUND)

Delegations

Seven participants went beyond just the Board’s willingness to delegate, to mention the importance of establishing a clear structure of delegations:

“a discretion matrix ... something I think every Board should do” (ADVISER)

7.3. Behavioural

Nineteen participants refer to various *behavioural* problems that can arise under in-house management. By far the dominant concern is the potential for *culture clashes*. Other behavioural concerns can be categorised as problems that might respectively arise following outperformance and underperformance (over and above the problems related to staff retention and termination, as discussed in Section 7.1). The focus was mainly on individuals. The organisational behaviour problems that might arise only received only occasional attention – we had expected them to figure more prominently.

Culture Clashes

The potential for *culture clashes* is singled out by all 19 participants that refer to potential behavioural problems as an important challenge to be managed.¹⁷ The underlying source of concern relates to bringing in investment managers that are highly paid and possibly of a different personality type to other staff within superannuation funds, where the traditional focus has been on out-sourcing and implementing:

“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)

¹⁷ 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.

While broad agreement exists that there are cultural issues to be managed, there is considerable variation in terms what participants see as the nature and source of the problem. Ten refer to remuneration differences as the point of tension, with six linking this to forms of jealousy (including the possibility that investment managers may get paid more than the CEO):

“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 disharmony that can arise from bringing a different type of personality into the organisation, often noting the tendency for investment managers to have large egos and a sense of entitlement:

“A lot of investment teams regard themselves as being a shit-hot. They get paid more, so therefore they think they’re worth more inherently as a human being. Whereas if it wasn’t for the rest of the business, they’ve got no money to manage.” (FUND)

“... 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 [x] people being different to the culture of [x+y]. It’s got to be a consistent business. ... you’re constantly kind of playing whack-a-mole.” (FUND)

Seven participants refer to differing cultures having the potential to be disruptive for business operations, largely by creating silos or undermining co-operation:

“You get that sort of jealousy within the organisation, and that can be quite disruptive to the whole business. ... And also you get some egos in the front office: ‘You’re telling me that I can’t do that trade because there’s some risk factor? F off...’” (FUND)

“In a large organisation, you’ve got to be careful you don’t have splinter groups ... you want to build this universal culture that ties everyone together.” (FUND)

“What we have found not-for-profits have always had a really strong, good culture, very collaborative, work closely together. As funds get larger I think there's no doubt that that becomes harder. But what we are seeing is that 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 teams and your compliance teams. It's not that 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)

Finally, nine participants observe that introducing investment staff necessitates a change in culture. This is usually referred to as neither a good nor bad thing: the comment is typically made in the spirit of recognising the inevitability of the culture change, and the need for the change to be managed:

“It’s very hard to control. If you set up a big investment team, your culture is going to develop almost despite what you want it to be because you’re making huge changes to the organisation.” (FUND)

Behavioural Pitfalls of Success

Five participants allude to the need to manage the *behavioural pitfalls of success* that can arise under in-house management. A number of closely related issues are raised, including the potential dangers of overconfidence, overextending (empire building), and becoming complacent. As one participant put it:

“Over-confidence is just rife in this industry ... assume the team’s doing well and adding value, there would be a great temptation to put more and more and more of the assets with them and lose that focus on keeping a bit of tension ... you can get a bit complacent if they’re doing well, and you can forget your whole philosophy and structure, and you can end up potentially giving them too much money.” (ADVISER)

Commitment Upon Underperformance

In addition to the problem of terminating staff or teams, four participants raise issues related to *commitment upon underperformance*, in particular the potential to interact with organisational behaviour. However, there is a lack of consistency in how this issue is viewed. Two participants allude to how organisational commitment to in-house management may be tested by underperformance. The other two focus on how the commitment to in-house management may act as a blockage to taking action – an extension of the staff termination issue that was discussed in Section 7.1.

7.4. Systems and Processes

Fifteen participants (75%) indicate that they consider it important to establish good *systems and processes* in support of any in-house management capability. A minority even intimate that confidence in the ability to successfully implement is a prerequisite for choosing in-house management (see Section 5.2). Aspects mentioned by participants include: the capacity to undertake and settle trades; portfolio and risk management systems; reporting systems; and compliance protocols. The quotes below reflect the broad recognition that systems and processes matter, and deserve due attention:

“You need to connect that up with the logistics that allow you to exercise that skill. So whether it’s the operational end and the need for great data, great analytics, great implementation ... you need a dealing desk, and all the costs associated with that. The compliance regimes are completely different.” (FUND)

“We look at the risk management compliance and oversight of an internal team... the risk associated with trade execution ... the risk management the culture has to be very strong, [as well as] the compliance control.” (ADVISER)

“People generally underestimate the value of the back office and the middle office.” (FUND)

While the majority acknowledge that systems are important, 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 reliable systems are harder to establish than they seem, and that in-house management gives rise to significant exposure to operational risk:

“I’ve seen some research of how you size up [the] risk of rare events in operational space, and the tail is huge ... front office technology for super funds, industry funds, is notoriously weak.” (FUND)

“What are the technology capital resourcing requirements ... around implementation structures that are best practice and therefore continuously mitigating any operational risk? ... If we bring that risk in-house, what is the impact on our operational risk reserves? How much is that going to cost; and what is the potential real cost to our members that might be better off-laid to a third party through external management? ... The operational risks are often underestimated when people think about internalising investment processes.” (FUND)

“Operational risks are huge ... Different groups can give that away at very low fees, whereas you’re sort of worrying about the option value of the operational risk.” (ADVISER)

“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 view the establishment of reliable systems as relatively straightforward, on the basis that the required knowledge and capabilities can readily be established in-house or out-sourced. 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 do is have to convince myself that I’m going to get people that are suitably qualified to do this in-house.” (FUND)

“So I think in this day and age, there’s enough expertise in the market to get that pretty right. I think funds are incredibly conscious of not making mistakes in that area. So it’s not something that we think is of great concern.” (ADVISER)

We count seven participants who discuss systems and process as if they are a significant challenge; and four that are largely dismissive of there being any significant issue. Most of those sitting in-between these extremes appear to consider systems as an important but manageable issue.

7.5. Other Challenges

Listed below is a range of *other challenges* that were mentioned:

- **Exposure to errors** (11 mentions) – In-house management results in the fund bearing the full cost and blame for errors, as external managers no longer provide a shield. The two main facets are loss of the ability to recover the costs of operational errors from external managers (7 mentions), and not being

able to pass off blame to the manager (6 mentions). In terms of the exposure to blame, the majority talk about this being borne by the Board or executive team; although one participant refers to the reputational risk for the fund as an entity.

- **Set-up costs are substantial** (7 mentions) – A number of participants refer to substantial set-up costs that will not be recouped until either a few years have passed, or in-house FUM reaches sufficient scale. A pay-off horizon of three years is mentioned by three participants.
- **Intellectual property issues** (6 mentions) – This relates to IP issues with external managers under a hybrid model, and was discussed in Section 5.4. Recall that while six participants perceive the potential for problems, a further eight did not see any significant issue.
- **Capture by in-house team** (4 mentions) – Four participants refer to the risk that the fund might get ‘captured’ by the in-house team. However, this was more than counterbalanced by those arguing that this should be avoidable through appropriate structuring, e.g. running a hybrid internal/external manager approach, or ensuring there is always an external option, such as passive investment.
- **Loss of flexibility** (2 mentions) – While the dominant view is that in-house management affords greater flexibility to access opportunities, two participants suggest that commitment to in-house teams might reduce the flexibility to change the overall strategy.
- **Loss of insights from managers** (1 mention) – One participant suggests that in-house management can limit the capacity to extract insights from external managers, who may become less forthcoming.

8. Executive Views: Success Factors

We conclude our findings with an account of what our interview participants indicate as the success factors for in-house management. Figure 9 lists the factors mentioned and the number of counts. During the interviews, we explicitly asked participants to nominate the “critical elements for successful in-house management”. As we asked this toward the end of the interviews, in some instances the answers appeared rushed and may not have been given complete consideration. As a consequence, we include in the counts any factors that are clearly considered to be integral to success based on the tenor of the broader conversation, in addition to the success factors that are expressly identified by the participants.

Consistent with the theme of considerable variation in viewpoints across the sample, the counts point to participants having differing perceptions about the key success factors. Of the twelve items that are listed, only three are clearly identified as success factors by more than half the participants. These are *governance* (75%), *staff selection and management* (70%) and *systems and resourcing* (65%). About half of the sample identifies the three next-ranked 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 median number of items mentioned by participants is 4.5 out of the 12 listed, with a range of two to nine items being identified. In summary, our participants appear to differ considerably over what factors are most important for successful in-house management. It is notable that the top four items – governance, staff, systems and culture – reflect the four key categories of challenges discussed in Section 8. They also align with the key elements of *governance*, *capabilities* and *alignment* that underpin the framework detailed in Section 2.

Figure 9: Success Factors Mentioned by Interview Participants

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

9. Concluding Comments

We draw on insights from the literature and interviews with executives from the Australian superannuation fund industry to *propose a framework to assist asset owners to make and implement decisions to manage assets in-house*. Our framework is effectively an organising structure that encompasses both the main theories and concepts, and the range of approaches and aspects identified during our interviews. The framework involves addressing four elements: capabilities, costs, alignment and governance; and is fleshed out in the form of a checklist of aspects to consider within each element. We make no claim that the checklist is comprehensive. Indeed, we encourage users to augment or filter the aspects that they consider important, depending on their particular objectives or requirements. Essentially we are suggesting four key areas to address, incorporating an assessment of net return impact, and offering this as a useful and flexible approach to analysing in-house management in a way that connects to concepts raised within the literature. The specific manner in which the framework is applied can vary depending on the user's circumstances and preferences.

Our other major contribution is to provide *an account of how the Australian superannuation industry views the issue of in-house asset management*. The most striking finding from our interviews is the surprising amount of diversity in approaches to deciding whether to manage in-house, and the emphasis placed on various aspects related to the decision and its implementation. Three-quarters or more of our interview participants place significant emphasis on six key issues: the impact on returns, alignment, governance, staffing, culture and systems. Beyond recognising the importance of these general areas, there is wide variation in viewpoints about the way in which they matter, and how much weight should be attached to various aspects within each area. Further, we often encounter contrary views, where it is argued that an aspect or item has been overstated in its importance, or should be interpreted differently. Some factors were seen as a positive by some respondents and as a negative by others. In short, there is no industry consensus. Given this, we trust that our general framework provides some structure that accommodates a range of views on when and how to manage assets in-house.

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