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Bigger is better for pension funds: study

By JANET MCFARLAND
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Internal management fees are lower, private equity boosts returns

Research has shown large mutual funds have a tendency to underperform smaller funds, which can operate on a lower-cost basis. So logic would suggest the same trend is true for pension funds with big funds lagging their smaller and nimbler peers.

Not so, according to a new study, which offers fuel to arguments that major public sector pension funds like the Ontario Teachers' Pension Plan and the Ontario Municipal Employees Retirement System should take over management of money for smaller pension funds who want to contract out the work.

A paper by University of Toronto researchers Alexander Dyck and Lukasz Pomorski found the largest pension funds - averaging $37-billion in assets - outperformed smaller plans - averaging $1-billion in assets - by 43 to 50 basis points annually.

"Bigger is better when it comes to pension plans," the paper concludes.

The difference in returns "sounds small, but it is huge economically," Prof. Pomorski says. It can amount to a 13 per cent larger pension at retirement for employees invested in a plan throughout their working lives, for example. And for government-run plans, it can mean taxpayers are less likely to have to make up for unfunded liabilities in the plan.

So why do big plans do better? One reason is that they are more likely to be internally managed, which means their assets are managed by in-house staff rather than by outside private sector money managers. Large plans manage 13 times more of their active assets internally compared to the smallest tier, the paper says.

The study says between one-third and one-half of the gains come from cost savings related to internal management, where costs are at least three times lower than under external management.

The even bigger factor for superior returns, however, comes from different approaches to investing. Big funds have bigger allocations in so-called alternative investments like private equity and real estate. And they get better returns from this asset class, with private equity and real estate yielding up to 6 per cent more at bigger pension funds than at smaller ones.

Big funds have the scale and negotiating power to strike the best deals in the private equity and real estate sector, and are more likely to be able to co-invest with other big partners in major deals, the paper notes. Smaller players either aren't invited to the table, or have to invest more passively through vehicles like real estate funds.

The most surprising finding in the paper is its discussion of a third factor influencing performance. It suggests plan governance has a major impact on fund performance, especially in the public sector for those pension funds that are heavily influenced by political considerations. Many U.S. government pension plans in particular have politicized board appointment processes and are constrained in their ability to pay staff beyond civil service levels, severely limiting the talent pool they can draw from for their money management.

The paper suggests governance can limit the ability of big pension plans to take advantage of their scale, noting U.S. public sector pension plans "have poorer overall performance" while corporate plans have stronger performance and stronger scale economies.

The data for the study comes from Toronto-based CEM Benchmarking Inc., which maintains a database of financial returns between 1990 and 2008 for 842 pension plans around the world, including U.S., Canadian, European, Australian and New Zealand funds.