

How Large Pension Funds Organize Themselves: Findings from a Unique 19-Fund Survey

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This article documents the organizational and compensation structures of 19 major pension funds around the world. Among the study's key findings are that more internal management is associated with greater fund size, lower operating costs, and higher net returns; internal compensation levels vary considerably around the globe; and the majority of fund's Boards of Directors continue to lack diversity. Looking ahead, the authors find that risk management is the number-one Board concern.

Keywords: Compensation, Cost, Internal Management, Organizational Design, Pension Fund

A Unique 19-Fund Survey

Through a collaborative benchmarking forum organized by CEM Benchmarking Inc. (CEM),¹ 19 leading pension funds from Australia, Canada, Europe, New Zealand, the United Kingdom, and the United States came together last year to share information on their organizational structures. Each of these organizations has significant internal operations of varying degrees of complexity. The overarching goals of the forum were for the funds to learn from each other and to gain new perspectives on shared management challenges related to organizational structure. This article summarizes the major findings of the benchmarking study, including the impact of internal management on the number of investment staff, fund performance, and costs. The article also takes a brief look at compensation, board composition, and strategic priorities.

The funds ranged in size from US\$12 billion to US\$341 billion, with an average of US\$90 billion and total assets of US\$1.74 trillion, as of December 31, 2010. On average, 49% of assets were managed internally. As Figure 1 shows, the number of full-time equivalent (FTE) investment staff in these organizations ranged from 20 to 647. Front-office (internal asset management, selection and oversight of external managers) FTE numbers ranged from 10 to 269, while governance, operations, and support (GOS) FTE numbers ranged from 5 to 427.

Figure 1: Number of Investment FTEs

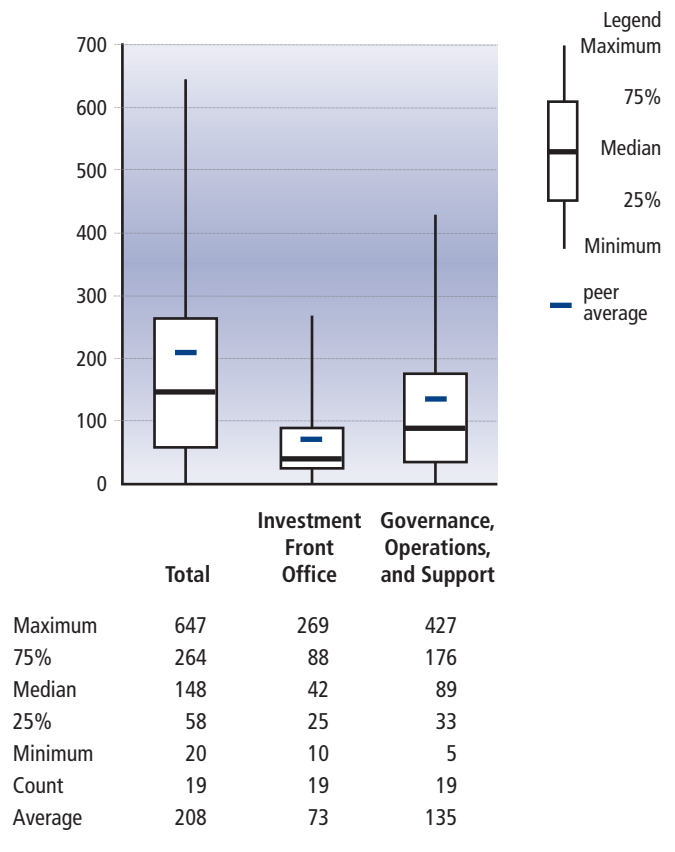


Figure 2: Investment FTE vs. Internally Managed Assets

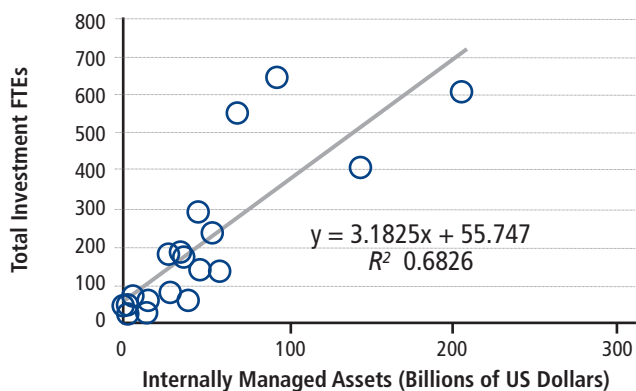


Figure 3: Governance, Operations, and Support FTE vs. Investment Front-Office FTE

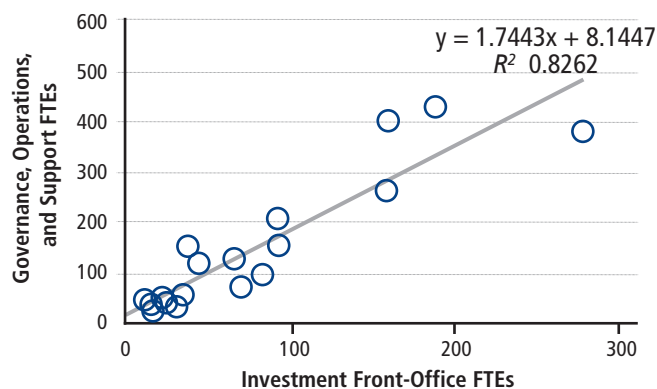
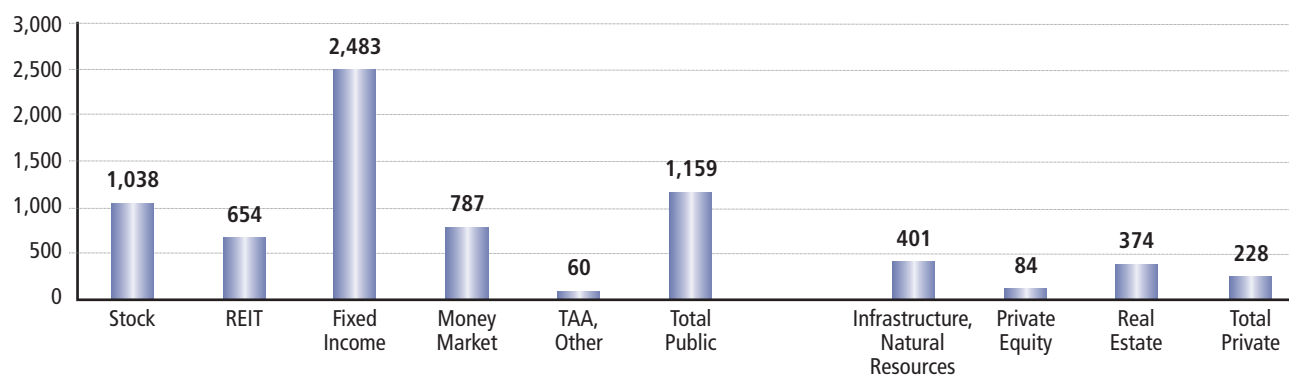


Figure 4: Internal Assets per Internal Asset-Management FTE (Millions of US Dollars)



Internal Investment Management Is a Key Driver of Total Investment Staff

The study found a strong relationship between total investment FTEs and total assets under management (AUM). However, there was an even stronger relationship between total investment FTEs and total internal AUM. As Figure 2 shows, almost 70% of the difference in total investment FTEs among the survey participants was attributed to differences in internal AUM.

When we broke down total investment FTEs into investment front-office FTEs and GOS FTEs, we found that, on average, six investment front-office FTEs were needed for every US\$10 billion of internal AUM and, furthermore, that a strong relationship existed between the number of investment front-office FTEs and the number of GOS FTEs. As the regression analysis in Figure 3 shows, for every incremental investment front-office FTE, an additional 1.7 FTEs were needed for GOS. This relationship was strong: 83% of differences in numbers of GOS FTEs were explained by differences in numbers of investment front-office FTEs.

Asset Mix Is Also a Key FTE Driver

While the amount of internally managed assets was a key driver of investment FTE numbers, the asset mix of internally managed assets was also important. As Figure 4 shows, the median internally managed assets per internal asset-management FTE was approximately five times as large for public assets (US\$1.159 million) as for private assets (US\$228 million). Meanwhile, the median internally managed assets per internal asset-management FTE was approximately 2.4 times as large for fixed income as for stocks.

There are several additional factors that may explain the differences observed in total investment FTE numbers: variation in the number and types of internal investment portfolios and strategies; number and types of external investment mandates; differences in volume and types of security positions and transactions; and level of dependency on consulting, custodial, and other third-party services. Greater involvement in investment activities such as risk budgeting or client account management may further contribute to the differences in total FTE numbers, as might organizations' differences in culture and history.

A Closer Look at Governance, Operations, and Support FTE

As noted above, we found substantial variation in the number of FTEs for GOS among the funds surveyed (from 5 to 427). This variation was seen across all GOS activities (see Table 1). For example, investment operations and custody had an average of 28 FTEs and a maximum of 184.

Table 1: Number of Governance, Operations, and Support FTEs by Activity

Activity	Average	Maximum
Board and CEO activities related to investments, CIO, support	8	48
Asset allocation	5	41
Risk management	8	38
Responsible investing, corporate governance	3	12
Compliance	2	7
Internal audit	1	6
Public relations and communication	3	10
Client account management	5	38
Finance and external reporting	13	58
Valuation and performance analytics	8	47
Investment operations and custody	28	184
Securities lending (internal)	0	2
IT applications, architecture, databases	23	122
Desktop, servers, network, security	9	47
Legal services	6	30
Human resources	5	20
Building, utilities, and office services	4	14
Non-specific allocated overhead	3	19
Total	135	427

To help us understand what caused this variation, we split the survey group into two subsets – high users and low users – based on whether the funds used more or fewer GOS FTEs per investment front-office FTE than predicted by the regression analysis. An analysis of the results in Table 2 showed that

- Funds that used more GOS FTEs than predicted by regression analysis used more in all 18 GOS activities.
- Four activities represented 49% of the total difference in GOS FTE numbers: IT applications, architecture and databases; investment operations and custody; valuation and performance analytics; and finance and external reporting.
- For a few funds, client account management had a large impact.

- The largest percentage differences were found in activities that could be provided by third-party or sister organizations, such as desktop, servers, network, and security; human resources; building, utilities, and office services; and legal services.

We also looked at the number of transactions performed by high users versus low users (see Table 3) and found that funds that used more GOS FTEs than predicted by the regression analysis

- performed more transactions per front-office FTE and
- performed more complex transactions involving such vehicles as structured securities, foreign exchange, and derivatives.

Table 2: Number of Governance, Operations, and Support FTEs per Front-Office FTE

Activity (ranked by % more)	Low Users*	High Users*	% more
Desktop, servers, network, security	0.05	0.22	352%
Human resources	0.03	0.11	249%
Client account management	0.04	0.10	183%
Building, utilities, and office services	0.04	0.12	208%
Legal services	0.05	0.14	185%
IT applications, architecture, databases	0.15	0.44	187%
Internal audit	0.01	0.05	248%
Compliance	0.03	0.07	155%
Securities lending (internal)	0.00	0.01	154%
Investment operations and custody	0.21	0.46	113%
Valuation and performance analytics	0.09	0.20	124%
Finance and external reporting	0.17	0.28	64%
Responsible investing, corporate governance	0.05	0.08	62%
Risk management	0.09	0.15	55%
Public relations and internal communication	0.03	0.06	75%
Board and CEO activities related to investments, CIO, support	0.13	0.20	55%
Asset allocation	0.07	0.10	39%
Non-specific allocated overhead	0.04	0.04	-20%
Total	1.29	2.81	117%

* *Low users* are the 12 funds that used fewer GOS FTEs relative to front-office FTE than predicted by regression analysis; *high users* are the 7 funds that used more GOS FTEs than predicted by regression analysis.

Table 3: Median Number of Transactions per Front-Office FTE

	Transaction Types	Low Users*	High Users*	Difference
	Stocks	1,272	2,135	863
	Fixed income (excluding structured)	126	249	124
More complex	Structured securities & other	10	27	17
	Foreign exchange	181	329	148
	Derivatives – exchange traded	31	234	203
	Derivatives – OTC	16	137	122
	Real estate	0	28	28
	Infrastructure, natural resources	1	2	2
	Private equity	1	4	2
	Other	0	18	18
	Total	2,121	3,534	1,413

* *Low users* are the 12 funds that used fewer GOS FTEs relative to front-office FTE than predicted by regression analysis; *high users* are the 7 funds that used more GOS FTEs than predicted by regression analysis.

Funds with More Internal Management Performed Better after Costs

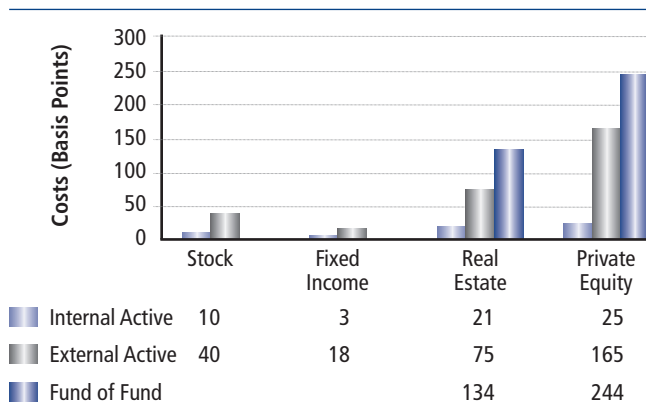
Since internal management was such a significant driver of investment FTE numbers, we examined how funds with more internal management have performed. Funds with more internal management performed better than funds with less, according to research using the CEM global universe.² For example, the regression analysis documented in Table 4 shows that for every 10% increase in internal management, there was an increase of 3.6 basis points in net value added; this increase was driven largely by the lower costs attributed to internal management.

Table 4: Regression Results: Net Value Added vs. Percentage of Assets Managed Internally

Internal Management Coefficient	0.36%
t statistic	2.7
Number of observations	5,605
Time period	1991–2010

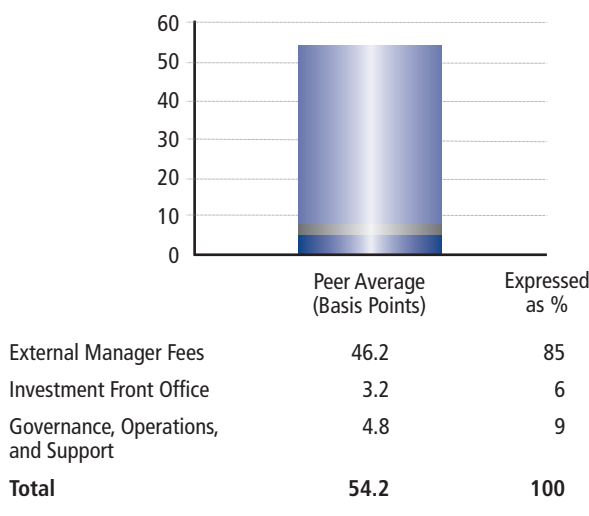
Based on an examination of 99 funds in the CEM global universe with more than US\$10 billion in AUM, Figure 5 shows that the median cost is materially lower for internal than for external active management for all asset classes studied (stock, fixed income, real estate, and private equity).

Figure 5: Median Cost of Internal vs. External Active Management



These broad findings are confirmed by similar findings for the 19 funds participating in the survey. Although internal management had the greatest impact on total investment FTE numbers, the costs associated with internal management were very low compared to external manager fees. The study examined total investment costs incurred by each fund and how these costs were divided among external manager fees, investment front-office costs, and GOS costs (see Figure 6). External manager fees represented an average of 85% of total costs, while investment front-office and GOS costs accounted for only 15% of total costs.

Figure 6: Breakdown of Investment Costs



Use of Internal Management Is a Function of Fund Size

Since internal management had such a strong impact on number of investment FTEs and on costs, we took a closer look at how its use changed with fund size in the broad CEM global universe. We found that as fund size increased, both the likelihood of that fund's use of internal management and the proportion of assets managed internally also increased: only 17% of funds under US\$10 billion, but 82% of funds over US\$50 billion, were more than 10% internally managed (see Figure 7); internally managed assets averaged 8% of total assets for funds under US\$10 billion versus 51% for funds over US\$50 billion (Figure 8).

Figure 7: Percentage of Funds with >10% of Assets Managed Internally

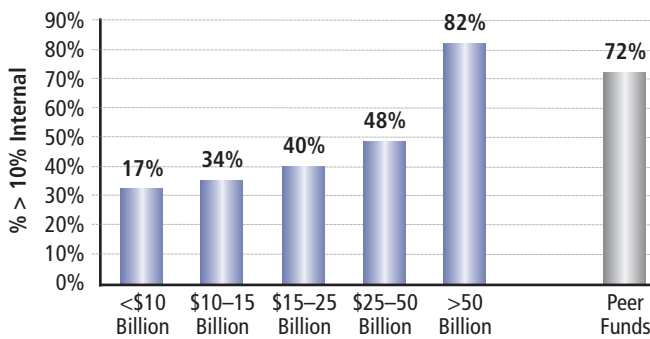
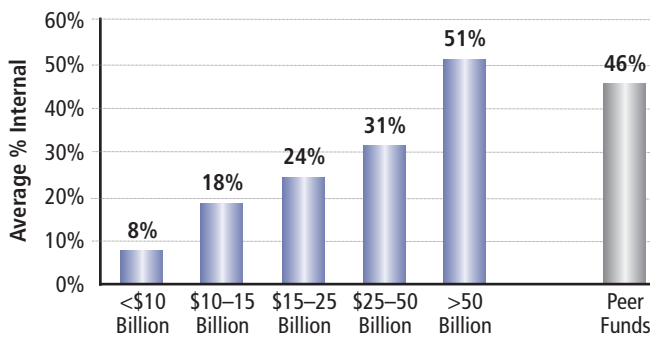
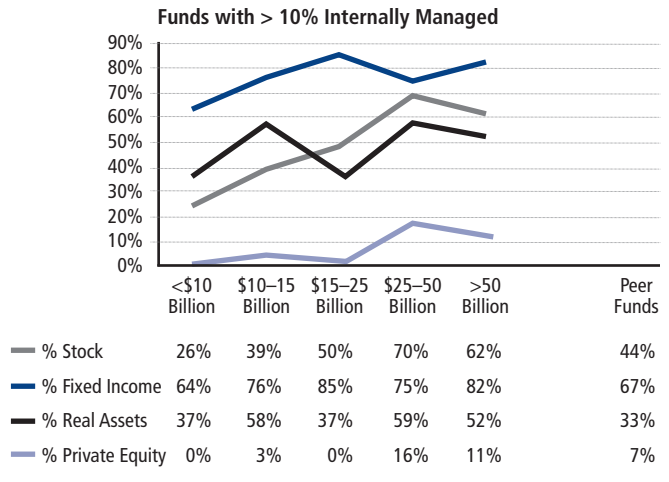


Figure 8: Average Percentage of Assets Managed Internally



A more detailed analysis of funds with more than 10% of assets managed internally (94 of 353 funds from the CEM global universe) provided insight into the use of internal management by asset class. As Figure 9 shows, fixed-income assets were most likely to be managed internally, regardless of fund size; while stocks and real assets (i.e., real estate, commodities, natural resources, and infrastructure) were the next most likely to be managed internally, funds did not tend to manage private equity internally until fund size exceeded US\$25 billion.

Figure 9: Percentage Managed Internally, by Asset Class



Compensation

A comparison of compensation levels per FTE by region (see Figure 10) found that average salaries were highest for Canadian funds. For instance, in Canada the average salary for investment department FTEs was US\$536,000; next were European/British funds at US\$246,000, followed by American funds at US\$148,000 and Australian/New Zealand funds at US\$139,000. Further, we found that the best predictor of compensation for the top five employees was the total number of FTEs in the organization: as the number of FTEs increased, so too did the average compensation for the fund's top five employees (see Figure 11).

Figure 10: Compensation per Investment FTE

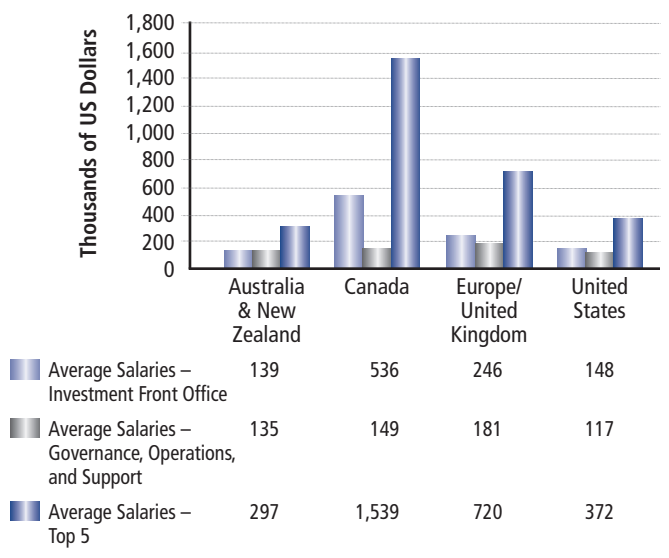
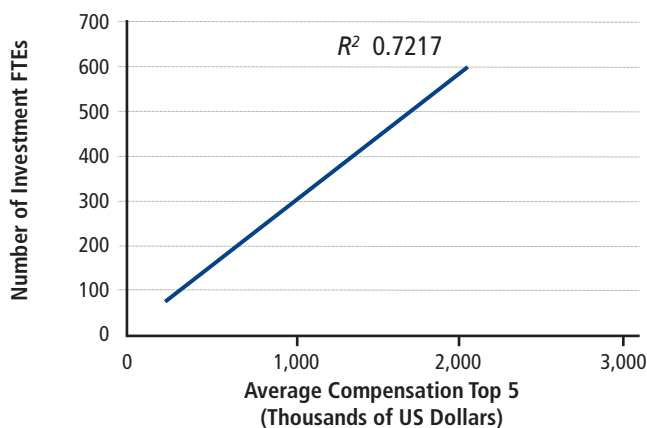


Figure 11: Number of Investment FTEs vs. Average Compensation for Top Five Employees



Board Composition and Strategic Priorities

There is broad consensus that it is best practice to have a Board of Directors (or Trustees or Governors) with diverse and relevant skill sets and experience, because this enables Boards to make better decisions. However, the majority of the funds surveyed (13 out of 18) had Boards composed almost entirely of voting Directors with lay backgrounds, whose experience was limited to that of fund stakeholders (i.e., sponsors, employers, unions, members, and retirees).³ The remaining funds had voting Directors with more diverse business backgrounds, some with very senior level experience in investments, finance, and various business disciplines. In 9 of the 18 funds, more than 15% of the Directors contributed senior investment or financial experience, although some of this experience resided in non-voting or advisory Directors.

The Boards of the surveyed funds pursued various measures to compensate for their lack of experience, time, and/or resources. One such measure was to use non-voting Advisory Boards and Advisory Directors. For example, one American fund had 5 non-voting Advisory Directors on its Board, another American fund used a six-member Advisory Council, and one Dutch fund had advisory members on its Investment Committee. Another measure was to retain pension or investment consultants on an ongoing basis. Among the funds in the study, four American Boards and one non-American Board retained an ongoing consultant. A third measure was to use Board support staff. An example were the Dutch survey participants, who separated their governance organizations from their investment management and pension administration organizations. The role of these governance organizations continues to evolve, but many have in-house staff with expertise to support the Board and oversee external service providers.

When asked to list their strategic priorities, 15 out of 19 Boards ranked risk management as number one, followed by organizational leadership, culture, or talent; asset allocation; governance structure; and relationships with key stakeholders. Table 5 lists the 10 most cited strategic priorities.

Table 5: Current Strategic Priorities

Priorities (ranked by frequency of mention)	Number of Boards Identifying as 1 of Current Top 5
1 Risk management	15
2 Organizational leadership, culture, or talent	9
3 Asset allocation	9
4 Governance structure	7
5 Relationships with key stakeholders	7
6 Internal systems	5
7 Cost effectiveness	5
8 Innovation	5
9 Infrastructure or natural resources	4
10 Compensation structures	4

Summary of Key Findings

In our view, the key findings of this study are the following:

- The level of internal management had the largest impact on the number of investment FTEs in the organization and on costs.
 - More internal management resulted in more FTEs but lower costs, because internal management is much lower in cost than external management.
 - For every investment front-office FTE, there were approximately 1.7 GOS FTEs.
 - Funds with more internal management performed better after costs.
 - Use of internal management increased with fund size.
- Compensation varied considerably by region and by number of internal investment FTEs.
- The Board compositions of the funds surveyed varied considerably. The majority had Boards composed mainly of lay voting Directors who reflected the backgrounds of the fund’s stakeholder groups; a minority had Boards with diverse skill sets and experience.
- Risk management was the most-cited strategic priority of the surveyed Boards; organizational leadership and asset allocation were tied for second place.

The value of benchmarking is to gain new insights into best practices. The 19 pension funds that participated in this survey are pleased to share the resulting insights with the *Journal’s* readers.

Endnotes

1. CEM is an independent global benchmarking company located in Toronto, Canada, that has provided investment and administration benchmarking services to large pools of capital (including defined benefit and defined contribution pension plans, endowments, and sovereign wealth funds) since 1991.
 2. The CEM global universe is a database containing 20 years of information on investment cost and performance. In 2010, the database covered more than 350 funds.
 3. Information on Board composition was not available for one fund.
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