Internal management does better after costs

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Background

Earlier CEM research showed that funds with more internal management outperform funds with less at the total fund level. For every 10% increase in internal management, net value added increased by 4.1 basis points on average. The reason is almost entirely due to the lower cost of internal management.

This paper examines the differential in performance between internal and external management at the asset class level.

Findings

Before costs there was no statistically significant difference in gross value added performance between internal and external management at the asset class level.

After costs are deducted:

- Internally managed EAFE stock outperformed externally managed by an average of 96 basis points net value added.
- Internally managed emerging market stock outperformed externally managed by an average of 28 basis points net value added but the difference was not significant.
- There was no difference in net value added performance for externally managed versus internally managed U.S. stock or fixed income.

These findings were similar regardless of the fund's country of origin and for fund size segments over $20 billion and under $20 billion in assets.

Table 1: Higher (Lower) Value Added for Internally Managed Assets in bps

	Gross of Costs	Net of Costs
U.S. Stock	(23)	0
EAFE Stock	57	96*
Emerg. Markets Stock	(32)	28
Fixed Income	(15)	0

* Statistically significant at the 95% confidence level.
Source: CEM Benchmarking Inc. global database from 1991 to 2009.
The total number of annual observations was 5,137.

Database

Findings were based on CEM Benchmarking Inc.'s (CEM) defined benefit fund investment database. CEM has been collecting cost and return information from global pension funds since 1991. In 2009, this included 363 global funds, amounting to nearly US$5 trillion in assets. The database includes a small number of participants that are sovereign wealth or other non-pension funds.

Implications for Action

Plan sponsors should consider increasing internal management for asset classes with high relative external management costs, such as EAFE stock, as a strategy for improving performance by reducing costs.

Description of Analysis

For each of four asset classes, we regressed the proportion of holdings managed internally against the value added for all the funds in CEM's database going back to 1991. The U.S. stock asset class includes all capitalization sizes and the fixed income asset class includes all types of fixed income.

The results are shown in Table 1. The numbers represent the amount by which value added from internal management exceeded external management in bps on average over 19 years for both net and gross value added. Net value added takes into account all costs of managing the asset class.

Results

Gross value added generated by internal managers was the same as external managers

Before management costs were deducted, internal management outperformed external management in EAFE stock and underperformed in U.S stock, emerging market stock and fixed income. But none of these differences in performance was statistically significant.

After costs, internal managers beat external managers in EAFE stocks

After deducting costs, internal management performed better than or equal to external management for all four asset classes. This difference was statistically significant for EAFE stocks. At nearly 100 basis points, the degree of outperformance was both substantial and statistically significant.

Cost differences were a key reason for the superior performance of internally managed EAFE stock. On average, internal management was 39 basis points lower cost than external management for EAFE stock.

These findings were true for mid-sized funds

Some of the pension funds in the CEM database are very large. To test whether internal management outperformed for funds under $20 billion, we repeated the same analysis using only funds in the $5 billion to $20 billion range. The results, shown in Table 2, were consistent with the results for the entire database.

Funds' country of origin not a factor

Finally, we checked whether the results were biased by European pension funds that might have an investment advantage in their home markets. We found no statistical difference in the results of European versus North American funds regarding skill in adding value in EAFE stocks.

Table 2: Higher (Lower) Value Added in bps of Internally Managed Assets for Funds From U.S. $5-20 billion

	Gross of Costs	Net of Costs
U.S. Stock	(2)	14
EAFE Stock	52	102*
Emerg. Markets Stock	81	126
Fixed Income	(11)	(1)

* Statistically signficant at the 95% confidence level.
Source: CEM Benchmarking Inc. global database from 1991 to 2009.

Contact information

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