Cass Business School
CITY UNIVERSITY LONDON

Monday 2 July 2012

Specialist pension fund managers trump balanced managers

20-year study of UK pensions industry analyses trend towards decentralised investment management

UK pension funds run by specialist managers sharply outperform those overseen by balanced managers, according to a new 20-year study due to be published in the highly-respected *Journal of Finance*.

Specialist fund managers, who focus on a single or a small number of asset classes, showed superior stock selection abilities compared to balanced managers, who focus on a wide range of asset classes.

The superior performance of specialist fund managers was most evident among UK equities, which is the dominant asset class for UK pension funds.

"UK equity specialists generated an annual average post-fee alpha of 35 basis points, whereas the average balanced manager generated a negative alpha of -54 basis points," said co-author of the study, Professor David Blake Director of the Pensions Institute at Cass Business School.

The study also analysed the UK pension industry's shift from single fund managers to multiple competing managers.

It found the trend towards multiple managers led to a significant hike in fund performance, even after accounting for the higher cost of management fees.

Professor Blake said: "Pension funds which switched from employing a single specialist to multiple specialists increased average performance by 131 basis points. Switching from single balanced to multiple balanced management led to a 63 basis point increase in performance. In both cases, fees increased by just three basis points.

"We found the switch from a single balanced or specialist manager to multiple, predominantly specialist mangers reduced the impact of scale diseconomies as the assets of a fund increased over time," he added. "While the shift to multiple managers incurs higher fees for the sponsor, the increase in pre-fee returns more than compensates for this."

The authors argue that fund sponsors employ multiple managers to promote competition and drive up performance. "In UK equities, we find that the average excess return generated by a fund in the year prior to the switch to multiple managers was -53 points, while the year following it was a positive nine basis points," said Professor Blake.

The study helps to explain the UK pension industry's "surprising" decentralisation move from balanced to specialist managers and from single to multiple managers.

“These switches are surprising because the mean-variance efficient portfolio chosen by a single manager will generally differ from the optimal combination of mean-variance efficient portfolios picked by a group of managers responsible for different segments of the portfolio.

“Employing multiple managers usually leads to a diversification loss, since individual managers will not be able to account for the correlation of their own portfolio returns with the returns of other mangers in the fund. Market timing strategies are also more difficult to coordinate,” explained Professor Ian Tonks, another co-author of the study.

“Our findings suggest that decentralisation actually improves performance sufficiently to compensate for the coordination problems that result. The shift to decentralised management can, therefore, be interpreted as rational, since it offers funds with growing assets under management a path for reducing the effects of scale-diseconomies. The move toward decentralisation means the pension fund can exploit the increased skills of specialized managers, as well as benefit from competitive pressures when multiple managers are used.”

In other findings, the study showed that fund sponsors allow decentralised managers higher risk budgets than centralised managers, due to the higher anticipated skills of decentralised managers.

However, again perhaps surprisingly, sponsors budget risk so that the overall pension fund volatility is lower under decentralised management. The authors argue this is because the sponsor is initially uncertain about the skills of the newly appointed manager and reduces risk accordingly.

In the case of UK equities, new managers receive between 40 and 45 per cent of assets to manage. This rises to 55 to 60 per cent after four years. This increase in portfolio allocation to the new manager is consistent with the sponsor learning more about their skills.

The dynamics uncovered by this study appear to be largely driven by two developments in the industry over the sample period: (i) the rapidly increasing size of pension funds and the associated market impact effects, and (ii) the introduction of specialist fund managers with higher levels of skills than balanced managers at the beginning of the 1990s.

‘Decentralised Investment Management: Evidence from the Pension Industry Fund’ by David Blake, Alberto Ross, Allan Timmermann, Ian Tonks and Russ Werners, forthcoming Journal of Finance

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