

# Insourcing investment management

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#### **About ASFA**

ASFA is a non-profit, non-politically aligned national organisation that is the peak policy and research body for the superannuation sector. Our mandate is to develop and advocate for policy in the best long-term interest of fund members. Our members – which include corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider members – represent more than 90 per cent of the 12 million Australians with superannuation.

Enquiries are to be made to ASFA.

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ASFA relies on the skills and experience of industry practitioners to make its Best Practice Papers relevant and accessible.

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James Bond  
Director of Investment  
ASFA

## **Document history**

- Version 1 – October 2016

# Purpose of ASFA's Best Practice Papers

ASFA's Best Practice series is intended to provide superannuation trustees, funds and their service providers with information about an array of concepts, processes and methodologies to address relevant issues.

Generally, ASFA Best Practice Papers are prepared in response to significant interest regarding the topic in question or in regard to issues that ASFA perceives need to be considered or addressed by the superannuation industry.

ASFA's Best Practice Papers are not intended to convey or mandate the only way to address an issue nor even the 'best' way. However, the consultative approach used to prepare ASFA's Best Practice Papers, which includes contributions from representatives of each of the various industry participants (such as trustees, fund executives, administrators, lawyers, actuaries and other key service providers) means that the findings, models and methodologies contained in them are representative of the highest (and most independent) thinking available from a diverse cross-section of the industry.

The concepts contained in this paper provide a considered analysis of the key issues, together with sound and prudent principles that can be developed and adapted to your organisation's particular situation. However, careful consideration should be given, including rigorous testing, before deciding whether or not to implement the processes outlined in this paper to ensure they are suitable and relevant for your particular circumstances.

## 1. Executive Summary

ASFA's Best Practice Papers (BPP) guide Trustees on issues ASFA perceives need to be considered or addressed by the superannuation industry. They do not describe the only way or even the 'best' way to approach a task. Each fund will have to evaluate its own distinctive approach to potentially insourcing investment management.

Traditionally, the vast majority of the assets under management in the Australian Prudential Regulation Authority (APRA) regulated superannuation industry have been managed by investment managers external to the superannuation fund. In recent times, an increasing number of larger funds have begun to insource the management of some or all asset classes to varying degrees. This paper draws on the experience of the funds that are leading this, amplified by research from widely cited academics and industry practitioners.

Importantly, ASFA stresses this paper is not a call for funds to insource investment. A number of funds are already insourcing and the trend looks to be established. However, this is balanced by many funds, including some of the largest, that have stated they have no intention to insource investment in the foreseeable future.

Trustees may face recommendations from management or consultants to insource. The aim of this paper is to evaluate the challenges facing Trustees who are considering those recommendations. It draws on research and current practice of funds, investment managers, consultants and academics to identify the elements of governance, process and risk management, which together, could be seen to reasonably represent best practice.

There are several reported motivations to insource. Industry discussion often simplifies the motivation as being "to reduce fees". However, none of the funds who are insourcing report that it is done solely, or even primarily, to reduce fees. Rather it is to achieve a typically wide array of goals including potentially better after fee and tax returns, flexibility, access, control and other investment synergies.

These potential benefits are offset by an array of risks. In part these will be risks the superannuation fund already faces, but they will have been managed by external investment managers who have expertise and experience in doing so. In some cases, the external manager also provides indemnities and warranties that partially mitigate the financial and reputational risks inherent in investment management. So a fund's risk management framework and risk appetite will be significantly challenged by investing through an internal team, whether a mandate is being transferred from an external manager or when a fund is pursuing a new, complex, untried capability.

While the motives may be attractive and sensible, and the risks deemed manageable, insourcing activities on this scale is challenging and the path should not be embarked upon lightly. ASFA contends that the key to best practice, and maximising the chance of success, is clarity of purpose. Insourcing will affect the organisation in many ways. It will be imperative that a clear mandate is established and adhered to as the path is embarked upon and finalised.

There is no specific regulation of insourcing. While APRA has not issued specific guidance, their public comments have directed Trustees to the existing regulations and guidance notes as demonstrating the types of issues Trustees are expected to have considered. They also regularly comment on the importance of project management because insourcing investment is a significant organisational challenge and should not unduly interrupt the other ongoing business of the fund.

After considering all of this, if Trustees elect to insource parts of investment management, this will eventually impact all aspects of a fund. The roles of all senior executives may have to be refashioned. This paper give some practical interpretation as to what may be required of the Board, its committees, the Chief Executive Officer (CEO), Chief Investment Officer (CIO) and Chief Risk Officer (CRO).

A more strategic risk is that insourcing may create inertia and a loss of flexibility within a fund as it is such a significant undertaking in terms of cultural and management issues.

A recurring theme is that there are role models for successfully managing investment processes on either side of the coin. Investment managers have put in place the governance, staff expertise, investment philosophies, processes and risk management framework necessary to undertake the investment process sustainably and successfully. Trustees should look to them for guidance. Of course investment managers sometimes also fail to deliver on the expectations that they set. Lessons can be learned there too.

In summary, ASFA is not advocating that superannuation funds should or should not insource the investment process. It is saying funds choosing to consider this as an option should proceed carefully, and weigh up all the opportunities, risks and consequences. They should also study other funds and investment managers for guidance. That may cause them to rethink. However, if deciding to go ahead, this paper will be a useful guide to best practice by laying out the many issues that impact on their potential for success.

## 2.1 Introduction

### 2.1 Purpose of Best Practice Papers

ASFA's Best Practice Papers (BPP) series is intended to provide superannuation trustees, funds and their service providers with information about an array of concepts, processes and methodologies to address relevant issues. Generally, ASFA BPPs are prepared in response to significant interest regarding the topic in question or in regard to issues that ASFA perceives need to be considered or addressed by the superannuation industry. ASFA's BPPs are not intended to convey or mandate the only way to address an issue, nor even the 'best' way. However, the consultative approach used to prepare ASFA's BPPs, which includes contributions from representatives of each of the various industry participants (such as trustees, fund executives, investment managers, administrators, lawyers, actuaries and other key service providers) means that the findings, models and methodologies contained in them are representative of the highest (and most independent) thinking available from a diverse cross-section of the industry.

The concepts contained in this paper provide a considered analysis of the key issues, together with sound and prudent principles that can be developed and adapted to your organisation's particular situation. However, careful consideration should be given, including rigorous testing, before deciding whether or not to implement the processes outlined in this paper to ensure they are suitable and relevant for your particular circumstances.

### 2.2 Aim and scope

This paper should not be seen as ASFA advocating for superannuation funds to insource investment management. Some funds are, and the trend appears to be increasing. Equally some funds have no plans to insource. While ASFA sees no reason why funds should not consider insourcing as one option for meeting their investment demands, insourcing is not imperative for successful investing for funds of any scale.

As such, Trustees are likely to face this issue at some point, and the aim of this paper is to evaluate the challenges facing funds considering insourcing parts of their investment management. It draws on research and current practices of funds, investment managers, consultants and academics to identify the elements of governance, process and risk management, which together, could be seen to reasonably represent best practice.

The paper draws on the experience of funds leading this initiative in order to benefit those following, as the industry grows and consolidates. This is amplified by other research into why and how superannuation funds might insource investment management. We particularly acknowledge research by:

- The Centre for International Finance and Regulation (CIFR)<sup>1</sup>
- G.L. Clark and A.H.B. Monk<sup>2</sup>.

### 2.3 Industry trends to insource investment management

Traditionally, the vast majority of the assets under management in the APRA regulated superannuation industry have been managed by investment managers external to the superannuation fund. In recent times, an increasing number of larger funds have begun to insource the management of some or all asset classes to varying degrees.

Insourcing is building capability (staff, processes and systems) within the fund to manage its assets directly as opposed to using an external investment manager. Often it will involve replacing an existing external manager. This is ultimately a 'make or buy' decision that is very common among all organisations and firms. Also, this choice is already being made. Asset allocation and risk management has long been internal (often advised by an asset consultant) while private equity has been external.

Insourcing may cover a range of different asset classes and tasks across the investment decision making process. It can range from managing all of an asset class or adopting hybrid models where management is shared between external and internal teams. The latter is a common approach in Australia at present.

Insourcing is happening at an increasing pace in Australia. This is occurring in concert with a global trend. On average,

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<sup>1</sup> Gallagher, D., Gapes, T. and Warren, G., In-House Investment Management: Making and Implementing the Decision, the Centre for International Finance and Regulation (CIFR), 2016

<sup>2</sup> Clark, Gordon L. and Monk, Ashby H., Principles and Policies for In-house Asset Management working paper, Global Projects Center, Stanford University, 2012

<sup>3</sup> Williams, K. and Cornelius, S., The Frontier Line – Navigating the Insourcing Trend, Issue 1, Frontier Advisers, 14 March 2016, pp. 3

the top ten sovereign wealth funds manage 62 per cent of their total funds in-house<sup>3</sup>. Of the top 200 largest defined benefit funds in the US, 26 per cent manage a proportion of their assets themselves. The Canadian pension funds are seen as leaders in this area and most of their largest funds insource, with most adopting a hybrid model. For example, the Ontario Teachers' Pension Plan, with funds under management (FUM) of C\$141 billion, has 80 per cent of its assets managed internally. Some pension funds go even further and are managing assets for third party clients.

In Australia the list of funds that now have their own investment teams includes AustralianSuper, Equisuper, REST Super, MTAA Super, Telstra Super, Cbus, UniSuper, QSuper and First State Super.

Research by the CIFR, supported by ASFA's engagement with members to develop this paper, shows there is a wide variety of views and approaches to insourcing across the industry. A recent paper by the CIFR based on a survey of CIOs and CEOs states:

*"Although there is a sizeable element of overlap, for the most part the points of emphasis and the manner in which they discuss the issues differ considerably. Thence 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."*<sup>4</sup>

The value of superannuation FUM in Australia is already around A\$2 trillion. Reliable estimates are that under current policy settings, FUM will reach A\$9.5 trillion by 2030. As FUM grows, so too will the size of individual superannuation funds. APRA data<sup>5</sup> shows that there are already eight funds with over A\$50 billion in FUM. A further nine have FUM of A\$20-50 billion. While only the larger funds have begun to insource systematically, the growth in the number of large funds will mean that insourcing will come into focus for a much larger number in coming years. Should the superannuation funds that currently hold A\$20-\$50 billion grow at the same rate as total industry funds under management, then there will be around 15 funds larger than A\$50 billion by 2030.

Scale is one of the driving forces behind insourcing. As FUM growth continues, Trustees may be asked to consider the potential motives and benefits of attempting to replicate and replace parts of a large and well-governed investment management industry in favour of building similar expertise in-house. The task of creating an internal investment capability is considerable and will have significant impact on other areas of the fund. Trustees will need to determine whether the assumption of a different array of risks outweighs any savings in costs and other benefits associated with insourcing.

While not imperative, superannuation funds may consider insourcing based on a growing body of practice and research available to guide them. There are no express regulatory prohibitions on developing an internal investment capability. However, success is not guaranteed. It is a complex and multi-faceted undertaking that needs to be carefully governed, implemented and continually monitored. Some investment managers have failed as businesses because of poor governance and many have produced poor investment outcomes below any expectations that they confidently set. Lessons can be learned from these as well as the many that have established very long term success both in business and investment terms.

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<sup>3</sup> Williams, K. and Cornelius, S., The Frontier Line – Navigating the Insourcing Trend, Issue 1, Frontier Advisers, 14 March 2016, pp. 3

<sup>4</sup> Gallagher, Gapes and Warren, op. cit., pp. 20

<sup>5</sup> APRA, Annual Fund-level Superannuation Statistics, [apra.gov.au/Super/Publications/Pages/superannuation-fund-level-publications.aspx](http://apra.gov.au/Super/Publications/Pages/superannuation-fund-level-publications.aspx). [Accessed 27 October 2016].

### 3. Key to Best Practice

In the early stage of the insourcing trend, it is apparent funds are pursuing multiple and varied objectives and the scope and scale of insourcing varies widely. ASFA will not attempt to closely define a single best practice governance path or set of steps.

The cornerstone of best practice is clarity of purpose. As the following section shows, there are many plausible objectives. Equally there are many plausible organisational structures and business plans that can be applied. Trustees will maximise the probability of success if they maintain a strategic focus on aligning the objectives with their plans and establish strong oversight, assurance, reporting and risk management processes. Clear success criteria are also critical.

It is likely that funds pursuing significant insourcing programs will have to adapt and change at all levels. Highly skilled and motivated investment teams will be hired and that will mean fiduciary skills of Trustees and independent committee members will need to expand so as to understand and evaluate their decisions. In addition to putting front office teams in place, operations staff will need to be recruited and integrated, with segregated lines of reporting. Then appropriate data on the outcomes will need to be gathered, measured and evaluated to enable fiduciaries to hold all of these professionals accountable to the tasks they have been set.

Investment management will encompass both exciting and mundane tasks and it will need to be relentlessly efficient. Checks must be ongoing to ensure compliance is within the risk appetite set by the Trustee. This methodical oversight is embedded in the culture of investment managers but it will need to be adapted and built by superannuation funds.

The governance and processes, once established, will need to be sustained into the foreseeable future, implying strong succession plans, and ongoing judgements on investment markets and the drivers of excess returns and risks. At times this will precipitate a need for change within the investment team. Ideally this will be done with foresight so opportunities are taken rather than failures responded to. These collectively are challenging tasks, but ASFA contends it is not beyond superannuation funds to do this well.

As a benchmark for best practice, Trustees could look to well-governed, successful investment managers who have achieved sustainable high quality investment management outcomes. One strategy would be to interact with existing external managers to compare the fund's internal management resources and procedures with those of managers who are currently employed and respected by the fund. The discipline applied to investment managers by competition in a market for investment services, will not be applied for superannuation funds. Therefore, new methods of assessing success and failure will need to be developed to replicate this market discipline

## 4 Goals of insourcing

Trustees have relied almost exclusively on external managers for many decades, through which superannuation funds have been successful investors. ASFA is not suggesting there is an imperative for funds, even large ones, to insource investment management. Rather, this section sets out a series of potential motivations for insourcing. It is self-evident that Trustees would need to be convinced this would have a high probability of resulting in demonstrably better outcomes to offset the risks.

In order to seek best practice, Trustees will have to first decide what is motivating the fund to change its investment practices. The core question is where does the fund identify a comparative advantage within which to establish an internal investment capability? A scan of funds in Australia, and globally, suggests a wide array of motivations.

These motives are not exclusive and they may apply to one or more asset classes or mandates. A major finding from the CIFR research is that there are no common set of reasons for any particular fund to insource. They conclude:

- *“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.”*<sup>6</sup>

To amplify this, Clark and Monk document a set of, “five key factors pushing institutional investors to move assets in-house”<sup>7</sup>. These are access, alignment, capabilities, performance and sustainability.

Most funds will not consider insourcing to be an ‘all or nothing’ decision. There is no evidence of an Australian superannuation fund with an ambition to internally manage all of its assets. There are also many funds that do not intend to undertake any internal management in the foreseeable future. Those internalising are all adopting hybrid models where internal management exists alongside external management. This is typically in one or more asset classes.

Motives for insourcing will also vary between asset classes and styles of management. The following are simple examples purely to illustrate this point and not to be taken as literal suggestions:

- It may not make much sense to insource a passively managed listed equity portfolio as the governance and management standards and cost of outsourcing are likely very competitive with insourcing.
- It may make sense to outsource an emerging markets portfolio as it is hard to obtain local expertise and the amounts invested might not justify this even for large funds.
- Subject to scale, it may make sense to partially insource actively managed local listed equities because expertise is available, strategies can be tailored to size and cost savings may be material.
- It may be advantageous to insource unlisted assets mandates if a fund wishes to secure scarce assets and make case by case decisions.

Insourcing will never be a straightforward decision. Internal and external teams offer different advantages and disadvantages on many dimensions. Trustees should be wary of management or advisers claiming that either model is comprehensively superior. In the end, best practice will entail the Trustees considering all of the intended and potentially unintended consequences and making a balanced decision. It may also extend to what type of management suits the culture of the fund (for example: passive, efficient, low cost and low remuneration versus active, risk taking, high performance related remuneration).

The likely major goals which could be presented to trustees by managers or consultants advocating insourcing are summarised below. More detail on these is in Attachment 1

### 4.1 Improve governance, control or flexibility

Insourcing can provide the opportunity to align the investment strategy and operations of the fund more closely to the goals of the fund. Clark and Monk explain that investment managers and other service providers may not have alignment of interests with the superannuation fund<sup>8</sup>. Examples of where this can occur are:

- dealing with principal and agent issues

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<sup>6</sup> Gallagher, Gapes and Warren, *op. cit.*, pp. 2.

<sup>7</sup> Clark and Monk, *op. cit.*, pp. 4

<sup>8</sup> Clark and Monk, *op. cit.*, pp. 3

- control and focus at fund level
- owning assets directly
- responding to unexpected events
- termination flexibility.

## 4.2 Improve risk-adjusted investment returns for similar mandates

This would be the simplest of motives and essentially implies substituting internal management teams for external managers. There is a common misconception that insourcing is primarily motivated by simple cost savings. Clearly any savings in fees are likely to be dwarfed by the potential differences in actual investment outcomes between the internal team and any external manager it replaces. However, if roughly equivalent levels of competence can be achieved, other advantages including lower costs and stronger capture of economies of scale combine to produce superior expected results.

This motive will also have quite different aspects across different asset classes.

## 4.3 Establish skills or access assets not available elsewhere

Funds may have an opportunity to establish investment teams to undertake tasks which cannot be effectively accessed from external managers. Examples of where this may be the case are:

- strategy (asset and currency allocation), particularly at overall fund level and within member investment choice options
- capacity constraints in listed markets
- avoiding having to share scarce assets (particularly unlisted assets).

## 4.4 Overall synergies

Establishing one or more internal investment teams can create cultural and synergistic advantages beyond the direct mandate being considered. When fully outsourced, the fund is remote from markets and the assets it owns, creating information asymmetry. By investing through an internal team, the improved general base of investment knowledge and expertise (which is currently captured by intermediaries) could be reflected in the following:

- In-depth knowledge and market intelligence to the Fund, assisting in making strategic investment decisions.
- A fall-back capability where the internal team can be called in at short notice to manage specific mandates should external manager expertise become unavailable due to unexpected termination or withdrawal by the manager (eg if an external manager has a team depart at short notice).
- More focused management of risk in areas such as liquidity, foreign currency hedging and asset rebalancing.
- Internal staff will have access to internal dynamics, such as member cash flows, liquidity requirements and interactions between asset classes that could assist in making better portfolio management decisions.
- Internal teams will build professional networks which can also provide access to other valuable skills or knowledge.

## 5 Risks of insourcing

In determining whether to insource, and how to structure the ongoing management of the process, Trustees should ensure they are comfortable with the risks involved and their ability to adequately manage them. These risks are discussed in this paper and they will form a guide for Trustees seeking best practice.

Overall, insourcing investment teams will present a whole new set of challenges for Trustees, especially culturally if and when pay scales start to diverge internally. Strategically this may result in an unintended inertia, a loss of flexibility (given set up costs of teams are large) and a loss of insights from the market or access to assets depending on how hybrid manager structures are set in place in various asset classes.

The most important risks include the following:

- Investment risk. Internalising management is about improving investment performance after all costs, tax and risks are accounted for. The primary risk is poor performance by the internal team. The types of specific risk to be managed will vary by mandates being managed. Examples include active management risk, credit risk, liquidity risk, currency risk and counterparty risk.
- Staff quality and retention:
  - » Trustees must consider whether they can attract and retain sufficient skilled and experienced staff (front, middle and back office) to sustainably implement a high quality investment operation within the culture and reward systems they choose to foster in their fund. This encompasses various risks such as inadequately trained/skilled staff, key person risk, lack of succession planning and employee mismanagement which might distract or demotivate.
  - » Policies would be required as the in-house capabilities develop and expand. The fact that Australia has a relatively small pool of domestic-based investment talent and our remote geographic location limits attracting high-quality staff from overseas impacts this. North American, British and European asset owners, who are often looked to for comparisons, have a greater pool to attract talent from.
  - » Depending on the investment process being established, some asset classes require significant staff resources and may even require presence on the ground internationally (examples are origination, execution and ongoing asset management in private equity, real estate and infrastructure). This could pose many cultural and administration challenges for staff
  - » Staff retention. Successful internal teams or individuals may seek to leave for improved career prospects. This is discussed further later in the paper.
  - » These risks are mitigated to some extent as insourcing becomes more widespread. There are already examples of staff moving between superannuation funds.
- Organisational priorities – investment staff will be effective advocates for their interests and it is possible that they will increasingly capture the Trustees' wider agenda and priorities. This may detract from the other objectives of the overall fund and absorb too much priority.
- Information asymmetry – investing is complex and the manager often holds an information advantage over the Trustee, which can impair common understanding and objective judgement. Internal investment staff and consultants control this risk with external managers. The same asymmetry could exist for internal teams and, without offsetting controls of some form, this might, even inadvertently, lead to an unbalanced investment debate between Trustees and management.
- External manager relationships. Insourcing may change the dynamic between the fund and its external managers. A partnership – model could be strained by insourcing, even in asset classes that are not currently insourcing.
- Reputation – all risks, particularly in relation to poor performance errors and fraud, could impact directly on the superannuation fund's reputation and the confidence of members.
- Operational risk – this includes the risk of trade execution errors, transaction processing errors, payment errors, inaccurate reporting, business continuity disruption, theft and fraud. This extends to information technology demands. While operational functions could be outsourced, this will require a suitable provider to be identified and monitored (which may be more challenging for global portfolios).
- Compliance – complying with legal and regulatory requirements, including without limitation those relating to insider trading, conflicts of interest, segregation of duties, fit and proper persons, risk management frameworks, investment governance, Operational Risk Financial Reserve<sup>9</sup>, confidential information and reporting obligations.

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<sup>9</sup> A reserve to cover the operational risk of business operations which will include investments by an internal team. Refer to SPS 114 and SPG 220

- Project risk – the transition from an outsourced approach to insourcing will be a significant project that will involve the risk of costs and timeframes being exceeded as well as the expected benefits not being achieved. Ad hoc projects will also be continuously required due to market, system and regulatory changes.

Superannuation funds using an external model face many of these same risks, but in different ways. Insourcing asset management functions transfers some of these risks from an external investment manager or custodian to the Trustee of the superannuation fund. Effectively it is transference from agency to operational risk, but it is challenging and it should not be underestimated.

If investment management is outsourced, protection is provided to the fund against some of these risks. This is through indemnities under contractual arrangements and diversification of risk by using manager insurance and the diversification of risk through multiple managers. Subject to the terms of the relevant contract (noting the requirement under section 116 of the SIS act that managers must remain liable for negligence), if there is a breach or error the fund may be able to recover some or all of their loss. Conversely, insourcing investment management functions will to an extent have an effect of transferring these risks internally within the fund with no recourse to third parties for losses incurred, other than from fund reserves or insurance.

## 6. Making the decision to insource

Historically, the superannuation industry has successfully relied almost exclusively on outsourced consultancy and investment management. There is a burden of proof to consider when challenging this. Clearly, some funds believe that has been met because they are pursuing insourcing programs, albeit within differing asset classes and at different paces and scales.

Trustees will need to conclude whether there is a strong probability that insourcing programs will improve risk-adjusted net returns to their fund's members, on a material and sustainable basis, to justify the risk of change. Identifying external managers that offer true risk-adjusted after cost value add with high probability is difficult and uncertain. So Trustees will be evaluating if internal teams can achieve similar returns at lower cost and ideally lower risk. Of course, what comes out of that in the end is also uncertain.

The typical investment process in a superannuation fund is that fund trustees, assisted by internal staff (sometimes a secretariat, but more frequently now investment professionals), take advice from asset consultants and then set objectives and strategies for a default fund and multiple choice options; both accumulation and pension. These strategies include the overall asset allocation and any structure for changes in this over time to reflect changing market conditions (dynamic, strategic, rebalancing, etc).

Fund management is a mechanism for implementing a part of the investment strategy, typically broken down first by asset class and then multiple mandates/managers within each asset class. Trustees approached with insourcing submissions will probably view them based on one or more of the motives listed earlier in this paper and in the attachment. There will be offsetting risks and the Trustee cannot be certain that the internal team will be successful and produce a better outcome than the existing investment arrangements.

Advocacy from management may be partially conflicted and will need to be managed. For example, internal teams may be motivated to advocate insourcing by the potential for improved remuneration, prestige, status and future career prospects.

There is no simple path to best practice in making this decision. As an example, Clark and Monk set out a hierarchy of nine attributes they feel lay the foundations of success; people, organisation, risk management, culture, asset selection, mandates, delegation and segregation, communication and networks<sup>10</sup>.

As a guide to what insourcing may require, funds will already have established manager selection processes. These involve experts, either internal or external consultants, usually both, in assessing the prospective manager's capability in the relevant investment mandates. Thorough due diligence is conducted on the manager and this provides the best chance of selecting good managers. It is hard to replicate this for internal teams. The use of one internal team to assess the capability of another is fraught with difficulties and may create conflict.

Trustees may seek to create independent assessment programs that replicate the external manager selection principles to assess if the internal teams are meeting expectations. On the other hand, Trustees may be privy to information that may not be clear for external managers (eg: team dynamics and effectiveness, internal appraisal programs, compliance and breaches of mandate, etc).

Trustees should have strong internal governance processes to ensure they are considering answers to:

- Where can an internal team create and sustain a competitive advantage? Where is the most material impact made?
- What mandates suit the objectives of the fund, its culture and its investment beliefs? (beta/alpha/asset allocation, etc)
- What priorities should be set and what pace of change initiated?
- What will the final plan look like (asset classes, percentage internal, allocation of risk budgets etc).

A particular challenge will be assessment of track records. Although it is constantly recognised that past investment performance is not a reliable guide to future performance, it remains true that track records play an important part in the actual decisions about appointing managers. A new internal team will not usually be able to display a track record. The

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<sup>10</sup> Clark and Monk, op. cit., pp 6-9.

relative importance of this will vary between types of mandates (active versus passive, listed versus unlisted, etc) but it is a key consideration the trustee will need to form a view on.

The key question becomes what amount of assets and risk budgets would a Trustee comfortably assign a new investment manager who has no existing process, untested support infrastructure and no track record of live investment performance? Will the Trustees hold an insourcing program to the same standard as an external manager? The acceptable answer may be 'no' if the strategic goals of insourcing are to be initiated and allowed to build over time.

ASFA does not believe best practice requires identical standards of appointment. Long-term strategic advantages are being sought and Trustees may initially elect to apply a 'fit-for-purpose' standard as opposed to 'best-in-class'. This will enable the internal capability to be established and seeded and it can then be held fully accountable over appropriate time periods. After all, every investment manager started without a track record and superannuation funds often seed new investment managers and/or new teams within external managers to seek first mover advantages in exchange for some establishment risks.

However, Trustees should be very aware of the comparative appointment standards being applied and satisfy themselves that the inherent conflicts and risks are being managed as well as possible. At the very least, best practice demands strong input from independent experts who understand the fund's philosophies and can provide objective advice before an insourcing decision is initiated.

The potential views of superannuation fund ratings agencies towards insourcing also need to be considered. Agencies all place a high weighting on investment expertise when rating funds and will presumably focus on this to a degree commensurate with the scale of the insourcing and the types of investment being undertaken. To the extent that ratings are an important objective for the fund, this issue could be significant.

To this point, ratings agencies have not been outspoken in regard to their preference or otherwise for internal management. Their views will become more known over time. Interestingly, this is one area where several informed, objective agencies will provide a visible assessment of the merits of insourcing. This may materially impact the comparative ratings of large and smaller funds that don't choose to pursue insourced management.

## 7. Regulation

Where the governing rules do not provide for binding death benefit nominations, the trustee often invites members to make a “non-binding death benefit nomination”. Where a deceased member has made a non-binding death benefit nomination, in deciding to whom to pay the death benefit the trustee should consider that nomination, along with other relevant matters. However, the trustee is not bound to follow the nomination and may decide to pay all or part of the benefit to a different person.

### 7.1 Overview

There is no regulation that directly prohibits insourcing investment mandates, however, a fund’s current governance and compliance frameworks are likely to require revision and enhancement. The fund may also be required to vary its existing AFS licence to manage assets and trade securities. APRA has stated in public forums that the following are important elements of an insourcing business plan<sup>11</sup>:

- demonstration of the link to members’ interests
- costs and benefits
- resources, capabilities and expertise (including support staff)
- systems and processes.

APRA indicates they will look for a Trustee’s recognition of the change in the fund’s risk profile, benchmarking, remuneration and independent assurance of the expertise and processes of the internal capability (both front and back office). All of these are also recommended as best practice considerations in this paper.

APRA has also indicated in consultation with ASFA that the decision to insource is itself a significant project for a superannuation fund. The process requires a robust governance structure that takes into account the complex relationship between those within the fund proposing insourcing and those making the decision. It is also important that decision makers have access to information and advice from those who are independent of the organisation. A Trustee should expect that APRA will closely monitor the project of transitioning from external to internal management for any material mandate. To achieve best practice at the outset, the fund should meet with APRA to outline what action it is taking and provide assurance that it has appropriate processes.

Because insourcing may represent a substantial shift in the nature of the fund’s operation, Trustees will need to confirm their compliance with APRA’s Prudential Framework. While there is no specific guidance, this will invariably require a review of, and potentially amendment to, a number of key frameworks, policies and strategies in order to ensure compliance. Most relevantly these may include the following Superannuation Prudential Standards (SPS) SPS 220 Risk Management, SPS 530 Investment Governance, SPS 114 Operation Risk Financial Requirement and SPS 520 Fit and Proper.

There may be others depending on the size, scope and complexity of the insourcing. Decisions on insourcing need to be as closely governed as appointing external managers, at a minimum. This may require Trustees to perform internal due diligence with the same or similar rigour as applied to external managers under SPS 231 Outsourcing. Trustees should ensure that such due diligence is conducted as independently as possible from the proposed internal team.

Trustees can refer to two guidance notes to infer what APRA will expect (SPS 530 and SPS 231). While neither of these specifies direct actions, best practice calls for decisions on insourcing to be at least as closely governed as appointing external managers. As such, the processes of SPS 231 would form the best guidance for Trustees until APRA publishes something more specific.

### 7.2 SPS 530 Investment Governance

This establishes the requirements for the Board to implement a sound Investment Governance Framework and to manage investments in a manner consistent with the interests of beneficiaries. The Board must:

- formulate specific and measurable investment objectives for each investment option, including return and risk objectives
- develop and implement an effective due diligence process for the selection of investments

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<sup>11</sup> APRA, Presentation to ASFA Investment Interchange, June 2016

- determine appropriate measures to monitor the performance of investments on an ongoing basis
- review the investment objectives and investment strategies on a periodic basis
- formulate a liquidity management plan.

### 7.3 *SPS 231: Material Outsourcing*

This requires all outsourcing arrangements involving material business activities entered into by an RSE licensee be subject to appropriate diligence, approval and ongoing monitoring. The Board must:

- have a policy, approved by the Board, relating to outsourcing or material business activities
- have sufficient monitoring processes in place to manage the outsourcing of material business activities
- have a legally binding agreement in place for all outsourcing of material business activities
- consult with APRA prior to entering into agreements to outsource material business activities to service providers that conduct their activities outside Australia
- notify APRA after entering into agreements to outsource material business activities.

## 8. Governance

### 8.1 Overview

Internalising investment management in a hybrid model is a challenging undertaking for a Trustee. Best practice calls for the governance structure and process for the decision to insource to be considered and clearly documented. Key elements of the governance challenge are set out in this Section. This is written from a general perspective and the principles will need to be adapted to the specific nature of the investment mandate being internalised and the fund's unique characteristics.

The first step in governance will be to clearly identify the motivation for insourcing and ensure that clarity of purpose is maintained. Governance bandwidth is always limited and must be prioritised. This may be a constraint that may crowd out other plans or at least impact sequencing, scope and timing. Trustees will have to ensure insourcing does not put other successful fund operations at risk.

Trustees should expect the fund to change markedly as investments are insourced in a material way. They should also consider whether Board membership should change in some way. In addition to simply having new staff doing new things, there will be new tasks and obligations for fiduciaries and existing management.

Insourcing may also impact culture because investment teams are likely to be drawn from the investment management industry, and in some ways bring that culture with them. They will also have established networks and ways of doing business that may be absorbed by the fund to its advantage.

Some of the governance issues that a successful investment program will need to address include:

- Leadership, including business leadership, staff leadership and thought leadership of the investment process
- Accountability, transparency and delegations
- How the investment capability will be allowed to impact the existing culture of the fund
- Clear measures of success, framed in the interests of members with clarity around how the interests of other stakeholders interacts with that
- How the actual outcomes will be evaluated against those measures of success and what the consequences of particular outcomes will be
- How the risk of achieving those outcomes looking forward will be evaluated over time as internal teams and markets change constantly
- The priority of time and effort to be applied by Trustees, management and support staff to the investment process and at what opportunity cost
- How much flexibility will be tolerated when implementing plans and how the organisation intends to learn from its experiences.

### 8.2 Member engagement

Trustees will need to consider the degree to which the insourcing plan is disclosed to members. At a minimum, the fund's investment managers must be disclosed in the fund PDS and other disclosure documents, but engagement is a wider concept than that. Is the internal team just another manager or are special disclosures around appointment protocols, monitoring, etc warranted? Salaries and other benefits and the impact on fees may need to be disclosed.

There is also an indirect consideration of how ratings agencies are likely to portray and comment on the internalisation process.

There could be the temptation to champion the internal team and its advantages prominently to members. This increases reputation risk. If for some reason (underperformance, market changes) the internal team is disbanded, or simply resigns, their prominence becomes a negative. This is a challenging balancing act. Presumably best practice would caution about promotion of an internal team until success has at least become evident and the program is well established.

### 8.3 Investment beliefs

If a Trustee is considering insourcing investment management, their first governance priority should be to recast their beliefs to include those necessary to oversee an investment process. The scope will be dependent on the mandates

being envisaged but a strong set of beliefs will be vital to keep the plan on course.

When mandates are insourced, the Trustee forgoes the discipline applied by the investment manager in regard to beliefs, process, adapting to changing investment markets, competition for assets and scarce alpha opportunities. Best practice calls for this discipline to be replicated within the fund and this starts with beliefs.

Therefore, Trustees should insist that any submissions to insource are predicated on submissions about how the fund's investment beliefs will need to evolve. This is an important template for assessing the likely success of an insourcing program and ensuring clarity of purpose is maintained.

## 8.4 Delegations

Delegations are central to best practice and any decision to insource will require a new set of delegations to be established. These will in turn establish the demands for expertise and resources at the various levels of the fund. Establishing delegations will be an iterative process as the insourcing program matures and potentially expands.

There is no standard delegation structure to guide Trustees as to what constitutes best practice. It will depend on the scope and scale of what is being insourced. Very broadly delegations will have to be established for:

- Appointing and terminating internal teams to specific mandates including the key elements of the mandates. These should be similar to the appointment processes and mandates governing external managers. A key consideration for Trustees will be the need for independent advice. In some funds, internal teams are delegated to appoint external managers, often with input from asset consultants. However internal teams should not have delegations to appoint themselves to mandates. Internal mandate appointments should be delegated no further than an Investment Committee.
- Appointing and terminating staff to the internal teams. These would be layered delegations with Trustees and senior executives (CEO and CIO) sharing the delegations appropriately.
- Assessing performance. This will involve establishing key success criteria in advance of the insourced mandate being established. Again, the Trustee could model this on the standards set for external managers with involvement of independent assessment as desired.
- Operational and support roles. These may be insourced as well and if so will again have to reflect the tasks, expertise and other governance applied to external manager appointments.
- Remuneration and other rewards for internal staff.

The authority to approve insourcing activities will differ from fund to fund, depending on the depth of expertise and organisational dynamics. Trustees should expect well established economic and strategic rationale for insourcing any mandate, along with realistic implementation plans, including costs and time frames. Risks of insourcing should be articulated along with mitigating measures. Best practice will call for this delegation schedule to establish who recommends and approves at the various levels of the process.

## 8.5 Fiduciaries

### 8.5.1. Board of Trustees

The Board of Trustees is ultimately responsible for all investment decisions and how they affect the funds members' best interests. It is unlikely that the board itself will make actual investment decisions after mandates are insourced. Rather, their role will be to ensure all the policies and processes are in place and review the outcomes against predetermined success criteria. A key task will be to settle appropriate delegations among the Investment Committee and various senior executives. The Board will also have to consider appropriate segregation of reporting lines between front and back office as well as strategic risk management staff.

All of these will vary between the asset class and styles of management (asset class, active, passive etc) being insourced. The Board will also have to consider the impact of change on management bandwidth.

The Board will face challenges due to the information asymmetry likely to exist between the Trustees and the internal management team advising on the decision to insource and its outcomes over time.

Together with continued compliance with SPS 530 Investment Governance, to achieve best practice the Trustee should be responsible for the following:

- Insisting on clarity of purpose for the insourcing activity and ensuring that all aspects align directly with that purpose.
- Establishing and monitoring the progress of business and strategic objectives.
- Managing risk and conflicts of interest, including installing a strong culture of risk identification and management throughout the entity as it relates to the insourced mandate. This will have to be established and operate in parallel to existing processes which govern external managers.
- Undertake a regular appraisal of the competency, operation and effectiveness of the internal investment team and mandates. The frequency should be set to match the risk level of the process but best practice would call for at least annual reviews, with greater frequency while the insourcing program is being established and maturing.
- Review and approve significant changes to products, product offerings and product fees which would flow from the insourcing initiative.
- Seeking assurance from management that:
  - The entity is acting in conformity with the terms of the Trust Deed and Constitution, the PDS, and the requirements of relevant legislation, regulatory obligations, licence conditions, codes of conduct and internal policies and procedures.
    - » The investment duties of the entity are being carried out with the required care, diligence and skill.
    - » All policies and procedures contain appropriate, up-to-date content and are being maintained.
    - » All monitoring and reporting processes in place to assist the entity to meet its responsibilities are sound and up-to-date.
    - » Strategies are being developed and implemented to respond to issues and trends in the financial industry which could impact on shareholders, investors in the schemes and/or members of the fund.

## 8.5.2 Investment Committee

In all likelihood, a Trustee considering insourcing investment will appoint an Investment Committee. In keeping with ASFA's theme that best practice is founded on clarity of purpose, the role and structure of the Committee could range across several models.

The Committee could be delegated to be involved in investment decisions.

- It is commonplace for investment managers to form Investment Committees to review major decisions in many asset classes. The supporting arguments are about expertise, strong review, breadth of experience and diversity.
- As such, Committee members with requisite expertise and experience will be required and it will change the nature of the required management team as well. There will need to be clear delegations between the Committee and management to ensure strong accountability.
- The major challenge for governance in this model is how will the Trustee hold the Committee to account for its decisions? Best practice would require a strong independent voice (presumably a consultant from outside the fund) to measure and evaluate the investment decisions and attribute accountability fairly between the Committee and management.
- In addition, how will underperformance be followed up? Committee processes are typically jointly accountable and as a majority of members are likely to be Trustees themselves it will pose significant challenges. Would Trustees be prepared to remove their Trustee colleagues from an underperforming Committee?

Alternatively the Committee could be established as more of a governing body with delegations to appoint investment teams, approve internal mandates, oversee the process and review the outcomes of investment decisions<sup>12</sup>.

- This type of role will probably provide a more natural governance fit with established practice in superannuation funds. A small Committee (typically five to nine) would be able to have wider scope without stretching to be involved in multiple asset classes.
- It will also enable the fund to attract stronger investment managers with the appeal of exercising stronger delegations for investment decisions.
- It will also make accountability very clear and the Trustee will be able to delegate a lot of the oversight necessary for an internal team thereby not encroaching too much on Trustee governance bandwidth.
- If the insourcing program is to be enduring and broad-based, ASFA would see this second form of governing Committee role as better practice because it is more flexible and sustainable.

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<sup>12</sup> Refer to *SPS 510* which discusses the establishment of Committees.

### 8.5.3 Audit and Risk Committee (ARC)

The ARC is the basis for establishing the necessary segregation of duties to manage risks, compliance and performance of the internal teams. Its charter will change significantly if an insourcing program is initiated and there will be revised delegations emanating from that. The ARC will also need to ensure that its internal and external audit plans appropriately cover the insourcing program.

Other areas that ARC will oversee include budgets, accounting and finance as well as overseeing the change management process.

## 8.6 Management

### 8.6.1 Chief Executive (CEO)

The role of the CEO in the decision to insource and then in the ongoing management process needs to be considered.

For example, is the CEO the proposer and advocate of insourcing or are they one of those who make the decision? How are these two potentially conflicted roles, advocate and decision maker, separated? It is likely that the CEO will see themselves as the champion of the internal management team, but if the investment governance structure of the fund relies on a competitive tension between internal and external management, as it almost always will, this role comes into conflict.

Best practice will almost certainly see no direct role in investment decision making for the CEO. The exception may be in back office functions but an alternative there is the use of the CFO. This will free the CEO to adopt a more strategic role to evaluate what level of insourcing makes sense, to provide checks and balances on scale and scope of the program and to maintain oversight on the insourcing business plans to ensure benefits are captured and policies are adhered to.

When insourcing investment, the CEO will play something of an indirect but nevertheless pivotal role, balancing the challenge to lead and champion the management team with the need to ensure competitive tension is maintained and business plans are faithfully executed. The CEO will also provide a useful focus to ensure independent assurance is provided where the approved governance model calls for it to settle the terms of reference for reviews, and ensure any follow up is actioned in a timely and thorough way. The CEO will also be the focal point for segregated decision and accountability lines between front and back office.

The implication of all this is that an investment internalisation program may well require a change to the priorities, expertise and role description of the CEO.

The relationship between the CEO and the CIO also need to be considered. The CIO might have an interest in increasing their own role and delegations through insourcing and the CEO is best positioned from a governance perspective to keep that in balance.

Key questions that need to be clarified to achieve best practice for the CEO role include:

- Is the role in oversight or as part of the investment process?
- How are CEO delegations structured?
- How are rewards and incentives structured commensurate with that?

These can be struck in a range of ways but clarity of purpose is again the foundation of best practice.

### 8.6.2 Chief Investment Officer (CIO)

The CIO can have a range of responsibilities depending on the insourcing model and motivations. Best practice will again be defined by clarity of purpose and consistency. The Trustees will have to be clear about whether the CIO is:

- The leader of the internal team and hence carries primary accountability for their decisions. In this case the accountability for external managers and management of competitive tension will need to be carried by some other stakeholder, perhaps the CEO or Investment Committee; or
- The leader of the full hybrid model and equally accountable for internal and external managers, and consequently managing the allocations of assets and competitive tensions between them directly.

Best practice will call for this defining governance decision to be made very clearly at the start of the insourcing program because it will call for a CIO with specific expertise. Management of expectations will be crucial to attract and retain the right person.

The CIO will be accountable for investment decisions but there should be clear segregation of reporting lines between the front office and the various investment support services that ensure compliance, risk management investment operations (trading, settlements, valuations, etc) and performance measurement and evaluation. Depending on the fund organisational structure this role could report through to the CFO and/or CEO.

### 8.6.3 Chief Risk Officer (CRO)

The CRO will have the role of ensuring any internalisation program is incorporated into the fund's risk management statement and decisions fall within the risk appetite of the fund. There will also be a significant extension of compliance and external assurance activity as it relates to internal mandates.

The Board is ultimately responsible for a fund's risk management framework and accordingly involvement at a Board level will also be required. Aspects of risk management are discussed further in Section 10.

## 8.7 Asset consultants

The role of asset consultants will change significantly in response to an insourcing program. The mandates given to consultants are quite varied across funds that have commenced insourcing. Two primary examples are set out below.

First, this paper asserts that best practice will involve very clear independent assurance to the Trustee about internal teams and this is an obvious role which consultants will fill. The challenge will be to structure forums and charters to allow the consultants to be independent in their work, and pro-actively challenge any aspects of the internalisation which are warranted. This is complex when the internalisation may of itself reduce the future role of the asset consultant.

Second, the CIO and internal team will doubtless retain consultants to advise on various aspects of investment strategy and implementation. Often they will be separate to consultants retained for assurance reviews.

## 9 Managing the investment team

### 9.1 Culture

Internalising investment management will have a major impact on the culture of the fund. It can be a major positive by widening the scope and scale of management servicing the Trustee. It can improve the general alignment between the investment task and members and give the Trustee alternative options with which to manage the agency risk embedded in all investment management, internal and external.

Funds will migrate from having the primary function to appoint and monitor external investment managers, administer member records, contributions and payments, and relationships with members and employers to becoming similar to an asset management organisation. For example, the asset management division will have a more directly investment performance driven culture and this may be different to the prevailing culture in the wider organisation.

There is no single path to best practice in culture but Trustees should anticipate that insourcing will definitely bring change and proactively create the necessary transition policies. Investment staff will be prominent in the organisation and demand different standards of remuneration and work practices. In many asset classes, regular international travel, attendance at conferences and discussion forums, and even the establishment of international offices will be necessary. To other staff such things may appear as rewards or benefits rather than a necessary part of the investment process.

A more significant change to culture may arise if the insourcing program is large and well publicised. In that case the very success of the fund may come to be defined by the outcomes of the internal investment team. This will profoundly impact culture for the fund overall.

The flip side to this is that the existing culture of funds may be a significant advantage in attracting and retaining investment staff who are seeking a different culture from that of the investment management industry. Certain staff may place high value on closer and more direct alignment with the members, larger mandates and working as part of the wider executive team in large funds that have a high public policy profile.

So the Trustee will need to decide how to manage culture in the face of insourcing. For example will they:

- Insist that the investment team adapt to the existing culture, including remuneration and rewards. Will this facilitate attracting and retaining sufficient talent to meet the plans for internalising? Are there enough skilled investment professionals prepared to work in this type of culture with potentially lower financial rewards to ensure sustainable investment teams at many funds?
- Or will they foster sub-cultures, enabling the investment team to develop a culture more aligned to the wider investment industry? This may help in some ways but it will also invoke potential reactions in the wider fund.

Regardless of management's preference, the growing internal investment team will be influential and visible in the fund and may tend to capture the culture over time as well and change it from within.

### 9.2 Remuneration and incentives

The remuneration of the internal investment team will be one of the most challenging decisions for the Trustee. The path currently being followed suggests that internal teams are accepting remuneration which is below that which would be earned by equivalently mandated and successful investment professionals in investment managers. The motivation for this to happen is cited as a combination of:

- Successful experienced staff simply being willing to accept lower comparative remuneration because:
  - » they wish to return something to members of funds after a successful career (effectively an altruistic motive)
  - » a career in a superannuation fund may appear more secure
  - » there may be an advantage in having potentially large mandates with a simple investment imperative, without the requirement to raise assets
  - » the lack of demands for client relationship management.
- More junior staff being willing to accept comparatively lower remuneration for the opportunity to gain entry to a lucrative profession and the necessary training to start a career.

The challenge for Trustees is to set up the insourcing program on a stable and sustainable footing while reaping the comparative advantages. Issues like overall fund culture, competitive tension and the motivation for insourcing

will clearly impact this. The major element of best practice will be ensuring an alignment of expectations in advance and outcomes. Trustees should be fully aware of the reasons why competent, experienced staff may accept lower remuneration on an ongoing basis.

A particular threat to guard against is investment staff who are prepared to accept lower remuneration because they:

- are unable to maintain more lucrative positions in investment management firms
- intend to accept lower remuneration temporarily and then seek material increases after establishing their profile and/or track record through the fund
- are seeking security of tenure without demanding performance hurdles.

A constraint on remuneration is that staff in superannuation funds are not able to be offered equity in the firm which, for some investment managers, is a way of monetising a long term successful track record. There is no obvious way around this, and Trustees will need to consider if this needs to be compensated for in other ways.

At present the remuneration benchmarks available for internal teams in superannuation funds are limited. That will probably improve as insourcing becomes more established among more funds. If that happens, Trustees will be able to position their remuneration practice against market comparators. Best practice in that circumstance will be a clear policy from the fund of how remuneration will be competitively positioned. Clear and strong policies will maximise the chance of matching expectations with outcomes and responding to changes in the overall market for talent.

Trustees will have to accept that staff will come from a talent pool of investment professionals who already work in a deep, established and very lucrative investment management and asset consulting market. They will need to be vigilant about the motivations of the candidates for internal teams in regard to remuneration and how these may potentially change over time.

Other issues the Trustee will need to address in setting up the remuneration policy are:

- The mix of total remuneration between base and performance pay, including what, if any, payments are deferred to better align mandate and remuneration horizons.
- The benchmarks for performance payments across the internal team. Are teams narrowly rewarded on the decisions they directly impact or is there a wider overall fund outcome measure as well?
- Do reward structures mirror the form of 'competing' external managers where applicable? Does this include compensation for not being able to offer equity?
- Should they insist on non-compete clauses for staff to guard against the prospect of them being continuously lured with higher financial rewards from the wider industry?

### 9.3 Change management

The establishment of an internal investment team is a significant change management program in its own right, extending to staff, process, systems, support, risk and compliance etc. To meet best practice, Trustees will need to use established project management disciplines to meet these obligations. Every asset class and mandate will be different but as a rough guide the following steps would be expected:

- relevant delegate considers a submission to establish an internally managed mandate. This would contain all relevant investment and business parameters for approval
- key staff are appointed including both front and back office
- governing documentation (Investment Management Agreement, mandate, etc) is completed and accepted by the Trustee, and the internal team
- operating systems are established and tested
- custodial, counterparty and other reporting and compliance structures are established
- independent assurance reviews are conducted to check expertise, processes and systems (front and back office); these could happen at various important milestones
- trial assets are traded to ensure the trading, administrative and reporting functions work
- mandate goes live and monitoring processes begin.

The other key with change management is to remain flexible. Some aspects of the business plan will change as implementation progresses. Constant review at each milestone and reasonable flexibility will contribute a lot to success.

Strategic change management considerations are:

- Which potential mandates to do first and why? 'Easy' ones (active vs passive), those with the most material gain, etc?
- The pace of internalisation? This could address asset class by asset class or perhaps some of all asset classes at the same time, etc.
- The plan could just be opportunistic and develop mandates when key staff and other resources can be acquired. Given external managers offer most services a fund needs there is probably no burning platform that will dictate the scope and pace of change.

## 9.4 Performance evaluation

### 9.4.1 Monitoring performance

The aim of performance evaluation is to accurately assess the degree to which goals have been met and the reasons for any variance against expectations (positive or negative). Assuming this can be done both quantitatively and qualitatively, the challenge for Trustees is to follow up and respond to the outcomes. Often it will take an extended period, even many years, before Trustees will be able to confidently assess the quality of an internal team's decision making. Along the way, interim assessments will need to be made. This is no different to what is done with external managers.

Once the internal mandate is live, the agreed performance measurement and evaluation process will activate. The key for performance monitoring best practice is consistency with the purpose and motivation for insourcing. Goals will have been approved and these must be checked.

The actual task of monitoring performance could be delegated to any of several stakeholders. Under the best practice theme of clarity of purpose this should be consistent with the motives for insourcing, the types of mandates and other delegations. The monitoring structure should also reflect strong segregation of duties and reporting lines between those accountable for the investment decisions and those evaluating them. The key position to clarify will be the CIO. As an example:

- If the CIO is the advocate for insourcing and has direct accountability to lead the internal team and be directly involved in investment decisions, there will need to be strong monitoring and evaluation processes at the Investment Committee. The CEO may also be delegated some oversight. The challenge will be to keep clear lines of accountability for external managers. This is because the internal and external managers may be competing for assets and risk budgets.
- Conversely if the CIO is set above the internal teams and has the clear accountability for both internal and external, and the mix between the two, the CIO will require strong evaluation support to undertake this. In this structure the Investment Committee would focus on the total fund outcome and the mix between internal and external would be a second order issue to evaluate.
- The reality is that in most funds the model will not be this clear cut and the Trustee will have to be precise about where accountability for decisions lies. The monitoring and evaluation task will have to be internally consistent, but manageable to reflect this.

In all cases, best practice calls for segregation and the staff undertaking the measurement, analysis, and reporting of performance should be on a management line excluding the CIO. This could be to the CEO or perhaps through a CFO, CRO or COO depending on the particular organisation structure.

Best practice will be to apply the scope and rigour of performance evaluation applied to external managers for internal teams. This will usually call for independent expert assessments to be made at appropriate intervals. This scope could be risk-based with more active management reviewed at a higher frequency, with existing review programs in place for external managers as a guide. There would also be an assessment of what additional tasks would fall to internal and external auditors in relation to internal teams, recognising that these lines of oversight are already in place for external managers. To keep equivalent levels of governance these would need to be created for internal teams.

In cases where external and internal teams are managing comparable mandates, performance evaluation can include comparisons to external managers to ensure that insourcing is still providing a comparative advantage for members. It may be worthwhile distinguishing between active and passive strategies as active strategies will be more likely to be volatile and hence this is more likely to be a consideration for them. To manage this risk, Trustees could consider

identifying back-up external managers in order to be better placed to validate and/or replace an in-house capability if required.

#### 9.4.2 Assessments by clients/members

There is another dimension to the dynamic of superannuation funds in regard to performance evaluation. The Trustee acts for the members in the task of holding the internal team fully accountable. It is always challenging for any organisation in any endeavour to rigorously and dispassionately assess its own staff and outcomes. Investment management is no different.

However the directors and senior executives of investment managers are partially assisted by the reactions of their clients (and their asset consultants). Even if the manager is somewhat blind to their performance, or remains optimistic without due cause, the discipline of institutional clients will act to terminate teams who are not meeting expectations or who are being eclipsed by those with better solutions. This is the benefit of the operation of the market and competition in keeping standards high.

Superannuation funds with internal teams will not have this layer of rigour and should seek other ways to compensate for that. There is no obvious way other than an external assurance program to replicate that and in seeking best practice, Trustees should remain very alert to it.

In time, ratings agencies may partially fulfil this role of assessing the quality of internal management indirectly on behalf of members. It will take some time before time series data becomes available and this model becomes clear.

#### 9.4.3 Managing underperformance

An often discussed challenge is what to do if an internal team is determined to be underperforming. Before establishing internal investment teams, Trustees should debate the process for handling this. Best practice calls for underperformance to be addressed progressively within a pre-established delegation structure:

- Initially the CIO and/or team will evaluate their performance and establish common understanding about the level and reasons for underperformance.
- Trustees may call for independent assessments of this to ensure they are not disadvantaged by the information asymmetry which exists between the investment professionals and the CEO/Investment Committee/Board as relevant.
- Mandates could be altered (risk taking and limits tightened, etc).
- In the end an underperforming internal mandate will need to be terminated.

Superannuation funds have established processes for terminating external managers who underperform. This is likely to be easier than terminating an internal team because it is more remote and less personal. Trustees should establish processes that are equally disciplined and be able to demonstrate the same standards of governance and oversight. Turnover of investment managers by funds is quite high and this implies Trustees should well expect to have to exercise termination discipline on internal teams at times.

It is also important to note that terminating internal teams can be expensive (redundancy payments and the opportunity cost of support systems, etc). These are not directly incurred when terminating external managers.

In the opposite context, termination risk is elevated for staff in internal teams. In investment managers, teams will be servicing multiple clients and multiple mandates. Some of these mandates will not perform to objectives but this risk is defrayed across the portfolio of clients that they are responsible for. In this regard, the teams' risk of ultimate termination from the organisation is somewhat diversified. In the case of internal teams in superannuation funds, they have only one client. Individual team members' careers are dependent on meeting the objectives of the single client, hence concentrating the termination risk for the individual.

Investment managers and investment banks tend to compensate for termination risk by increasing remuneration and incentives, acknowledging that this is the cost of asking people to assume volatility in employment. Trustees should consider this in developing the appropriate remuneration and disciplining strategies in ensuring that high quality staff would continue to see internal teams as attractive career options.

#### 9.4.4 Managing outperformance

Another less discussed performance management issue is how Trustees will deal with outperformance. Teams that perform very well over extended periods may well challenge the fund in several ways, including seeking:

- to manage a greater share of the fund's assets than was planned
- higher rewards, either as base remuneration or higher performance pay than would otherwise be planned
- more influence over the fund's investment policies generally
- to monetise the track record in a variety of possible ways including:
  - » establishing an investment business attracting other clients (discussed below)
  - » leaving the fund to establish a business
  - » seeking seed funding and other support from the fund.

In many ways the challenge of managing outperformance will be harder than managing underperformance. This will be even truer if, along the way, the fund has promoted the skills of the internal team and intertwined itself with their success. This will empower the internal team in any negotiations to secure more rewards of many types. Trustees will have to guard against this in setting expectations and contractual obligations at the outset of an insourcing program. Non-compete clauses in employment contracts may also be considered.

#### 9.5 Scope creep

Despite the original scope of the insourcing plans, if and when successful processes and then track records have been established, the fund or various internal stakeholders may seek to go further and source mandates from other institutions. There is no evidence that superannuation funds are intending to do this at present but Trustees should be aware that it may well arise at some point. Successful internal teams will potentially present strong business cases to their fund's Trustees, built on one or more of the following motivations:

- Further assets will enhance economies of scale and the savings can be put to the benefit of the members of the fund by reducing fees.
- Larger scale will support larger investment teams with greater scope and support staff and resources.
- A larger FUM will enhance the investment process, for example by enabling the fund to achieve critical mass for a given process, access larger shares of unlisted assets or acquire assets without co-investors.
- Larger scale will enable the investment team to be deeper, improving risk management around staff turnover, succession plans, attracting more and better talent, giving greater opportunity for experience and advancement.
- A profitable investment operation will enable greater remuneration to retain and attract talent.
- Winning and retaining external clients will act as a validation (or not) for the internal team from other objective stakeholders. It is a valuable, constant, independent assurance review.

These are all debateable points and the key to best practice is simply to ensure the Trustee has considered this potential path at the outset of the insourcing program and is ready for the eventuality. It will be less effective if decisions on this, which are so relevant to the culture and philosophy of the whole fund and not simply the investment team, are considered in a cool environment rather than when an internal team has been successful and is strongly advocating the course. Naturally if that debate goes on for an extended period it could be very distracting to other priorities and the core task.

## 10. Managing the investment process

Best practice will clearly identify the mandates that internal teams will pursue and the process for how these may be changed. However at a more strategic level establishing an internal team of any form will also create other implications for how various elements of the full investment capability interact with each other.

Some of these potential challenges are discussed below.

### 10.1 Competitive tensions with external managers

Given the hybrid model—where both internal and external management co-exist within the fund—is the most common model currently being pursued, a key aspect of governance will be how the competitive tension thereby created is managed. This goes directly to clarity of purpose and will have significant follow-on implications for both delegations and the accountabilities of key stakeholders.

In managing prospective tensions for any particular fund, the Trustee should be aware of the broader industry environment. The scale of potential insourcing is likely to be materially disruptive to the investment management industry. A direct result of insourcing is that external asset managers will lose funds under management and the associated revenue. Depending on how far insourcing is taken by the superannuation industry as a whole, this disintermediation has the potential to alter the dynamics of the funds management industry, including the ongoing sustainability of some of the firms and their ability (or desire) to service existing superannuation clients.

Should the industry develop advanced insourced capability, external asset managers may be less inclined to originate and source assets (particularly in the unlisted markets), only to have the management of these assets be taken away from the manager once the deals are closed. Trustees will need to be aware that the alignment of interests between external managers and the funds will become more complicated with the introduction of internal teams.

Asset managers will naturally prefer to work with funds where there are continuing revenue streams during the life of the assets and while performance remains strong and within mandate expectations. Funds can also work with external managers on partnership arrangements where responsibilities are shared, however arrangements will vary for individual superannuation funds, and partnership models have yet to be proven to work effectively across the board.

The superannuation fund may be large enough to provide funding for insourced investments through cash flow rather than by reducing external management. Indeed for funds that have reached capacity in certain mandates with external managers this may be the only option as current managers cannot take greater allocations.

Regardless of the backdrop for any fund, Trustees should recognise that tensions will arise and they will be varied. A key one is that external managers may feel that internal teams are able to access intellectual property, directly or indirectly, and over time use that acquired knowledge to gain an advantage in some way. This also creates a potential legal liability and Trustees must ensure clear protections for the intellectual property of managers are in place.

Alternatively, externals may feel they are assessed more vigorously and have to meet higher hurdles with perhaps less than fully objective assessment. These tensions will vary depending on the motivation to insource which will in turn influence the types of mandates established. It will be important for the Trustees to agree policies on this in advance and then ensure the correct governance, liaison and respect is afforded to external managers. In most cases, they will remain an important piece of the fund's investment resources for the foreseeable future.

Typical ways to respond to the various challenges, both real and perceived, include:

- clarity of mandates, disclosure, clear reporting lines and evaluation accountability
- establishing completely segregated internal teams to deal with external managers
- use of Chinese walls policies limiting information access; this will be different if the internal team is complementing rather than competing with the external managers.

The Trustee may elect to set up internal management as a 'competitor' for allocations of assets to manage. This will require:

- Similarity of mandates and a level playing field to ensure the competition is, and is seen by the internal teams to be, fair.

- Governance processes to make the necessary judgements about relative quality and allocate accordingly. This will include clear delegations to a relevant Committee or individual.
- Limits and decision rules to ensure the aims of the hybrid model are met. This further implies clarity of the model when staff are being hired to ensure expectations are met. For example, successful internal teams may expect ever growing allocations within the asset class, even to a point where the original goal of diversity among several managers is potentially compromised.

Conversely the fund may choose to insource as a complementary function to external management. In that situation there will be minimal competitive tension but it will limit the application of insourcing only to mandates where competent external management cannot be identified.

There is little evidence funds are planning to establish internal teams to manage all of the assets in a particular asset class, particularly where active management is being pursued. Even if this were to be the case, there is some indirect competitive tension because best practice would call for Trustees to continue to judge the quality of internal management against some objective benchmark. In the case of actively managed assets the most likely benchmark will be universes of investment managers pursuing similar mandates.

## 10.2 Competitive tensions among internal managers

Once established, internal teams will legitimately seek to be engaged in the wider investment process beyond their own, perhaps narrow mandate. This will have many positive effects for culture, morale, succession, quality assurance etc. However there is also the potential for tension.

One risk of internal teams is the advocacy for greater FUM to be directed to the asset class being managed. Incentive plans will potentially contribute to this. Even if this were not present, the nature of investment managers is to increase the size of their own portfolios, motivated by prestige, market footprint, reputation, etc. This is no different to the pressures within investment management companies but at least there, a discipline exists from clients and consultants (as discussed above) who will have a direct influence on allocations of assets.

This will challenge the disciplined investment management process, which would allocate assets in accordance with established objectives and strategies. Internal teams, who are the experts in their areas, will also be very persuasive in front of decision makers such as Trustees, Investment Committees and CIOs.

Left unattended, this practice could aggregate assets to the loudest and most convincing investment team and their asset class, and not necessarily the ones mostly like to contribute to the strategy of the fund. Trustees have to be clear on how assets are allocated, both between asset classes and between managers (internal and external) within the asset classes, embed that process within the investments division and empower the CIO and asset allocation staff appropriately.

An associated consideration is how the establishment on internal teams impacts the overall asset allocation decision making. It is well established that strategic asset allocation (SAA) and perhaps dynamic asset allocation (DAA) make a very significant contribution to the fund's investment outcomes. Typically external managers in various asset classes do not have input to DAA or SAA decisions. With internal teams this potential conflict arises. It should be distinguished from an internal team simply advocating for additional cash flow to its mandate. Rather it is the tension around internal teams, specialising in a single asset class seeking influence on DAA decisions.

The Trustees should consider this in establishing the processes because it is a material risk. Often asset class specialists will have confident views about return and risk prospects for the market return (beta) of their asset class or mandate. However the asset allocation decision is dependent on relative return and risk and its interaction with the fund's objective. These are quite distinct and the influence of a specialist internal team should be closely considered and managed in this process.

## 11 Investment administration and support

Establishing an internal management process will require Trustees to establish, in parallel, a support (back office) structure to facilitate the investment decision making and trading. This is a significant undertaking in its own right with specialised staff processes and governance required.

It is relevant to note that the fund's custodian and other service providers may be able to provide some or all of these services on an outsourced basis. A decision to internalise investment decision making does not automatically entail insourcing administration. However even in a partially outsourced model new administration capability to oversight it will be required.

### 11.1 Entity structure

There are alternative ways to structure insourced investment functions.

The legal structure of the superannuation fund itself will in part dictate how the entity employing the investment staff, holding assets and facing investment markets and counterparties should be best structured to manage tax, liability and other considerations.

There are also general governance and cultural issues to consider. One alternative is to house the team directly within the superannuation fund. This will embed the team directly within the culture of the fund and imply a significant degree of harmony with various staff and operational policies. The second alternative is establishing a separate business entity. This entity could have a separate Board with responsibility for both business and investment decisions and outcomes. This model will facilitate a more separate investment team and to a degree confine any cultural issues to that entity<sup>13</sup>.

A decision on this will be influenced by the purpose of the insourcing. For example are the internal team intended to be the central investors in some or all asset classes or are they going to compete for assets and risk budgets? Separating the investment team will create a more distinct investment operation and potentially enable a more distinct culture and working environment. This may even extend to a separate Board which could act in some ways as an investment committee of review for the team directly as opposed to the Fund itself. This may more closely mirror the way external managers are governed on behalf of the fund where they have governance structures within their organisations to review and oversee the investment process.

A risk with creating a separate entity is that the investment team will potentially be disconnected from the main fund and perhaps even 'drift' away, possibly even to the point of becoming like an external manager. There will be a challenge in overseeing the entity and its board and ensuring that culture and operations remain sympathetic with the fund.

### 11.2 Support services

Best practice requires support divisions, such as investment operations, tax, legal, fund accounting, human resources, risk and compliance and information technology are ready to support insourcing activities. The management and governance of these areas is critical to success. This is likely to require the recruitment and training of support staff and it may be difficult to find appropriately experienced and qualified people.

IT systems are a specific challenge and an insourced investment operation will require specialised front and back office systems. This can be a significant burden to establish and maintain, including keeping current with regulatory changes. It is important for Trustees to recognise the ongoing costs of systems, not just the establishment costs.

A decision will need to be made about whether these support services are embedded in the administration teams that currently support the fund or a separate investment support function with these various services is established. This would allow administrative and support staff experienced in investment matters to lead that team and it would perhaps allow clearer priorities and budgets to be set. This in turn may allow for more disciplined cost/benefit analysis and business plans and budgets to be prepared and managed for the insourcing initiative.

Other services that will need to be significantly upgraded are audit (internal and external) and business continuity management.

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<sup>13</sup> Williams and Cornelius, op. cit., pp 10.

### 11.3 Policies and documentation

All mandates awarded to internal teams must be documented in an Investment Management Agreement, in the same way external mandates are contracted. This should include fees, investment objectives, permitted instrument types, trader limits, use of derivatives, counterparty and liquidity risk management etc. These parameters should be codified into mandate compliance systems.

Internal teams should have policies and guidelines that document the approved practices in managing specific mandates. This should include exception handling. Trustees should establish robust feedback loops on performance of internal teams. Regular reporting should be independently provided to Trustees and senior executives.

The back and middle offices teams should provide control and oversight on trading activities so that any erroneous or unauthorised activities can be detected within a short period of time, preferably 24 hours. These teams should be segregated from the front office investment teams. Internally managed mandates should be subject to performance monitoring, conducted by independent performance analytics teams.

## 12 Risk management and liability

### 12.1 Risk management

As a consequence of any investment insourcing, the risk dynamics of the fund will change. Trustees will need to identify these changes and review and revise their risk management frameworks.

Effective risk management will require:

- appropriate processes/policies/limits/guidelines to be developed and maintained
- ongoing compliance monitoring of these processes/policies/limits/guidelines, including the required system functionality and resources to do this
- reporting of breaches of these policies/limits/guidelines and processing errors, with effective follow-up actions taken
- a strong risk management culture across the organisation.

Policies will also be required for conflict management and risk of failure to ensure material conflicts of interest are appropriately identified and managed. This should set out the process and controls for:

- identifying and monitoring conflicts
- assessing and evaluating conflicts
- deciding upon and implementing a response to conflicts
- managing conflicts in order to give priority to the duties to, and interests of, beneficiaries
- maintaining a record of all identified conflicts and the action taken to avoid or manage them
- developing and maintaining the Register of Relevant Duties and the Register of Relevant Interests.

A fund's internal audit procedures may also need to be adjusted and/or enhanced to take into account any changes to the risk management framework.

Personal trading by the investment team will have to be subject to an appropriate policy commensurate with the types of mandates being insourced. Listed equity mandates offer the most prevalent risks of this type but they exist in different ways in all asset classes. Relevant policy should:

- provide a brief summary of the law relating to insider trading and other relevant laws
- set out the restrictions on dealing in securities
- set out the process for the capture and maintenance of information related to the Directors, employees and contractors of the Trustee holding and dealing in securities.

### 12.2 Liability and insurance

To meet best practice Trustees should ensure there is adequate insurance protection against losses from fraud and negligence due to internal investment management operations. Insuring internal investment operations may result in an increase in premiums, however, inadequate insurance will be a significant risk of insourcing investment.

In an external management model the managers hold their own insurance and are responsible for indemnifying the fund in case of negligence and fraud and in some cases breach of agreement. Total recovery of large losses from managers can be problematic for a variety of reasons. However, this risk may be mitigated by appropriate due diligence and ongoing monitoring of managers and their performance. By insourcing investment, the fund essentially forgoes this layer of protection that diversification of risk through external managers provides.

Trustees must also maintain adequate financial resources to address operational risk events with the potential to affect their businesses. As discussed previously, insourcing may have a significant impact on a fund's overall operational risk. Trustees will therefore need to critically assess their Operational Risk Financial Requirement Reserve (ORFR) strategy and compliance with SPS 114 when determining appropriate ORFR target amounts.

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<sup>14</sup> SPG 220, pp. 4.

# Attachment one: Goals of insourcing (detail)

More detail on the prospective motivations for insourcing parts of the investment process is set out below.

## 1 Improve governance, control or flexibility

### *Dealing with principal and agent issues*

Clark and Monk apply the concept of 'broken agency' to explain this issue that results from a misalignment of interests due to inappropriate distribution of risks among principals and agents. This might well distort investment decisions and portfolio construction .

Insourcing investment will impact alignment of interests. Internal teams can be established in a way in which they are free to focus on the single task of seeking high risk-adjusted investment returns. They should have a direct alignment with the ultimate aim of members and Trustees. Conversely, external managers face a different range of agency issues which can potentially distort this alignment. Some potential examples of this (noting that investment managers will address these in various ways) include:

- The need to gather assets, which can distract portfolio managers through marketing and business development duties. Managers generally will have multiple clients, which creates a client servicing demand. Portfolio managers are at times drawn into these demands.
- Fees, and particularly performance fees where managers often seek payment when exceeding targets but do not give up any base fee when underperforming. Of course funds can at times negotiate beneficial performance fee structures and they are not forced to use them.
- The need to share scarce assets or limited, capacity constrained alpha among multiple clients.
- The need to manage the business of the external manager which may again call on portfolio managers.

These various priorities will differ among investment managers and specific investment teams depending on the ownership, organisational structure and culture of various managers. Managers will also vary their business structures to deal with these issues and the potential impact will vary from manager to manager. The Trustee will need to ensure they understand these various agency issues (and potentially others) as they impact both internal and external management teams as they evaluate insourcing initiatives.

### *Control and focus at fund level*

The internal team has an advantage of seeing the whole fund and making judgements about risk budgets, priorities and mandate allocations at that level. External managers will never be able to fully see this and it will constrain them, in some ways.

One way this may manifest itself is that an external manager seeking profit by retaining FUM could not be realistically expected to hand back assets in an asset class mandate if risk/reward expectations were deemed unattractive. Indeed, even if they were so inclined it would be hard for them to make these assessments without an overall view of the fund's risk budget and the opportunity cost of risk. Internal managers should be able to be managed and incentivised to do this more readily.

This is more relevant to some mandates than others and in hybrid models will not necessarily be an overt constraint to getting a good mix of expertise.

### *Owning assets directly*

By exercising direct ownership, particularly in unlisted assets, funds can ensure their rights are exercisable directly and protected. Often external managers will attempt to lock in management arrangements, which can make it difficult for the fund to change managers if performance suffers or for other reasons. Additionally, funds can also ensure tax and legal ownership issues are appropriately set up for the specific fund in multiple jurisdictions.

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<sup>15</sup> Clark and Monk, op. cit., pp 3

Insourcing may also better enable co-investment programs where additional assets and/or improved ownership terms could be secured.

### *Responding to unexpected events*

Internal teams will provide flexibility in the face of market events, which can cause unpredictable valuation, liquidity and access to assets.

External managers, particularly when assets are shared in collective investment vehicles, will have varied and changing priorities in times of crisis. They may wish to secure their management or perhaps be challenged to redeem assets when valuations are uncertain. A superannuation fund can be affected by this even indirectly if an external managers other clients are reacting unpredictably. If liquidity is scarce the manager may be forced to ration it among clients. While an internal team cannot prevent a fund being impacted by extreme events, it may provide more flexibility and security in responding to them.

Direct access to the markets also means that funds will not need to queue with other clients of a manager at times of market volatility to unwind or to implement any desired exposure.

### *Termination flexibility*

The internalisation of investment management comes with less flexibility in managing resources if the mandates do not perform against established objectives. While external managers can be terminated contractually, terminating internal staff is more complicated.

Balancing that is the flexibility that comes from an internal termination perhaps being limited to an individual rather than an external manager. Conversely, the external manager takes on the responsibility of managing the ongoing team (succession planning, training, etc).

## 2 Improve risk-adjusted investment returns for similar mandates

### *Improved performance after fees, costs and tax*

This is not simply about reducing fees and several issues relevant to this are discussed below:

- The variance between good and bad outcomes of all investment managers is very wide and it is sensible to assume this variance will translate to superannuation funds internally pursuing similar mandates. To the extent that a single team replaces external managers, the benefits of manager diversification are progressively forgone. This is only a challenge when the internal team dominates an asset class. In a hybrid model where the internal team is not the sole manager in an asset class, manager diversification can be maintained to the degree desirable.
- Investment success is largely dependent on the skills of investment professionals acting as a team to implement a disciplined process. To realistically expect success, Trustees will need to convince themselves that the fund can attract and retain sufficient investment professionals of at least equal competence to external investment managers. This extends not only to key front office staff but also support staff, administrators, etc. Even good teams will suffer variations in performance. Self-evidently this is difficult to determine with certainty.
- If fee savings are predicated on reaping economic rents (excess profits) from investment management firms, this may be feasible but it becomes more questionable if funds intend to capture economies by savings on remuneration and/or other benefits paid to investment professionals. This is discussed further below under cultural considerations.
- Tax is incurred by superannuation funds at the fund level and not mandate by mandate. Internal teams may be better positioned to consider tax as a strategic expense and make decisions about appropriate structures. Balancing that will be expertise in actually using tax as an efficient tool to improve risk-adjusted net returns. This is specialist and funds may not be able to attract and retain strong comparative skills.

### *Cost savings*

Advocacy for insourcing may in part be motivated by cost savings. These are able to be demonstrated because:

- Some market participants have stated they believe fees for many asset classes and mandates remain high and that (successful) investment management is a highly profitable business.
- Usually fees are calculated as a percentage of FUM and as funds are growing the fees rise, often faster than costs of an internal team would be budgeted to rise.
- There is debate in the industry asserting that fees are falling and Australian institutions receive lower fees than those in other countries. If this is the situation for a specific fund, it would make the case for insourcing (on an

after-fee expected return) harder to support. Trustees, in considering insourcing, should consider fees carefully (if it is part of the justification), because each instance will be different.

Essentially insourcing involves swapping a fee that rises with FUM (net contributions  $\pm$  investment returns) for a fixed cost that rises much more modestly in most cases. However Trustees will need to consider business plan scenarios where FUM may not be growing. This may not necessarily simply be at the overall fund level but it may be within the specific investment mandate which is being in-sourced, which could itself be limited due to risk management (diversification) or market capacity limits.

Industry data confirms most of the economy of scale benefits from growth in FUM have been gained by the investment managers and intermediaries at the expense of fund members. Insourcing will be a major step in redressing that. This is a very material and beneficial outcome in the wider context of the superannuation industry.

Fees are always an important detractor from net returns. However to the extent that superannuation funds face an extended future period of lower than average returns, fee savings may have a disproportionately large impact.

### *Impact on different asset classes and management styles*

This motive has different aspects across asset classes and styles of management. As examples:

- For passive mandates in listed asset classes this motive could be comparatively easy to sustain. Passive management does not call for highly differentiated stock-picking skill. Hence performance differences are typically not large and the cost efficiency argument is more dominant in evaluating comparative expected outcomes.
- For active mandates in listed assets the issue becomes dominated by the skill and resourcing of the internal team. Fee savings may be apparent and presented as large, particularly in dollar terms, but outcomes of active managers vary widely and are not persistent across time.

In unlisted asset classes there is no equivalent to passive management and the mandates held by superannuation funds contain fewer and often larger assets. This amplifies the risk of active decision making. Fees charged in these assets classes are typically higher (compensating in part for the greater resources required to undertake these mandates). The fee savings from insourcing are therefore potentially higher but this is offset by the higher risk of underperformance by the internal team, which may not be as experienced or well-resourced.

### *Other issues*

Substituting internal for external management will call for like-for-like comparisons. This paper outlines the wide array of capabilities, systems and resources needed to implement and support a best practice investment management process. Investment managers with multiple clients and multiple asset classes are able to reap efficiencies in support costs but superannuation funds will typically not.

Trustees should ensure cost efficiencies are presented in meaningful ways. Dollar costs can appear very large when compared to existing superannuation administration budgets. However when compared on a percentage of FUM basis they may be smaller and have to be evaluated in comparison to the fund's overall costs to members.

## **3 Establish skills or access assets not available elsewhere**

### *Strategy (asset and currency allocation)*

As the industry developed, these decisions were often taken by boards and/or investment committees based on advice from asset consultants. As funds are growing and becoming more competitive they may seek to develop unique insights and use this as a comparative advantage.

There is also a growing acceptance of funds being dynamic in asset allocation and this can provide a motive for establishing an internal team. Broadly speaking it is not feasible for superannuation funds to simply outsource asset and currency allocation decisions to an external manager.

### *Capacity constraints in listed markets*

This is usually ranked as a very important motivation for large Australian funds to establish internal teams. It is particularly the case for active mandates in Australian equities. A typical case is made along these lines:

- Once a fund has A\$10-\$15 billion allocated to Australian equities there is a need to move beyond the optimal five-six 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 passive exposure or bringing some of the funds in-house.”

The A\$3 billion capacity constraint has become a rough industry rule of thumb. Because of its simplicity and the wide array of investment styles and mandates pursued in all asset classes this motivation is often challenged. Nonetheless many funds cite capacity constraints generally as a key motivation for insourcing.

In evaluating this case Trustees would have to consider why these constraints exist for a fund and how an internal team will alleviate them. It is feasible that investment managers will refuse mandates above a certain dollar value. This could either be because the market limits the size of positions needed to employ a certain style, or the manager may simply wish to seek a diversified client roster to manage their business risks and apply dollar limits on each client (in part this could happen to reserve capacity for smaller clients willing to pay higher fees).

Similar motivations around capacity constraints are unlikely to apply to international listed assets.

### *Avoid sharing assets in limited supply (unlisted assets)*

In unlisted asset classes such as private equity, infrastructure and real estate assets are limited and investment managers often acquire them on behalf of multiple clients in syndicates and/or collective investment vehicles. As funds grow large they will seek larger shares of these assets and the desire of the managers to diversify its clients will act to constrain the exposure of each client superannuation fund to these assets.

Establishing an internal team will alleviate this constraint and enable the fund to build a distinct portfolio or unique assets. However these mandates pose significant challenges (hence their often higher fees and costs and more complex contracts and mandates):

- The manager has to actively source the assets incurring significant costs on research, due diligence and bidding for assets which might not ultimately be acquired by the fund.
- The assets will require ongoing management. This means that resources in an unlisted management mandate tend to grow with asset numbers. In a superannuation fund that cannot diversify the team across multiple mandates, this will pose a challenge to maintain.
- Assets are different, perhaps in different countries with different regulatory and tax regimes. This calls for deeper teams with varied skills, sometimes without actual assets to manage as the various investment cycles come and go.
- Assets are typically held for longer horizons and cannot be easily exited at times. This means internal teams need to be sustained for long periods increasing the demand for succession planning and related skills.



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