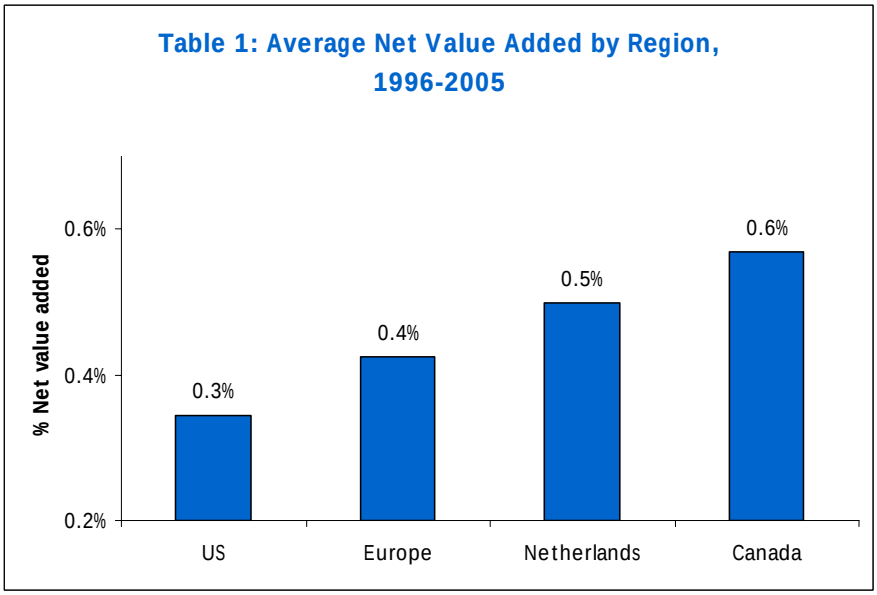
Dutch Funds Added Value

The net value added of Dutch pension funds that participated in the annual investment performance database of CEM Benchmarking Inc. averaged 0.5% per annum over the past ten years. As shown in Table 1, this compared favourably with the US participant average at 0.3% and the European average at 0.4% but was below the Canadian average at 0.6%.

Table 1: Average Net Value Added by Region, 1996-2005



This article examines whether the source of the value added, noted above, was derived from selection skill within asset classes or from asset "mix" effects. The article also considers the performance impact of cost, fund size, investment management style and asset mix. Finally, the article reviews a standardized measure of value added per unit of risk.

Our consideration begins with a summary of the global investment performance database of our firm. It contains long-term return, cost and risk data from over 700 of the world's largest and most influential funds based in Australia, Canada, Finland, France, Ireland, Norway, Sweden, the Netherlands and the US.

In data year 2005, the average fund size in the database was €8 billion. The proportion of public and other funds was 55%. The balance was corporate funds.

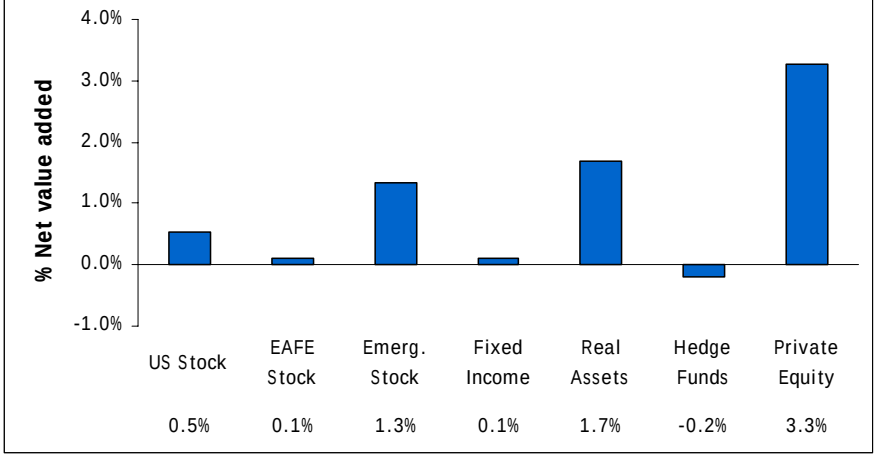
Value added is a key measure of implementation skill. It reflects primarily the value added from active management. Value added equals a fund's total return minus its policy return. It is the value added over what could have been earned passively by indexing a fund's policy mix decision. Any return in excess of 0.0% means that a fund has performed well relative to passive alternatives.

Net value added equals value added minus total asset management costs. Total asset management costs are the sum of investment management costs and oversight, custodial and other costs. Table 1 shows that Dutch funds and pension funds in general have generated value added net of costs over the past ten years. Contrary to the efficient market hypothesis, active management added value.

Value added can be disaggregated into value added from selection within asset classes and from "mix" effects. Dutch funds generated positive selection value added in all major asset classes except hedge funds. Note that the data for hedge funds reflects a five-year period from 2001 to 2005.

As shown in Table 2, Dutch funds performed particularly well in emerging stock, real assets and private equity where the net value added was 1.3%, 1.7% and 3.3%, respectively.

Table 2: Average Net Value Added by Asset Class for Dutch Funds, 1996-2005



Value added reflects the holding weighted value added of all mandates in each asset category including indexed holdings. Averages shown are the simple averages for the 10-year period of all annual observations of funds with holdings in the asset category. Value added for Hedge Funds reflects the 5-years ended 2005. Real assets include REITs, real estate and other real assets such as commodities, oil and gas partnerships, and infrastructure.

Mix value added is caused by timing, rebalancing and differences between a fund's actual holdings and its policy holdings. The average mix effect for Dutch, European, and Canadian funds was statistically indistinct from zero. The average mix effect for US funds at -0.1% was statistically significant.

One factor that drove Dutch fund performance was low cost. Our research has shown that low cost funds outperform high cost funds. On average, for every basis point of additional total cost incurred, funds lose 0.3 basis points of net value. In other words, paying more does not get you more.

In the ten-year period to 2005, Dutch fund total costs averaged 21 basis points, the same as European funds, while Canadian funds averaged 33 basis points and US funds, 38 basis points.

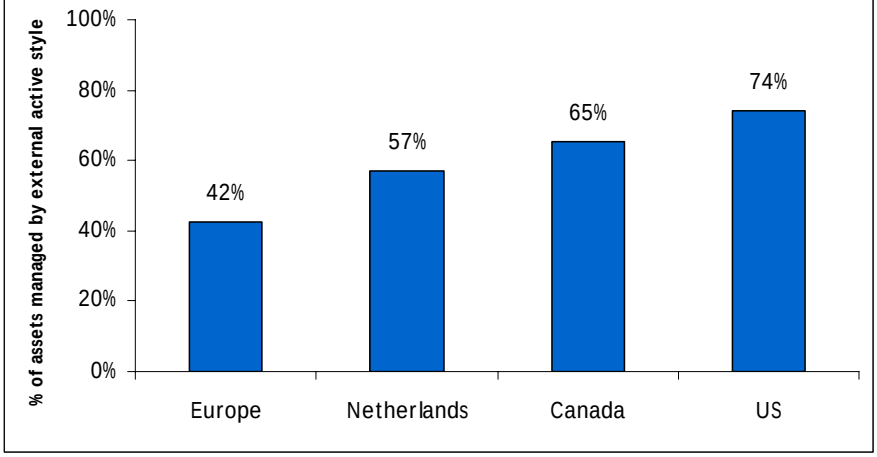
There were two main reasons for the low cost of Dutch funds. The first reason was size. Our research indicates that each ten fold increase in fund size is associated with an 11 basis point decline in total cost. For example, a €1 billion fund has costs that are 11 basis points lower than a €100 million fund.

The Dutch funds in our database enjoyed significant economies of scale. In 2005, there were 13 Dutch funds in our database. Total assets were €369 billion. The median size was €11 billion. This compared to a median of €1 billion for 100 Canadian funds and €4 billion for 144 US funds. The median size of all 23 European funds in our database was €18 billion.

The second reason for the low cost of Dutch funds was style. We measure four implementation styles: external active, external passive, internal active and internal passive. The internal and passive styles group together as low cost styles. External active management is substantially more expensive than the other styles.

To illustrate, our research shows that the cost to manage EAFE stock under the three low cost styles ranges from 6 to 10 basis points. The cost to manage EAFE stock under the external active style is 46 basis points. As shown in Table 3, Dutch funds used less of the high cost external active style than Canadian and US participants (57% versus 65% and 74%).

Table 3: 2005 External Active Management By Region



Differences in asset allocation over the 1996 to 2005 period were also examined as a possible source of the low cost of Dutch funds. However no conclusive evidence was found. For example, compared to US funds, Dutch funds had a higher level of low cost fixed income (45% versus 31%) but also had a higher level of high cost real estate holdings (9% versus 4%).

We have explored the benefit of active management. What about the risk of active management? We define active management risk as the standard deviation of net value added. Based on a fund's mean net value added and the standard deviation of a fund's net value added, we can measure a fund's value added per unit of risk. This measure is called the information ratio.

The information ratio requires consecutive years of data for a given fund. Therefore, the measurement period used in our comparison was a seven year period from 1999 to 2005, the choice being a trade-off between the number of participants and the number of years. The analysis was restricted to Dutch, US and Canadian funds.

In this period, the average net value added for Dutch funds was 0.6%. The average net value added for US and Canadian funds were 0.7% and 0.8%, respectively. Dutch funds had a lower net value added. However, compared to US and Canadian funds, Dutch funds had lower volatility associated with their annual value added returns.

The resulting information ratio for Dutch funds was 0.5%, which means 0.5% of incremental net value added per 1% of incremental risk. The information ratio for both Canadian and US funds was 0.3%. Therefore, Canadian and US funds generated higher net value added but at a higher risk level. In other words, compared to Canadian or US funds, Dutch funds generated the most net value added per unit of risk.

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