



Internal Management Performed Better

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Findings

Funds with more internal management performed better than funds with less during the 16-year period ending December 2006. On average, funds earned 0.46 basis points more net value added for every incremental percent of internal management.

Discussion

We believe one of the reasons why internal management performed better, and will continue to perform better, is costs. On average, each incremental percent of internal management saved 0.28 basis points relative to external management during the 16-year period. A second factor is fund size. Our research shows that larger funds outperform smaller funds for many reasons, including economies of scale. When we added fund size (log 10) to our regression equation, funds with more internal management continued to outperform but the impact was reduced by one-half—on average, funds earned 0.23 basis points more net value added for every incremental percent of internal management.

We also examined the relative performance of internally versus externally managed holdings in the U.S. for each major asset class. Internal

management outperformed external management in all classes reviewed.

Outperformance in Real Estate, REITs and Other Real Assets was significant at the 95.1% level. See Exhibit 1.

Methodology

In our analysis, we regressed net value added against the percent of internal management. Net value added equals total return minus policy return and total costs. Policy return is the return earned passively by indexing a fund's policy asset mix. Total costs include investment management, oversight, and

administrative costs. The analysis used almost 4,200 annual, paired observations for defined benefit plans from 1991 to 2006. The above finding was significant at the 99.8% level.

CEM's investment performance database was the data source. This database contains annual return, benchmark, asset holdings and cost data from 700 of the world's largest pension funds in Australia, Canada, Finland, France, Ireland, New Zealand, Norway, Sweden, the Netherlands, and the U.S. In the most recent data year, the assets of defined benefit funds and defined contribution plans were over US\$5 trillion.

Exhibit 1: Internal Management Performed Better

