J.P.Morgan

How Australian asset owners became asset managers

Some of Australia's largest asset owners are evolving into asset managers to deliver greater efficiencies and benefits to their members.

Australia has built one of the largest retirement systems in the world with almost AUD$3.5 trillion in assets under management. It was perhaps no surprise then that Australia was named as the most successful pensions market globally in 2022.

As the mandatory superannuation guarantee continues to grow Australia's pool of assets, more local pension funds are actively managing a growing proportion of their portfolios in-house. The shift from owner to manager has been underway for several years and is redefining the industry and its influence on investment markets.

"This shift has been primarily driven by funds in an effort to reduce investment-related costs. Other considerations are also at play including attracting and retaining talent to better meet investment objectives, changing regulatory requirements, and evolving demands of the marketplace," says J.P. Morgan Head of Platform Sales - Securities Services, Australia and New Zealand, Nick Paparo.

The country's largest superannuation fund, AustralianSuper, now manages about 44% of its AUD$265 billion internally and expects that level to rise to 60%. The shift has saved the fund about AUD$750 million since it began the internalisation program in 2013 – a key consideration given fees are increasingly being targeted under new regulations.

Further, the AUD$70 billion fund Cbus recently said its internalisation program had cut its main fund's investment fees by AUD $410 million since 2017.

They are not alone.

Almost two-in-three funds recently surveyed by J.P. Morgan for our inaugural Future of Superannuation report, believe the insourcing investment trend is being driven primarily by cost reduction. It allows funds to spread largely fixed investment management costs across their growing funds under management rather than pay percentage-based fees.

In-sourcing delivers benefits beyond lower fees

Larger super funds are starting to dominate the local industry, which is undergoing rapid consolidation under the government's Your Future, Your Super regulations.

A new investment performance test has prompted more than a dozen smaller funds to merge in the past 18 months while research by local regulator, APRA, has shown that funds with assets of more than AUD$50 billion can more easily spread their costs over a wider membership base to keep their fees lower.

In-house asset management is a key strategy to drive fees lower, and it can also provide other advantages, according to Cbus Super, Chief Investment Officer, Kristian Fok.

"We see a whole range of benefits including greater insights for our asset allocation process, sharpening our external manager selection, highly efficient liquidity and exposure management, extensive incorporation of responsible investing principles to drive long-term sustainable returns, and more granular risk and performance analytics," Fok said.

UniSuper CEO Peter Chun also sees broader benefits for the fund.

> *"Outside of the obvious advantages of producing efficiencies and reducing costs, insourcing also provides other benefits to our business. We are able to tailor products and strategies that we offer our members. If we take ESG for example – we're able to fully integrate these strategies and have really strong active engagement – a seat at the table with listed companies."*

A common strategy across the industry is for internal teams to co-invest alongside external private equity managers which have identified and sourced the asset. Cbus has also relied on its internal team to create its own strategy (particularly on the quant side), which is then outsourced to external managers to execute.

[1] https://www.thinkingaheadinstitute.org/research-papers/global-pension-assets-study-2022/

[2] Small and medium super funds face sustainability challenges | APRA. (2022, June 08). Retrieved from this link.

Strengthening infrastructure

Those benefits can only be derived from a skilled in-house team and extensive infrastructure to support them.

Many super funds rely on their culture to attract staff given they can't compete with traditional fund managers on salary alone. Since the inception of their internalisation journey several years ago, Cbus has built its team who manage its internal investments to about 115 people.

> *"A key consideration for funds is how do they continue building their infrastructure while attracting and retaining the right talent to ensure that they're able to continue expanding their internalisation strategy," Paparo said.*

About one-third of funds who took part in the Future of Superannuation report said attracting and retaining talent was their biggest challenge over the next three years.

Funds need to bolster their middle office services, encompassing order management systems and investment book records to trade and match those transactions with counterparties.

"The key thing is having a clear strategy and not doing it half-heartedly," Cbus Super's Fok said. "It's a complete re-orientation of an out-sourced model, to one where you take responsibility for all of those things."

Funds are also building data platforms to provide deeper insights into their portfolios, allowing them to move quickly and better manage insourced and outsourced providers. "With the evolution of insourcing and the need for middle office services, there comes a different level of appetite for the data that funds require to manage the assets within their portfolio," Paparo said.

"That's where we have seen the evolution of our capability – not only are we now providing traditional fund administration and custody; we've evolved to provide a full-scale middle office service as well as a comprehensive data service to be able to bring that all together for funds," Paparo continued.

Internal trading teams also need a significantly higher level of market research to remain competitive against external fund managers. While the cost of running in-house teams is traditionally lower, it can lead to a false economy if net performance is still lower.

Deeper research requirements

J.P. Morgan, Head of Sales and Marketing, Markets and Platform Sales, Australia and New Zealand, Stephen Jani, said historically, asset owner C-Suite managers were the main users of high-level, macro thematic research.

"The direction of our research is now channelled more towards in house portfolio managers and execution teams for their dedicated asset classes and liquidity considerations," he said. "It is more granular and targeted now that they're an evolving manager as well as an owner."

There are now major similarities between an asset owner and a traditional fund manager's execution teams who implements their macro thematic strategy, while optimising liquidity and execution costs, in either OTC or exchange traded forums. Execution is a critical function given the size of these asset owners, whose internal teams manage such large funds and have the potential to impact markets.

"The size of the assets under management are so material that when they enter the market, they can have an impact on liquidity," Jani said. "So they really focus on optimising liquidity via efficient execution, when trading directly in the market, as opposed to allocating to an asset manager."

Australian super funds held more than one-third of ASX listed companies at June 30, 2021, according to one analysis[3].

"There's only so many available assets domestically so when looking further afield, utilising the expertise of a global custodian and markets provider across all asset classes and private markets becomes so important," Jani said.

Super funds derive dividend imputation tax benefits from investing in local shares, which explains part of the at home bias, but their growing size still requires a move offshore. Funds such as AustralianSuper are setting up offshore offices as they invest more heavily around the world.

[3] Adiwongso, S. (2021). Super fund influence over the ASX is falling. Rainmaker Information. Retrieved from this link.

Managing the risks

Not all growing funds are convinced the benefits of insourcing outweigh the potential drawbacks.

Funds such as Hostplus have argued that they can negotiate lower fees with managers, achieving the same cost saving outcome as internalisation, and Australian Retirement Trust is also yet to go down the insourcing path.

Funds must identify their competitive advantages, while ensuring a robust alignment between governance structures and organisational culture.

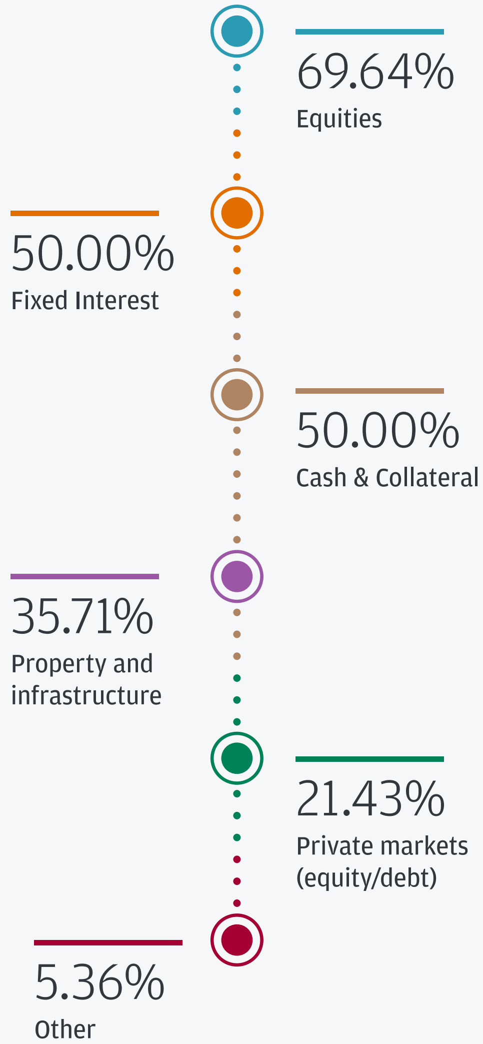
Many funds have taken a measured approach, initially outsourcing relatively simple asset classes such as cash and passive equities. A rising number of funds are becoming more sophisticated and now managing assets that require significant skill such as private markets.

UniSuper took this incremental approach to insourcing more than a decade ago – today about 70% of its approximate AUD$100 billion of assets is run internally.

"We had some very clear parameters on what we were going to manage in-house and what not. We were not going to manage anything where we clearly didn't have any competitive edge," Chun said.

"There are multiple pathways to achieve the outcomes of internalisation, and it requires commitment. Don't think of today – think of tomorrow to ensure that you create a sustainable model without necessarily having to reengineer and redesign. You need to be confident that what you employ will last the journey of time," Paparo said.

When funds consider insourcing investment management, which asset classes are they most likely to manage in-house?*



*Respondents were able to choose up to a maximum of 3 answers.

Publication Contributors.

Nick Paparo
Managing Director
J.P. Morgan

Stephen Jani
Managing Director
J.P. Morgan

J.P.Morgan