

# **Costs Matter:**

How costs impact the performance of the worlds' largest institutional investors

Webinar July 14, 2021





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### Agenda

- Logistics and Introductions
- Research Review
- Q&A



## Logistics

- Attendees in listen only mode.
- Question are welcome. Submit using "Question" function on control panel.
- Audio/technical issues during webinar: call GoToWebinar at 1-800-263-6316.
- Webinar replay and slides will be posted at nirsonline.org/events.



### **Speakers**



#### Dan Doonan

NIRS Executive Director and Report Co-Author



#### **Alexander Beath**

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### At CEM Benchmarking we benchmark value for money for the worlds' largest institutional investors.



25+ years of data – assets, returns, benchmarks, costs and more



1000+ unique institutional investors in the database, 300+ in any one given year



\$12 trillion USD in assets under management in 2019



Importantly, because our focus is benchmarking costs, there is no bias with respect to performance

### Who is this webinar intended for?

- Institutional investors
  - DB / DC pension funds
  - Sovereign wealth funds
  - Buffer funds
  - Endowment funds
  - Other asset owners (family offices etc.)
- Others with an interest in institutional asset
  management
  - Consultants
  - Academics
  - Asset managers
  - Others (think tanks, etc.)

### The ABCs of any investment portfolio. Returns are comprised of three parts:

### Return = Alpha + Beta – Cost

- A. Alpha Excess return or "value added".
- B. Beta This is an investible benchmark.
- C. Cost This is what you pay.

## Investors pay for alpha.

## \$12 trillion:

Total AUM in the CEM database at the end of 2019 (USD)



### \$850 billion:

The amount spent seeking alpha between 1992-2019<sup>+</sup>



### \$30 billion:

The amount spent getting beta between 1992-2019<sup>+</sup>



+ Calculations of cost are approximate for illustrative purposes. Cost of beta is assumed to be 2bps with the remainder being attributed to alpha. Cost in dollars is calculated from average investment cost times total AUM by year. For exact calculations contact CEM Benchmarking.

# Alpha is 85 basis points.

80% of AUM is managed actively.



#### 1. Notes

CEM universe 1992-2019, 8092 total observations

Private equity benchmarks have been standardized. Average PE value add is 0.07bps.

# Net alpha is 19 basis points.

75% gross alpha is consumed by costs!



CEM universe 1992-2019, 8092 total observations

Private equity benchmarks have been standardized. Average PE value add is 0.07bps.

These are averages. What do the distributions look like?



### The distribution of net value added is broad.

You might expect 19 bps of alpha on average, but it'll be +/- 240 bps in any one given year.



1. Data includes over 8,092 fund/year observations spanning 1992-2019.

2. Private equity benchmarks have been standardized using lagged blends of small cap equity.

### The distribution of investment cost is narrow.

The difference in cost across funds is only +/- 31 basis points.



1. Data includes over 8,092 fund/year observations spanning 1992-2019.

2. Private equity benchmarks have been standardized using lagged blends of small cap equity.

# Over 1-year, differences in return are usually dominated by differences in alpha.

Your 1-year return was 3.34% above average<sup>1</sup>



1. Data is representative. Line-item impacts on differences in total return can take positive or negative values. The impact of differences in alpha and investment cost have been set equal to their 1-year standard deviation.

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How do the distributions change with time?



# Over 4 years, the distribution of net value added is cut in half compared to 1 year.



4-year net value added<sup>1,2</sup> vs. 1-year net value added

Data includes over 1,700 independent 4-year fund/rolling-period observations spanning 1995-2019 (i.e., 1992-1995 – 2016-2019).
 Private equity benchmarks have been standardized using lagged blends of small cap equity.

# 1. The good news. The average net value added remains positive over long periods.



# 2. The width of the net value added distribution collapses.



#### 3. The distribution of cost is persistent.



#### Net value added distributions collapse. Cost distributions persist.

40% 30% Frequency 20% 10% 0% 30/0 Dolo 300 500 Dolo 20/0 20/0 0% 20/0 20/0 500

1-year NVA













# Why does this matter?



### 10-years:

Impacts of differences in cost become visible through the noise.

#### Your 10-year return was 0.88% above average<sup>1</sup>



1. Data is representative. Line-item impacts on differences in total return can take positive or negative values. The impact of differences in alpha and investment cost have been set equal to their 10-year standard deviations.

### 100-years:

Eventually, differences in cost are most important.





1. Data is representative. Line-item impacts on differences in total return can take positive or negative values. The impact of differences in alpha and investment cost have been set equal to their 100-year standard deviations.

# Alpha focus:



Cost and value focus:



How do you achieve good alpha?



### What impacts alpha? Being active.

	Alpha		Net value added	
Variable <sup>+</sup>	Impact (bps)	How important	Impact (bps)	How important
Size (per 10-fold change)	1.6			
Percent internal+	7.3	*		
Percent active <sup>+</sup>	71.7	***		

<sup>+</sup> Impact of percent internal / percent active is the difference between a portfolio that is zero percent internal / active and one that is 100% internal / active.

# Net of costs, size matters and internal management matters.

	Alpha		Net value added	
Variable	Impact (bps)	How important	Impact (bps)	How important
Size (per 10-fold change)	1.6		7.6	**
Percent internal	7.3	*	22.1	**
Percent active	71.7	***	38.7	***

<u>Size</u> - Bigger funds do better because they have lower cost implementation.

<u>Internalization</u> – Funds that internalize do better because internal management is much less expensive than external.

# Funds that added more value tend to be bigger, more internal and more active.



Increasing size, more internalization, more active management

# Should only large funds pursue active management?



Examples are too simplistic. They ignore:

- Sources of value added
- Sources of value destruction

#### How institutional investors create value:

#### Small cap U.S. equity

- +53 basis points of net value added Actively managed small cap U.S. equity portfolios beat the market. Indexing would destroy value.
- **87 percent actively managed** The average U.S. institutional investor's small cap U.S. equity portfolio focused on generating alpha.
- 8 percent internally managed The average U.S. institutional investor's small cap portfolio could have lower cost.

How institutional investors destroy value:

#### Large cap U.S. equity

- -2 basis points of gross alpha Large cap U.S. equity portfolios are highly efficient. Active management destroys value.
- **37 basis points of investment cost** The average large cap U.S. equity portfolio is far too expensive.
- 51 percent passive Most U.S. institutional investors index large cap U.S. equity, but 49% remain actively managed (2017).

### Four key takeaways:

- Funds have added value by active management, +19 bps
- Long term, differences in alpha tend to become small.
  Differences in cost are persistent.
- Funds that added more value tend to be:
  - bigger,
  - o more internal,
  - $\circ$  more active.
- Low cost is not necessarily cost efficient. High cost is not necessarily cost efficient either.

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## Questions

