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Institutional Investors Re-Direct Risk Budgets

By James N. Tamposi, CFA®

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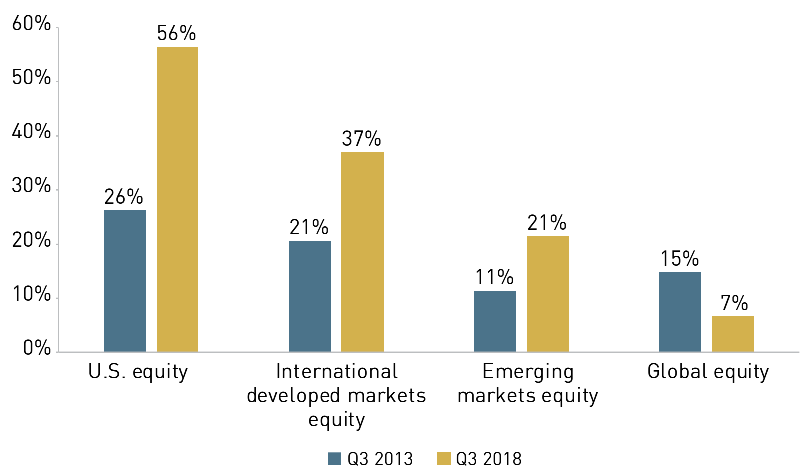
As institutions seek to lower costs while simultaneously boosting spending to attain high-quality strategies/managers, Cerulli Associates observes a sweeping re-allocation of risk budgets. Institutions are pulling back allocations from certain equity managers because of their inabilities to generate alpha. Many have chosen to reallocate their budgets toward strategies that are esoteric or competitive to enter (e.g., private equity). This article explores where and how investors are cutting costs, and where they are redeploying their risk budgets. It also investigates how fee negotiations play an increasingly important role in the institutional space.

Figure 1

PUBLIC DB PLAN PASSIVE ALLOCATION AS PERCENTAGE OF TOTAL EQUITY ALLOCATION, Q3 2013 VS. Q3 2018



Analyst Note: Analysis included 68 public DB plans in 2013 and 62 public DB plans in 2018.

Source: Pensions & Investments

KEY POINTS

As active managers struggle to prove their worth in efficient markets (large-cap equities and developed market equities), institutions increasingly have allocated to passive and redirected their risk budgets toward strategies that are more likely to generate alpha (namely, strategies in inefficient markets).

Manager consolidation is another avenue through which institutions trim costs. By rationalizing their active manager lineups in certain portions of their portfolios, they can redirect the risk budget that otherwise would have been spent on employing additional managers. Cerulli Associates sees the increased interest in global mandates as evidence that consolidation will continue.

An allocation to passive and the consolidation of active manager relationships translates to larger allocations to the remaining active managers. These larger allocations magnify institutions' bargaining power, enabling them to negotiate better terms.

Institutions' allocations to passive strategies have increased drastically since the 2008 recession. This increase has been one of the most significant headwinds for active managers in recent years. Contrarian managers have been especially hurt by broad market performance. Core and value-tilted strategies have had particularly great difficulty while pure growth strategies have fared better. In response to the push to passive, many active managers have moved to more concentrated positions. Active managers seek to decrease costs wherever possible to compete with passive, but that decrease alone has been an insufficient response. Markets have performed so well that active managers have resorted to increasing their active shares to justify their fees. Despite these moves, institutions are continuing to re-allocate to passive. Importantly, not all strategies are affected equally.

Where institutions go passive depends on where active is proving the least profitable. Investors are allocating to passive investments in efficient markets, such as large-cap equity or developed markets equity. Between 2013 and 2018, U.S. public defined benefit (DB) plan sponsors shifted 30.2 percent of their domestic portfolios from active to passive mandates (see figure 1). By paying less for their large-cap exposures, institutions can employ their risk budgets on a more concentrated portion of the portfolio, or on strategies that are better equipped to attract excess returns. As one $300-million public DB plan manager explains, "Allocating to passive domestic allows us to spend money on other active investments that would give us a better return."

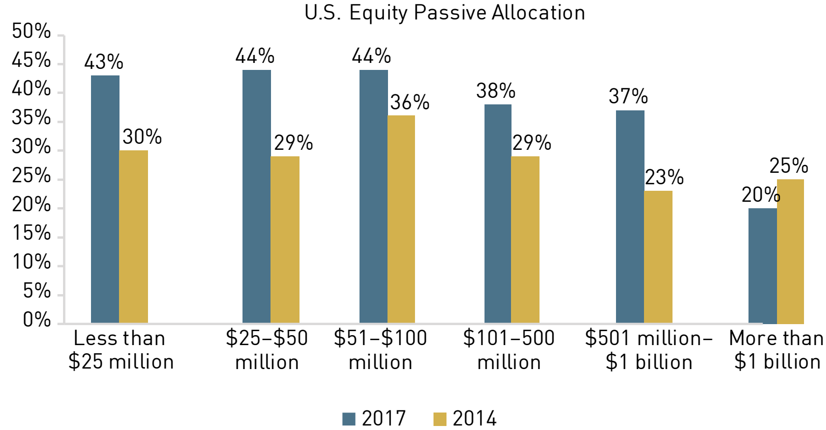
RISK BUDGETS INCREASE IN ESOTERIC STRATEGIES

"The trend is to go passive in the U.S. market, go active in the international space," says an investment consultant with whom Cerulli spoke. Another consultant tells Cerulli, "Active is increasing in smaller caps and less efficient, illiquid areas like emerging markets." In public markets, international and emerging markets strategy managers are safer from the push to passive—active managers are better able to deliver alpha in these esoteric, less-efficient markets. Endowment and foundation asset allocations illustrate this trend. According to data gathered from the NACUBO-Commonfund Study of Endowments, passive allocations increased more in the U.S. equity space than the international equity (MSCI EAFE) space in all but one size cohort of endowments. Almost all size cohorts show a dramatic increase in the portion of the U.S. equities portfolio that is allocated to passive investments (see figure 2).

In addition to an increased interest in international and emerging markets equity, institutions are moving toward private markets. Notably, pricing dynamics in private markets differ substantially from public markets; managers in the private space generally have more bargaining power. Top-tier private equity managers are becoming increasingly difficult to hire because investors, desperate for excess returns, compete to secure allocations. This dynamic means that private equity managers are not subject to the same pricing pressure as public equity managers. Top performers are making fewer fee concessions, if any at all; because they have more bargaining power, they often are able to dictate terms.

Figure 2

ENDOWMENTS' PASSIVE MARKET SHARE OF U.S. EQUITY ALLOCATIONS, 2014 VS. 2017

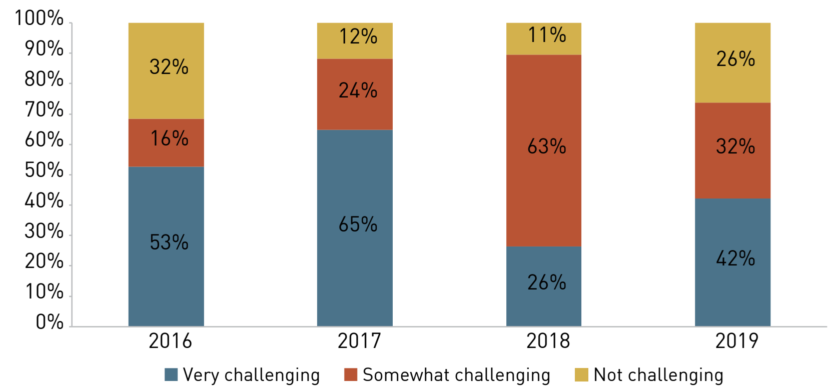


Analyst Note: For figure 2, 2017 is the latest data available.

Source: NACUBO Commonfund Study of Endowments, 2015 and 2017

Figure 3

ASSET MANAGERS' CITATION OF COMPETITION WITH PASSIVE MANAGEMENT AS A CHALLENGING FACTOR IN GROWING INSTITUTIONAL ASSETS, 2016–2019



Source: Cerulli Associates

Although the shift from equity to alternatives plays out mainly for endowments, foundations, and public DB plans, corporate DB plans are re-allocating their budgets in a different way. Increasingly, corporate DB plans are de-risking their portfolios. A corporate DB plan sponsor with more than $15 billion in assets tells Cerulli: "We are heading toward a passive equity strategy. As a fully funded plan, there is no need for risk in equity; [we are] shifting our risk budget to fixed income." Although the beneficiaries of cost-cutting tend to depend on the type of institution, the victim is usually the same: public equities.

Despite year-to-year fluctuation in the percentage of managers citing it as "very challenging," competition with passive is a persistent problem for active managers in the institutional space (see figure 3).

CONSOLIDATING MANAGER LINEUPS

A consultant with more than $2 trillion in assets under advisement (AUA) tells Cerulli, "For portfolio construction, clients have larger passive allocations than they had 10 years ago, but that trend has leveled off." This plateauing effect is important to note because if investors are not moving additional funds toward passive, they will look to cut costs in other ways. Consolidating active managers' lineups is often employed for many reasons, cost reduction being one of the most prominent.

By re-allocating their portfolios to fewer managers, investors can secure better rack rates with larger positions. Investors and consultants are especially keen on evaluating overlapping exposures when considering positions to consolidate. The strategies in which institutions are merging their lineups generally align with the push toward passive; institutions are cutting down their active manager lineups in efficient markets, such as large-cap and developed markets.

One outsourced chief investment officer (OCIO) with more than $1 trillion in assets tells Cerulli, "Consolidation is not as much of a factor in less capacity-constrained asset classes, like emerging markets, small and micro-cap, extended credit." Furthermore, consolidation is mainly happening in equity portfolios. One consultant with more than $500 billion in AUA tells Cerulli: "The fixed-income side is becoming more diverse, as core fixed income has not delivered as an asset class, so more (allocations to) high-yield, emerging markets debt, and direct lending ... Those parts of the portfolio are becoming more complex. Equity is still the largest component of a diversified portfolio, but there are fewer managers in the lineup than years ago."

In addition to cost reductions, institutions are consolidating their manager lineups for numerous other reasons. Especially following the 2008 recession, many institutions and advisors focused on diversification. Deemed by one research call participant as "the U.S. consulting curse," many institutional portfolios became diversified across so many managers that it became difficult to generate tracking error; too many managers in a portfolio led to too many offsetting exposures. Institutions have thus rationalized their manager lineups to achieve idiosyncratic risk.

Another reason why institutions seek to consolidate manager lineups is to simplify their processes. As one consultant puts it, "Clients are more comfortable with fewer managers ... allocating to many managers makes it difficult to monitor for the client, a ton of decisions." By rationalizing the group of managers an institution employs, it will spend much less time on ongoing operational due diligence and investment due diligence. This time can instead be used to identify better-performing managers.

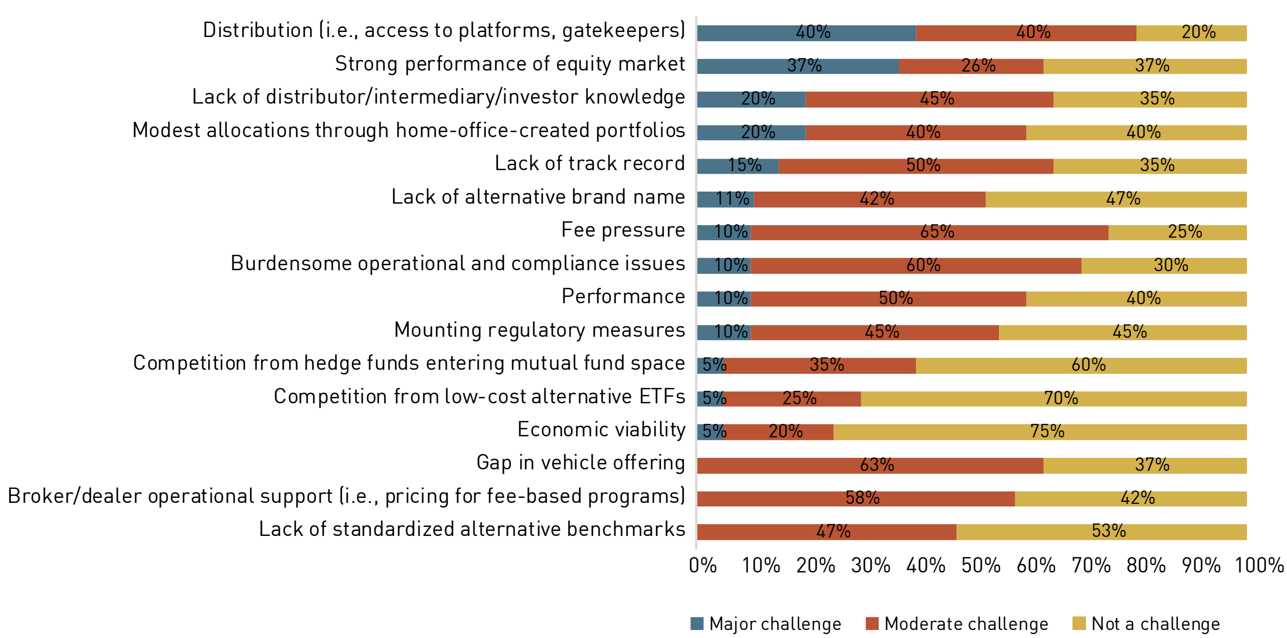
Equity managers can respond to this trend by going in one of two directions—by building more focused strategies (i.e., concentrated equity) or by building broader, flexible strategies. A focused, concentrated strategy avoids the probability that exposures will overlap with other mandates. A broader strategy positions the manager to be a one-stop shop for an equity allocation.

GLOBAL MANDATES

Across its research of institutional markets, Cerulli observes an increased

Figure 4

ASSET MANAGERS: EXTERNAL CHALLENGES TO THE DEVELOPMENT AND DELIVERY OF ALTERNATIVES, 2019



Source: Cerulli Associates

interest in global equity mandates. Consolidating manager lineups plays into this theme, because global mandates cover all geographic exposures. A $75-billion corporate DB plan with whom Cerulli spoke mentions that global is simpler from an asset allocation perspective given how the investing environment has changed: "Originally, [we] wanted to be able to use levers, move up and down, be tactical. Now, we're less tactical and more focused on asset allocation." Another DB plan tells Cerulli: "We started with U.S. mandates, then moved into some international mandates, and then we moved into global. If we were starting with a fresh sheet of paper, we would just do all global mandates."

FEE NEGOTIATION

An additional trend of increasing importance is the act of fee negotiation. Investors tend to negotiate fees most aggressively when they believe they have the most bargaining power. Hence, redirection of risk budgets and manager consolidation magnify the bargaining power of investors in efficient markets, thus making it easier for them to negotiate better fees. Fee discussions occur at various points during the due diligence process, and a $5-billion public DB plan tells Cerulli that these conversations are occurring earlier in the process: "Even more so now, we are doing more fee negotiation right up front, before starting a deep dive into a particular manager."

Although fee pressure still presents a challenge, it is much less of a concern for alternative managers than it is for their traditional strategy counterparts (see figure 4).

The primary factor feeding into investors' bargaining power is size—larger investors can negotiate lower fees due to the size of their allocations. As one investment consultant puts it, "Size matters; a large client account ($200 million) negotiating an active large-cap mandate should have much more power than a small client account ($20 million) negotiating an active small-cap mandate." In addition, because of their vast manager lineups, larger institutions interview managers more frequently and better understand the lay of the land. They can pit managers against each other competing for the business. Meanwhile, smaller clients use intermediaries, such as consultants and OCIOs, to negotiate better terms on their behalf. Some managers allow intermediaries to pool funds to get the lower rack rate. Similar to large investors, consultants work with everyone, so they know how things stand in terms of fees.

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