Pension fund switch to decentralized management right way to go, landmark study finds

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As pension funds have grown and become increasingly complex many have turned to using multiple, often pricier specialist managers to steer their investment decisions.

Has it been the right move?

A new study of the British pension fund industry, funded by the Rotman International Centre for Pension Management at the University of Toronto, shows it has, resulting in improved performance.

A team of British and American researchers looked at data from British pension funds between March 1984 and March 2004. Most funds switched from using a balanced management structure, where a manager oversaw a host of asset classes, to a decentralized, specialist management structure, with different managers for each asset class and even multiple specialists within each of those classes.

"Having this huge panel of funds and managers that they were paired with, in all kinds of situations, really allowed us to answer this question of, 'Are these guys getting their money's worth?'" said Russ Wermers, a co-researcher at the University of Maryland.

"We indeed find that specialist performance is not just cheap talk" and the higher management fees specialists charge are in line with better performance, added researcher Allan Timmermann of the University of California.

Using several different pension fund managers can lead to problems with portfolio diversification, because managers may not coordinate their investment decisions with each other. But the study found the use of multiple specialist managers more than made up for that downside through superior stock-selection skills. Pension fund sponsors dealt with coordination and diversification problems by setting lower risk levels for their portfolios. Multiple managers also added an aspect of competition that created incentives towards higher performance.

Pension funds represent a major share of the market. In 2005, pension fund assets amounted to more than $18 trillion U.S., compared to $17 trillion for worldwide mutual fund assets.

This is the first study to look at the effect of different pension management structures on performance and risk-taking.

Provided by University of Toronto

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