Bigger is better in pension funds, researchers find

September 12 2011

The health of the pension system is front page news in countries around the world with an ongoing debate on required contribution rates or minimum retirement ages. An equally relevant issue is how efficiently savings invested in pension funds are managed. A paper written by two professors at the University of Toronto's Rotman School of Management points to economies of scale in pension funds as a powerful tool to increase the wealth accumulated for retirement.

The largest pension funds -– those that average $37 billion in assets -- outperformed smaller plans –- an average of $1 billion in assets -- by 45 to 50 basis points, or 0.4 percent each year, the study found.

The annual difference "sounds small, but it is huge economically," points out Lukasz Pomorski, an assistant professor of finance at the Rotman School, who co-authored the paper with colleague Alexander Dyck, who is the Rotman ICPM Professor in Pension Management.

The difference can amount to a 13 percent bigger pension at retirement for employees invested in the plan for their full working lives. For government-run pension plans it can mean taxpayers are less likely to have to make up for an unfunded liability.

"Large mutual funds typically underperform their smaller equivalents," says Prof. Pomorski, adding one reason is that mutual funds do not have the same incentive to cut costs as they grow. "So we are quite surprised and happy to find this is not true for pension plans."

One thing that makes larger funds different is their increased use of internal (in-house) management. The related costs savings account for up to half of the improved performance, the study found. The other half comes from larger pension funds' flexibility to invest more in alternatives such as private equity and real estate, both of which afford large plans lower costs and higher gross returns.

The findings suggest it may be beneficial to encourage the ability of larger funds to manage the assets of smaller pension plans that do not enjoy the same leverage. The results of the study also suggest potential weaknesses in defined contribution saving schemes, for example, RRSPs. "I would be much happier to be able to invest in a portfolio similar to the Canada Pension Plan Investment Board than in a mutual fund, if only because of the substantially lower costs," says Prof. Pomorski.

More information: The complete study is available at: papers.ssrn.com/sol3/papers.cf … ?abstract_id=1690724

Provided by University of Toronto