Public Funds' Lead Manager System: Meaning and Implications

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Korea's large-scale public funds have increasingly shifted towards a "lead manager" system where they outsource investment management to one lead manager acting as an outsourced chief investment officer (OCIO). This is expected to create a critical opportunity for the asset management industry to take a qualitative leap forward based on a new business model and for the public pension funds to stably improve returns. However, this may become a mere fad due to low awareness about the OCIO of funds and capability shortfalls of the industry. In the view that the lead manager system should provide utility differentiated from existing asset management practices, this article explores structural issues in current practices such as low management fees, and then presents tasks to develop the system into a competitive investment tool.

Introduction

Recently, there has been a shift in how large-scale public funds manage their assets. Rather than investing in wrap accounts provided by securities firms or purchasing individual funds suggested by investment advisors, they have increasingly hired a lead manager, a structure somewhat similar to a fund of funds. The lead manager system was first introduced in Korea back in 2001 when the investment pool for public funds was formed by the Ministry of Strategy and Finance (MOSF). More recently, a couple of large-scale funds including the Housing and Urban Development Fund, and Employment and Workers' Compensation Insurance Fund

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switched to the lead manager system. In 2015, Korea Securities Finance Corporation also followed suit by launching the investment pool for private pension funds. Such a trend observed among large funds over KRW 1 trillion is forecast to continue for some time.

From the asset management industry's perspective, the lead manager system means an increase in institutional demand for asset management. Amid the recent contraction of publicly placed funds coupled with the increase in privately placed funds and outsourcing of discretionary investment management, asset managers are increasingly required to shift away from selling individual funds towards providing asset allocation funds with diversified portfolios. Korean securities firms have also made utmost efforts to break away from their brokerage-oriented revenue structure and position themselves as a wealth management service provider. At this juncture, the lead manager system adopted by Korea's large-scale pension funds means an advent of a new business model for the industry, and one of new growth engines to secure global competitiveness for regulatory authorities.

As such, the lead manager system can be an important opportunity for Korea's asset management industry to take a qualitative leap forward. Nevertheless, the system has limitations to take hold successfully in the market. To be recognized as an effective management tool by pension funds that outsource investment management, the system should build confidence in long-term portfolio stability and sound track records to offset high costs. For this, the asset management industry must build their ability as a fund of funds, which is quite different from managing individual funds. But it is difficult to make the much-needed capacity building efforts due to structural challenges under the current outsourcing practice, e.g., low management fees. Irrationally low fees and monolithic services may increase the likelihood where the lead manager system ends up being a mere fad rather a fundamental fix.

Under the circumstances, this article first explores the current state of Korea's lead manager system, and then covers its limitations and necessary improvements considering that the system must be able to provide utility differentiated from large-scale pension funds' existing management practices. Based on the observations, I finally draw out implications and concrete tasks that should be carried out for the system to take hold as a competitive asset management business model.

Public funds' introduction of the lead manager system

Korea's OCIO model (the lead manager system) kicked off in 2001 when Korea's Ministry of Strategy and Finance (MOSF) formed an investment pool for public pension funds. The investment pool was created under the MOSF's leadership to help small- to mid-scale pension funds with lack of management professionals and infrastructure to enhance their asset management efficiency. At that time, the MOSF appointed Samsung Asset Management as a lead manager. To bring competition to investment outsourcing, Korea Investment Management was additionally selected in 2012. During the nascent stage, Korea's asset management industry had neither experience in managing funds of funds for institutional investors nor relevant infrastructure. Hence, early-stage lead managers had to carry out massive initial investments in human resources and infrastructure, which created the economy of scale effect and high entry barriers. In addition, some of the standards set during the early stage by the public fund investment pool have firmly taken root as industry practices: For example, a lead manager is reappointed every four years, and the 6bp management fee is regarded as a de facto cap. In addition, the case of the public fund investment pool functions as industry standards when defining lead managers' service scope and their role (e.g., sub-manager selection, and advisory services for the fund).

More recently in 2014, the Ministry of Land, Infrastructure, and Transport (MOLIT) switched to the lead manager system for the KRW 30 trillion Housing and Urban Development Fund that had until then been managed via wrap accounts provided by securities firms. Due to uncertainties about which industry (securities vs. asset management) would be a more competitive lead manager for public funds, the MOLIT opted for a multi-manager system after commissioning related research. Accordingly, one asset manager (Mirae Asset Global Investments) and one securities firm (Korea Investment & Securities) were selected, which created a competition structure for lead manager services for a single fund. Such a structure for a single asset owner was also adopted by the Workers' Compensation Insurance Fund and the Employment Insurance Fund operated by the Ministry of Employment and Labor (MOEL). In 2015, the Workers' Compensation Insurance Fund (KRW 10 trillion) chose to hire an asset manager (Samsung Asset management), while the Employment Insurance Fund (KRW 7 trillion) selected a securities firm (Korea Investment & Securities).

Lead managers in Korea

	Public Fund Investment Pool		Housing and Urban Development Fund		Workers' Compensation Insurance Fund	Employment Insurance Fund	Private Fund Investment Pool
Client	Ministry of Strategy and Finance		Ministry of Land, Infrastructure, and Transport		Ministry of Employment and Labor		Korea Securities Finance Corporation
Investment Manager	Samsung Asset Management	Korea Investment Management	Mirae Asset Global Investments	Korea Investment & Securities	Samsung Asset Management	Korea Investment & Securities	Korea Investment Management
Appointment	Dec. 2001	Dec. 2012	Apr. 2014	Apr. 2014	Apr. 2015	Apr. 2015	May 2015
Fee[1)]	6.0bp	6.0bp	5.9bp	5.9bp	4.5bp	4.5bp	Similar to public pension funds
AUM	KRW 15tn	KRW 4tn	KRW 15tn	KRW 15tn	KRW 12~13tn 2)	KRW 7~8tn[2)]	KRW 1tn
No. of Staff	15	14	12	12	14	13	8

Note: 1) The fees in the table are estimated under the method adopted by the Public Procurement Service (except for the investment pool for private pension funds).
2) Assets of the MOEL's Worker's Compensation Insurance Fund and Employment Insurance Fund are currently being transferred from managed accounts to the respective lead manager.
Data: As of end-November 2015.

In May 2015, Korea Investment Management won again in the bid for a lead manager of the investment pool for private pension funds, reaffirming the market's high entry barrier created by massive initial investments. Although regarded as a common tendency found in funds of funds, the entry barrier seems to grow even higher in Korea due to compounding reasons such as the market's low management fees for excessive service requirements.

Challenges for an ideal system

As described above, the lead manager system for managing large pension funds is expected to be an effective, competitive investment vehicle for both asset owners and the asset management industry. For the system to take hold in the market, both institutional investors and asset managers are required to renew their awareness of the system and make extra efforts.

First, pension funds that delegate fiduciary management should have a process for making reasonable decisions related to the costs for introducing and maintaining the lead manager system. It would be unwise to have high expectations for superb management performance without reasonable costs. Currently, most funds delegate lead manager selection to the Public

Procurement Service which presents prospective lead managers an estimated fee level that a client institution wants. Under such an arrangement, the estimated fee level is regarded as a de facto cap on management fees. In practice, candidate asset managers tend to propose management fees that are 0.2bp to 0.9bp lower than the level. Thus, actual management fees are estimated to range from 4.3bp to 5.8bp.

The problem is that management fees have competitively fallen since the launch of the pension fund investment pool in 2001. The estimated fee level fell from around 6bp to 4.5bp, and the downward trend tends to continue amid intensified competition among asset managers. One of the primary reasons is that government ministries newly adopting the lead manager system in general try to bring down the fee level amid audit concerns. But it is necessary to guarantee a minimum level of costs for a designated lead manager to carry out asset management. For example, a management fee of 4.5bp for KRW 10 trillion AUM means management fee revenue of KRW 4.5 billion. However, hiring human resources required by public funds alone costs at least KRW 3 billion.[1)] In addition, a lead manager must build a system physically separated from its existing infrastructure, which requires substantially high costs. Consequently, lead managers face difficulties in investing in database or other hardware for enhanced management efficiency, and have little room to provide soft money such as advising services and research projects. In decision making related to reasonable fees, funds should calculate costs based on services they demand, rather than make relative comparisons on competitors' fee levels.

Determining a reasonable fee level is directly linked to a lead manager's roles and responsibilities required by an asset owner. More specifically, this is about deciding which part of the asset management (plan-do-see) process should be outsourced to a lead manager or be internally carried out by a fund. And lead managers are most likely to be assigned for "do" activities, creating excess returns (α) instead of market returns (β). But it is observed that most pension funds fail to provide clear guidelines on lead manager roles and responsibilities. For example, strategic asset allocation is a key determinant to long-term fund management performance and thereby one of the most important decisions. Accordingly, most funds carry out that internally and receive advisory services from their lead manager. But because most pension funds are without management professionals, lead managers are increasingly required

1) A lead manager for a public fund is required to hire more than 13 professional managers with over 10 years' experience.

to implement a substantial part of actuarial valuations and subsequent strategic asset allocation tasks. On the contrary, many pension funds inappropriately intervene or place limits in various activities for generating excess returns including tactical asset allocation that must be left for lead managers' discretion. Fundamentally, such a problem is believed to have stemmed from performance evaluation and incentive schemes. To address the problem, funds delegating investment management must clarify lead managers' roles and responsibilities, and accordingly evaluate performance only based on pre-defined services. Moreover, the result of performance evaluation must be directly linked to incentives.

The most imminent challenge for lead managers is strengthening management capacity as a fund of funds. Lead managers are primarily required for searching for and managing superb sub-managers in and out of Korea. Cases of global managers of funds of funds demonstrate that database construction via in-depth research (e.g., manager research) is one of key competitive edges. It is important to build database including track records of funds as well as lead fund managers. Also necessary is a more sophisticated system to allocate funds to sub-managers once they are selected. It is desirable to adopt a strategy maximizing overall excess returns by adjusting weights of sub-managers based on a thorough evaluation of their alpha-generating ability.[2] This means implementation of a so-called risk budgeting system for active risk.

Last, lead managers should differentiate their competitiveness with superb advisory services. Most pension funds opting for the lead manager system want to hire external managers due to lack of internal management professionals or systems. Nevertheless, it is impossible to delegate the whole investment management process to external entities because "plan" and "see" cycles cannot be outsourced easily. Hence, lead managers should supplement these areas with advisory services. They must bolster internal capacity to provide practical advisory services related to long-term actuarial valuations, asset-liability management, establishing target returns and risk tolerance, setting benchmarks and asset classes, implementing norm portfolios and strategic asset allocation, performance evaluation, incentives schemes, and other "plan" and "see" cycle issues.

2) In general, this is measured by an information ratio.

Closing and implications

Although the lead manager system for institutional investors has been adopted in Korea's discretionary investment management market for more than a decade, the market has yet clearly established lead managers' roles and direction. Desirably, lead managers should be positioned as an OCIO. To accomplish this, prospective lead managers should equip themselves with quality human resources and systems requiring substantial costs. But it is just physically impossible to build a well-functioning lead manager system with current fee levels (less than 5bp). In the long run, lack of human resources and systems will result in poor management performance and undermine investor confidence.

It is more important than anything for funds that have adopted or consider shifting towards the lead manager system to take into account a long-term investment horizon. Any unreasonable efforts to cut costs in the short run will end up cutting long-term returns. Lead managers' management performance is measured and evaluated by client returns deducting all costs such as direct and indirect costs. It is worth emphasizing that calculating reasonable costs considering the cost structure is a precondition to achieve higher returns with cost reduction.