Unpicking the ties that bind

A recent network analysis of asset manager selection unveils the power of social ties over meritocracy in the Swiss pension industry. MURAT ÜNAL examines the broader issues this raises and implications for Australia's super industry.

The Swiss pension fund industry is often cited as being very progressive in the European context and consequently seen as a potential role model for other markets to follow.

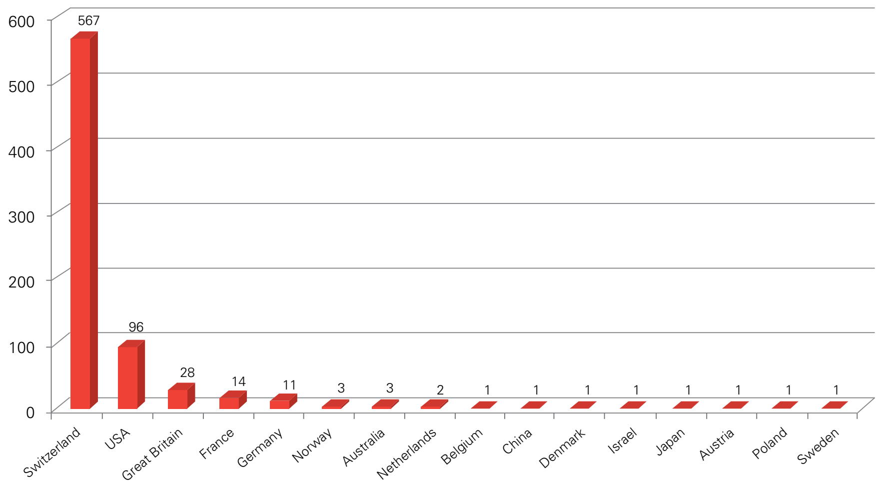
We looked at the major pension institutions with collective assets under management (AUM) of 350 billion Swiss Francs (CHF), analysing 732 external mandates managed for them by asset managers in diverse asset classes. The conclusion was that selection of external providers is not necessarily based on merit and that investors and their beneficiaries alike face risks which have not been addressed before.

By analysing the links between Swiss pension entities and their asset managers, based on real mandates, we identified central players within the system and got interesting insights. Swiss pension funds mainly work with Swiss asset managers (567 mandates, see Chart 1) which under objective circumstances (real open architecture) should not have been the case. This is particularly interesting when one asks why investment consultants failed to bring about greater diversity, seemingly pushing specific asset managers on their shortlist rather than considering a broader universe of potential players.

The other major cluster within the core network is composed of American asset managers (96 mandates) leaving virtually no room for asset managers from other countries. What does that mean in terms of diversification of views and the robustness of portfolios and the broader system, considering that Swiss asset managers and their American counterparts look at the world differently than their peers in Continental Europe or Asia-Pacific? Just take the example of a European bond manager from Germany and his current view and long-term scenario of developments in the Euro zone which might strongly contradict the views of its Swiss and American counterparts.

This lack of diversity of perspectives among asset managers potentially carries substantial risks as systems are more stable when there is greater dispersion. In the following we will focus on some relevant questions and interesting findings that arise from this research.

Chart 1

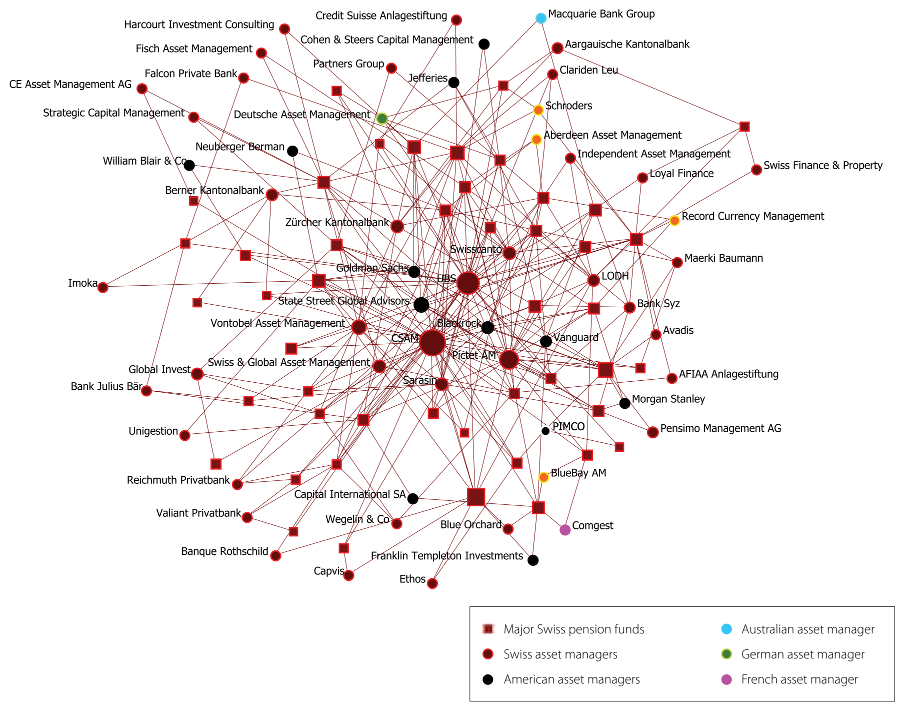


Is size of the pension fund responsible for its openness vis-a-vis international managers?
Despite the generally low level of non-Swiss asset managers serving Swiss pension funds, a large pension fund (AUM >10 bn CHF) is over three times more likely to employ international asset managers than a small pension entity (<5 bn CHF AUM). The larger the asset base, the more international asset managers are generally considered. Does this confirm the resource-based view that large pension entities are more sophisticated and, due to their resources, in a better position to serve their needs in a more optimal way? But how about the argument that smaller entities are more flexible to manoeuvre and based on access to investment consultants get access to equal opportunities?

Is location why Swiss pension funds employ more non-Swiss asset managers?
The Swiss pension funds that are most international in terms of manager selection are irrespective of size, located in either Geneva, Zürich or Bern. A pension entity established in Geneva is on average employing three times more international asset managers than a pension fund located in the remaining cities (ex Zürich and Bern). Being located in Zürich means that the probability doubles compared to all other Swiss cities (ex Bern and Geneva). And interestingly enough, being headquartered in a capital city like Bern increases likelihood by at least 50 per cent compared to other cities across the country (ex Zürich and Geneva).

We thought the world was more complex – can it be reduced to just a few simple factors?
Are we dealing with social network dynamics which lead to decisions in favour of certain asset managers rather than objective criteria? And can we safely assume that these findings can be transported to other jurisdictions such as Australia? As the Swiss evidence shows, pension funds located in major hubs (such as Melbourne and Sydney in the case of Australia) but also in capital cities (such as Canberra) could potentially be more exposed to international asset managers than others located elsewhere. Furthermore depending on the overall AUM, they might be considerably more exposed to international asset managers than their smaller counterparts. What does this mean for pension entities outside those hubs and the ones with less AUM?

Network graphic



Note: The larger the circles the more mandates the individual asset manager is in charge of and the larger the squares the more mandates the anonymous Swiss pension fund has actually outsourced to external asset managers.

SWISS PENSION FUNDS AND THEIR PROVIDER NETWORK

The network graphic above illustrates the core network of Swiss pension funds (which are anonymously represented as red squares) and their asset managers. The red circles represent their Swiss asset managers and, as you can clearly see, Credit Suisse Asset Management (CSAM) forms the core of this network together with UBS. The larger the circles, the more mandates the individual asset manager is in charge of and the larger the squares, the more mandates the anonymous Swiss pension fund has actually outsourced to external asset managers. The dominance of CSAM and UBS in itself is not a surprise but what is compelling is the dominance of Swiss asset managers overall as external mandates predominantly include international strategies of Swiss pension funds (ie investments outside of Swiss asset classes). The second dominant cluster is represented by American providers such as Goldman Sachs, State Street Global Advisors, Blackrock and Vanguard with Goldman clearly dominating commodities investments whereas the latter three occupy mainly the passive and enhanced index portfolios business. What would it mean for Australian pension funds for example when they discovered that certain asset classes such as commodities are dominated by a single or few players and what influence does it have on pricing of commodities and consequently on performance of their investments? Wouldn't it be in the best interest of the asset owner to ensure a broad diversity of players rather than concentration of single or a few nodes, especially with regard to providing more stable returns?

The only non-Swiss and non-US asset managers in the core network are Comgest (France, pink circle), Record Currency Management, Aberdeen Asset Management, Schroders and BlueBay (from the UK, yellow circles), Macquarie (Australia, blue circle) and Deutsche Asset Management (Germany, green circle). Only Deutsche Asset Management and Comgest from France are from Continental Europe and there is a virtual lack of Asia-Pacific or Latin American asset managers in the core network of mandates?

Why does this matter? Because network research tells us that diversity matters. Take the example of emerging market exposure (let's say to China). We believe that for pension funds in Switzerland it makes a big difference having local Chinese managers on board rather than Swiss players with local Chinese capacity. Furthermore, in the current Euro zone crisis having your money managed by mainly non-Euro zone country asset managers (such as Swiss, British and of course the large bulk of US managers) carries a variety of risks, as seen in anecdotal evidence where an American manager tried to explain its shorting strategy in Euro zone bonds to a German investor based on his scenario of a downfall whereas his Continental European counterpart's view was more of a positive one to contribute to greater stability in the system and the maintenance of the Euro zone.

Which view do you think resonated more with the German investor's expectations and identification?

This diversity of perspectives is unfortunately not represented in the Swiss pension funds network dominated by non-Euro zone players. There are important lessons to be learned here, even from a systemic risk perspective as central nodes (too big to fail), in certain asset classes or overall, pose risks to the pension fund system and lead to less stability and potentially lower risk-adjusted returns. What we should prefer is a more balanced representation of international asset managers from different jurisdictions to add resilience to the system and thus avoid potential fallouts.

What we definitely need is more transparency of this kind for the sake of pension funds and asset owners in general, to get a good overview of their providers embedded in the wider ecosystem. This is also crucial on the individual portfolio level that asset managers run for their clients. In this context it should no longer be acceptable to opt for blackbox strategies just based on the fact that the asset manager delivered good historic results, thus substituting performance for transparency. This is particularly true for hedge fund strategies run without any transparency at all. As in the case of nuclear reactors, we seem to be not at all aware of the potential risks that this might cause. Just think of the situation where money allocated from Australian pension funds to 'intransparent asset managers' is used to destabilize the equity market in their home countries, thus leading to undesired outcomes based on their ignorance of what is really going on in the manager's portfolio. Intransparency also leads to much higher fees and thus potentially lower returns.

Pension fund managers, apart from relying on more diversity of views among their external asset managers, should determine the level of transparency and phase-out opaque asset managers relying on intransparency to potentially cover up the added risks involved in managing portfolios. There is no free lunch as we know but greater systems stability is something we all should aim for.

THE IMPACT OF SOCIAL NETWORKS

It is not a coincidence that pension funds located in cities close to major airports tend to have a more diverse range of international asset managers as the existing infrastructure allows for greater networking apart from the selection bias of people to opt for such central hubs. It is also not a coincidence that historical ties (here the US and Switzerland) and therefore greater past networking lead to more intensive cooperation disregarding other players which potentially might be a better option.

In light of the current tax evasion war which is continuing among the US and Switzerland as I write, it will be interesting to see what impact it will have on the dominance of US asset managers in the Swiss pension fund provider network. What we don't portray here, and what the data clearly shows, is the existence of almost exclusive clusters within the Swiss pension fund network where specific asset managers serve a tightly knit and homogeneous community of certain asset owners. This could be traced to: Proximity (geospatial location), where pension funds virtually sit opposite their provider in the same city; employees among asset owners who changed jobs and took along their past connections to asset managers; or even investment consultants active for specific clients promoting a specific shortlist of providers as opposed to the objective universe that we should expect. The argument that Swiss asset managers are better suited to manage local equities is questionable as most Swiss companies (such as Nestle) are active globally and the international scope of an asset manager is even more important than being close to the organisation's headquarters.

Although strong social ties certainly involve greater trust among participants in the overall system, it also leads to blindness when it comes to innovative ideas and asset managers outside the established network, thus leading to undesired outcomes. By bearing in mind that these social and organisational network-related issues play a role in the decision making process, pension funds should rethink their external mandates and try to understand what impact a concentration based on the above mentioned factors could potentially have on the wider system. A more holistic view is required, looking at the pension entity from an ecosystem perspective in which it is embedded. This would also allow for a better understanding of who is serving who in the Australian pension fund system and, at the same time, who dominates in certain asset classes or sub-segments. More transparency is badly needed and dynamic network analysis can help regulators and the market participants alike to identify systemic risks, as shown in the few examples given here.

Using competing investment consultants in the manager selection process (rather than one), opting for an asset manager with a different country of origin (if suitable) as recently done by an Austrian asset owner who opted for a Copenhagen-based equity manager rather than his counterpart in London, can make a difference. Bearing in mind the network-related impacts that we highlighted above and becoming more aware of those factors can greatly help in bringing about greater stability and, through increased transparency, potentially better returns. SF

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Dr Murat Ünal is Chief Executive Officer, Funds@Work AG (Germany).