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Is big really beautiful? The limits of pension consolidation

Many governments are thinking about merging their disparate systems. New research finds real benefits, but capturing them is difficult.

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Pension systems face a tough road. Long-term economic growth is slowing, pulling down returns, and political uncertainty is high. Funding levels have deteriorated, and despite recent improvements, pension funds will continue to be under pressure as beneficiaries live longer. Regulators are sharpening their focus on achieving greater efficiency and effectiveness for the industry.

While defined-benefit (DB) and defined-contribution (DC) schemes around the world are forming different responses to these challenges, there is a common theme in many countries: consolidation. The United Kingdom is pooling the investments of its local pension schemes. The Productivity Commission in Australia is reviewing the competitiveness and efficiency of the country's pension funds, with ongoing focus on subscale funds with poor performance. The Netherlands has already seen the number of its funds fall by 60 percent from 2005 to 2015[1]—and there may be an additional 20 percent reduction in the coming years.[2] In several other parts of Europe, governments are thinking about merging smaller pension schemes into larger plans.

The simplicity of the consolidation argument is appealing: bring smaller funds together and achieve economies of scale, from the back office to investment activities. Everybody wins—or so it would seem. After all, some of the largest pension funds tend to have high investment returns as well. For example, the Canadian Pension Plan Investment Board (CPPIB), which manages $350 billion, has achieved average returns of 12 percent annually over the past five years. And the Dutch pension fund ABP, with $550 billion under management, has achieved average returns of 8 percent per year over the same period.

In this article, we test the three most common arguments made in favor of consolidation: that it will result in better investment performance, lower costs, and stronger governance and organizational health. What we find is that while there is merit to all three arguments, economies of scale do not automatically translate to "economies of consolidation," as numerous pitfalls can let the benefits slip away. Pension systems that want to achieve synergies through consolidation need to integrate funds carefully, using a few essential best practices: develop a clear target model that articulates the drivers of value, don't let politics interfere with a focus on value creation, ensure effective decision making, keep the integration moving quickly, and reduce uncertainty for employees and members as quickly as possible.

Argument 1: Scale drives better investment returns

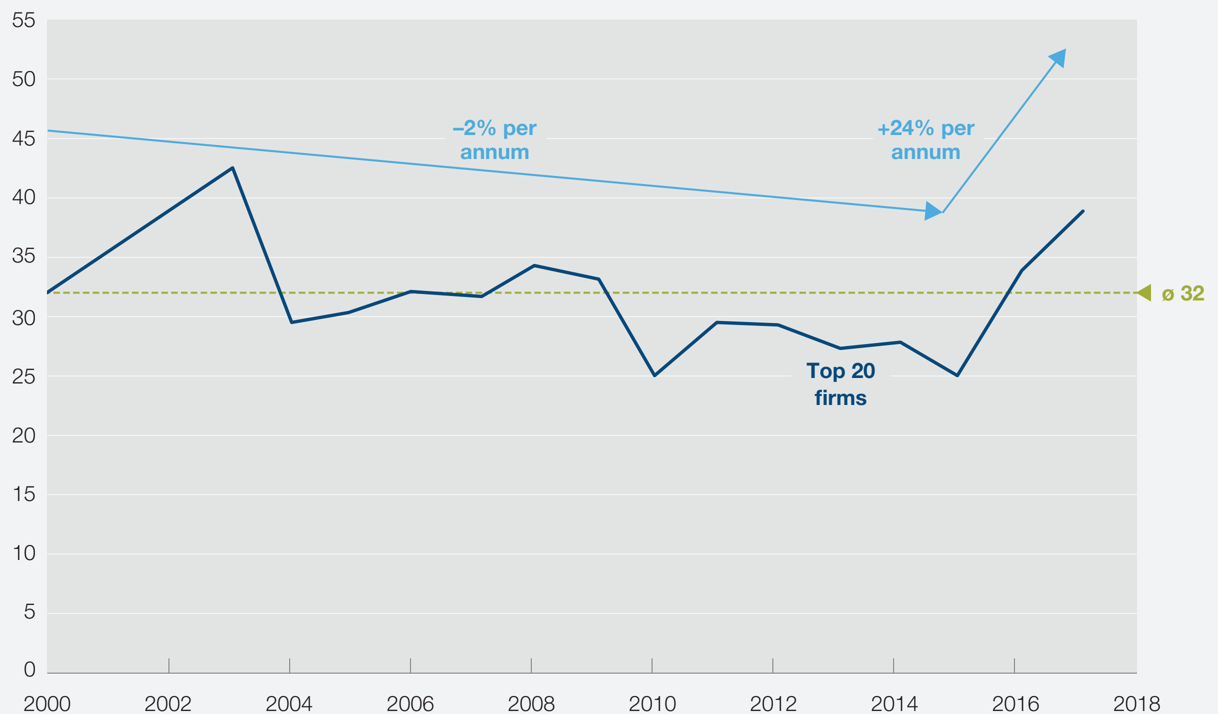
Some believe that larger pension funds should generate higher gross investment returns, reasoning that larger funds have better access to the most attractive opportunities, many of them in illiquid asset classes and available only through preferential treatment by the most successful external managers. With more investors and capital rushing into private equity (PE) and other private markets, access to these attractive investment opportunities (and the most successful external managers) will become increasingly difficult to achieve. Already, investors find it "hard to get [their] money in the door."[3] The most successful managers can afford to work only with the largest investors that can make significant commitments, thereby reducing their administrative burden and saving costs.

Our recent research shows some evidence for the theory that investors are gravitating toward the biggest managers. The largest private-market firms are beginning (but only just) to claim a larger share of fundraising (Exhibit 1).[4]

Our research also finds that the largest funds have recently outperformed smaller funds, with less variation between top- and bottom-quartile performance than that observed among smaller funds (Exhibit 2). It seems that if a pension successfully places its capital in one of these megafunds—which is

Exhibit 1

Big firms' share of fundraising has increased since 2015.



Source: Preqin; McKinsey analysis

not easy to do—it will gain access to a better collection of deals, ones that, for the moment, are generating superior returns.

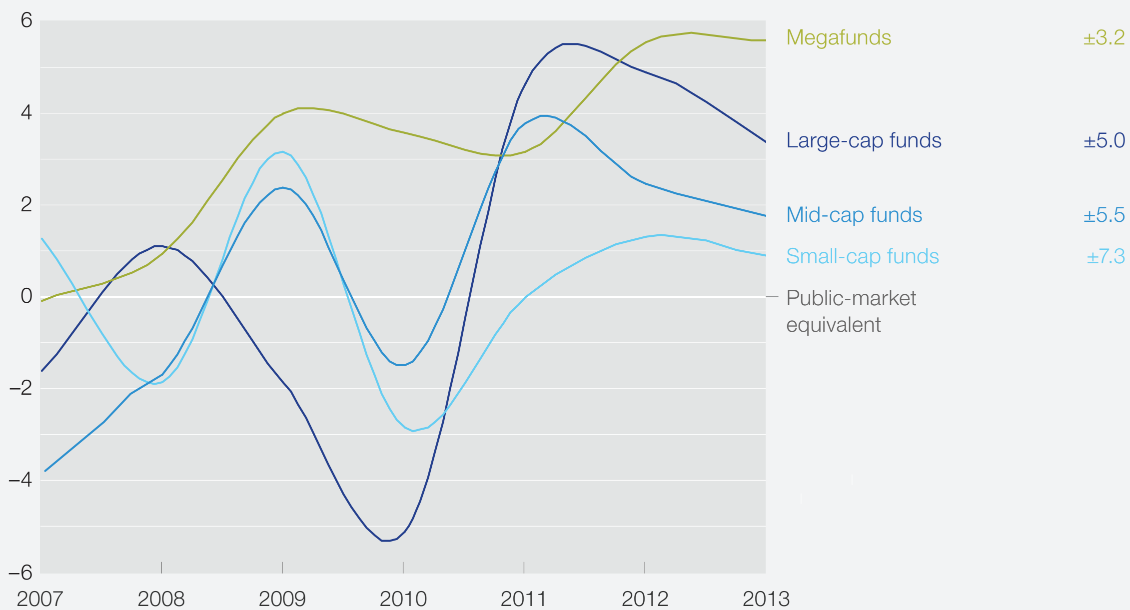
But other research suggests that smaller pension funds can do just as well as larger ones. CEM Benchmarking (a strategic partner of McKinsey & Company) analyzed the investment performance of 49 US pension funds from 2010 to 2015[5] and found almost no correlation between fund size and achieved gross investment returns (Exhibit 3). In fact, differences in scale explained only 4 percent of the difference in gross returns. It appears that smaller funds can hold their own, despite their lesser ability to place capital with the largest managers.

How do they do it? If returns are similar for smaller and larger pension funds, it seems that they have equal access to the asset classes that have performed well—which has often meant alternative assets. An analysis of the PE allocations of large and small pension funds, for example, shows no indication that large "ticket sizes" are a must for participation in this asset class. The PE allocations of the smallest funds (those with total assets under management [AUM] between $1 billion and $5 billion) are not significantly different from those of the largest funds (those with total AUM more than $50 billion) (Exhibit 4). Even at ticket sizes as low as $50 million, smaller pension funds are able to gain access to this diverse and competitive asset

Exhibit 2 **Measured by pooled returns, megafunds have outperformed since 2008.**

Global private equity pooled returns by fund size relative to public-market equivalent, percentage points

Top- and bottom-quartile variation from the average, percentage points



Source: Cambridge Associates; Thomson One; McKinsey analysis

class.[6] (And in the future, the advent of new liquid alternatives products should make it even easier for small funds to gain entry.)

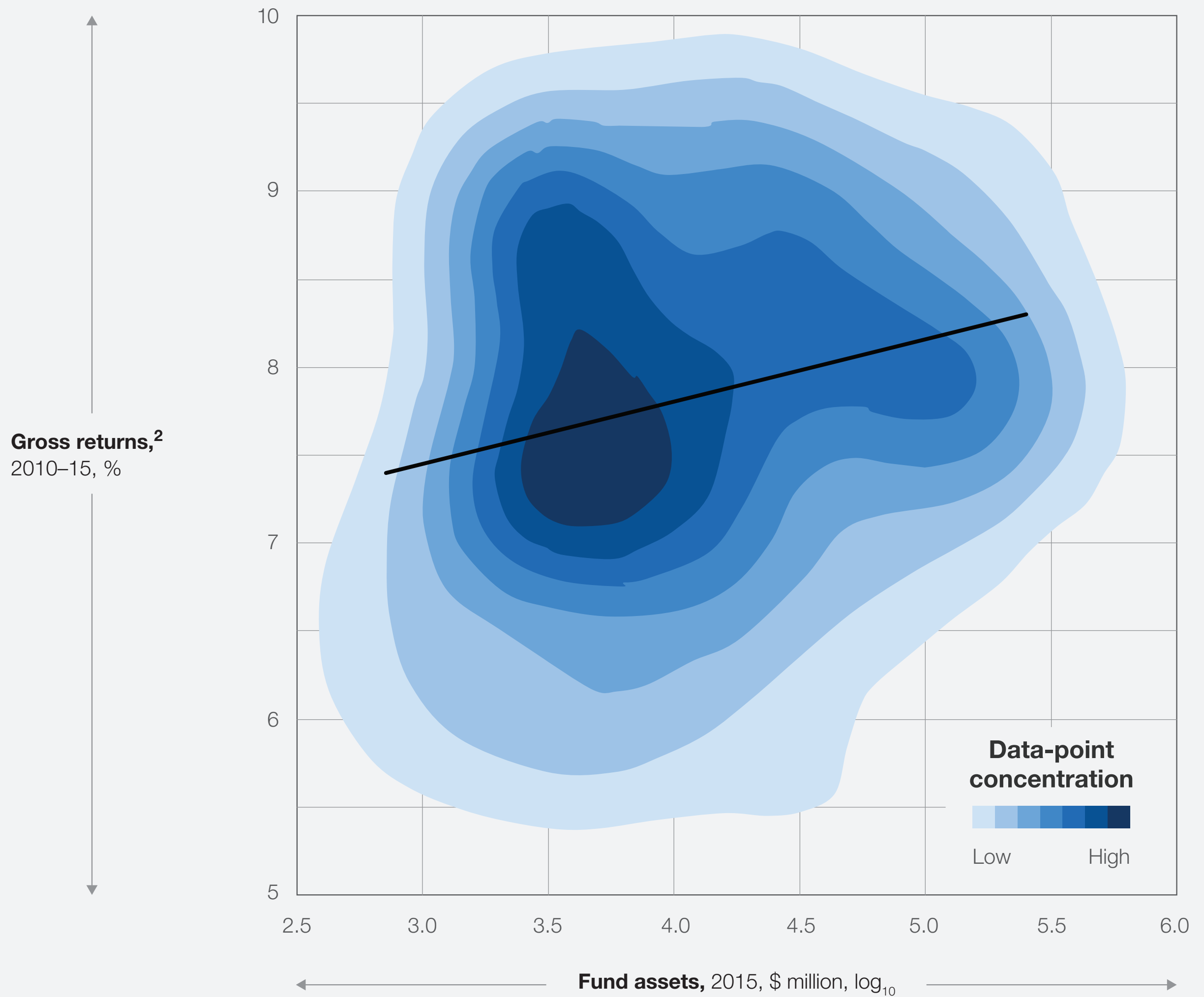
This may seem odd, as entering any new asset class requires a minimum level of commitment that will make the required investments for research and building a new team worthwhile. And such a minimum commitment will always be easier for funds operating at larger scale. However, the answer lies in the pension fund's preferred implementation style (or the choice between internal and external management) and the scope and complexity of the planned investment strategy. Building an internal team of investment professionals to make direct investments in global infrastructure, say, will require a sizeable investment and is open only to pension funds of a certain size. But investing with a small set of highly reputable PE managers requires fewer resources and is easier to do, even for smaller funds.

So, it appears that both large and small pension funds enjoy access to illiquid asset classes whose returns have been greater than those in public markets. And analyses by CEM Benchmarking suggest that size differences explain only a very small part of the observed differences in investment returns. If current trends continue, and larger private market funds outperform smaller ones and access to these outperforming large funds becomes increasingly complicated to secure, our findings might change. But at the moment there seems to be little merit in the

Exhibit 3

Gross returns show no correlation with fund size.

US pension funds,[1] gross returns vs fund assets



Note: The proportion or percentage of variance explained by a regression is 4%.

[1] n = 49.

[2] y = 0.30x + 6.42.

argument that greater scale per se drives higher gross investment returns.

Argument 2: Scale lowers costs

The second key argument for consolidation is that larger scale will drive down average costs per participant for both administration and investment management. Again, the logic is intuitive, and the underlying reasons also sound compelling. Across the whole business system, greater scale should allow for more efficient operational processes, and scalable IT platforms should save money. Greater scale should

provide stronger negotiating power with third parties, such as pension administrators, fiduciary managers, investment consultants, and external asset managers.

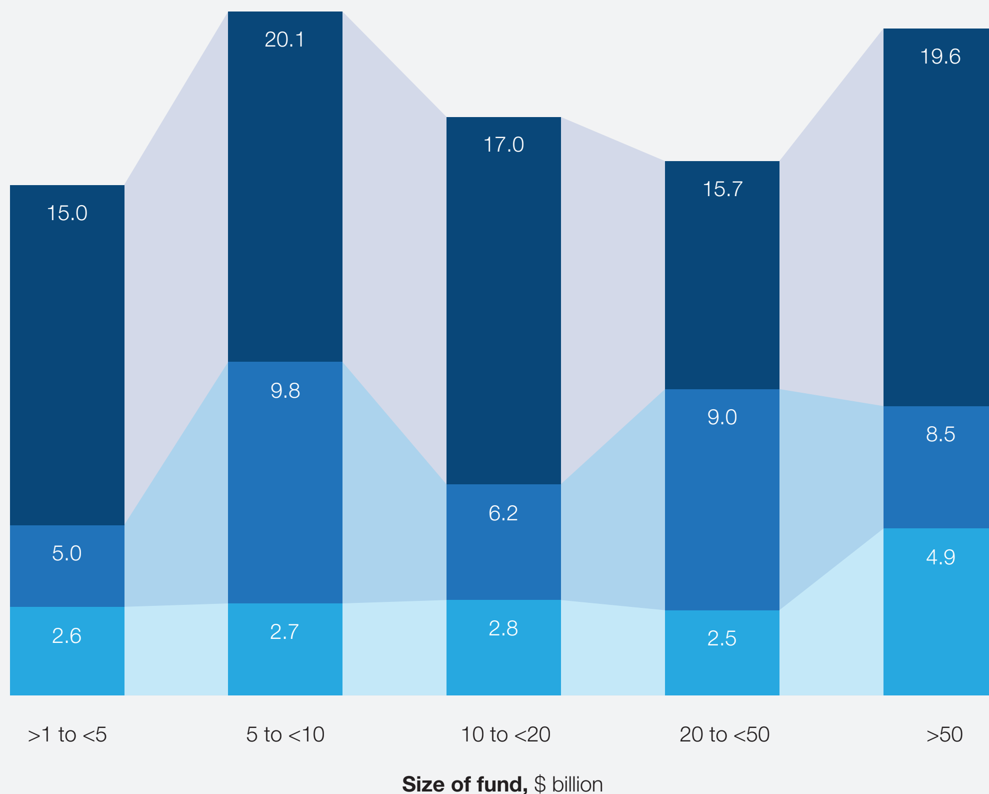
Even more powerful, at-scale pension funds can move some of these third-party activities, notably investment management, in-house and thus significantly reduce their costs. That idea has gained particular prominence with investors' increasing allocations to alternative and illiquid investments. We have seen that smaller funds can gain effective access to alternative assets, which allows them to capture comparable gross investment returns. But can they do so in a cost-efficient way? Or do they end up with lower net investment returns than their larger competitors, because they incur higher costs? Many proponents of consolidation claim that bringing investment management in-house will yield significant savings, particularly in private markets.

Does scale lower costs? Here, our findings are more conclusive and encouraging than they are in the first argument. For administration costs, which, on average, account for roughly 10 to 15 percent of the total, CEM Benchmarking finds clear evidence of

Exhibit 4

Allocations to private equity do not vary much by size of fund.

Allocations to private equity, defined-benefit pension funds[1] in United States, 2016, %



[1] Based on defined-benefit pension funds with funds under management >$1 billion with allocation to private equity.

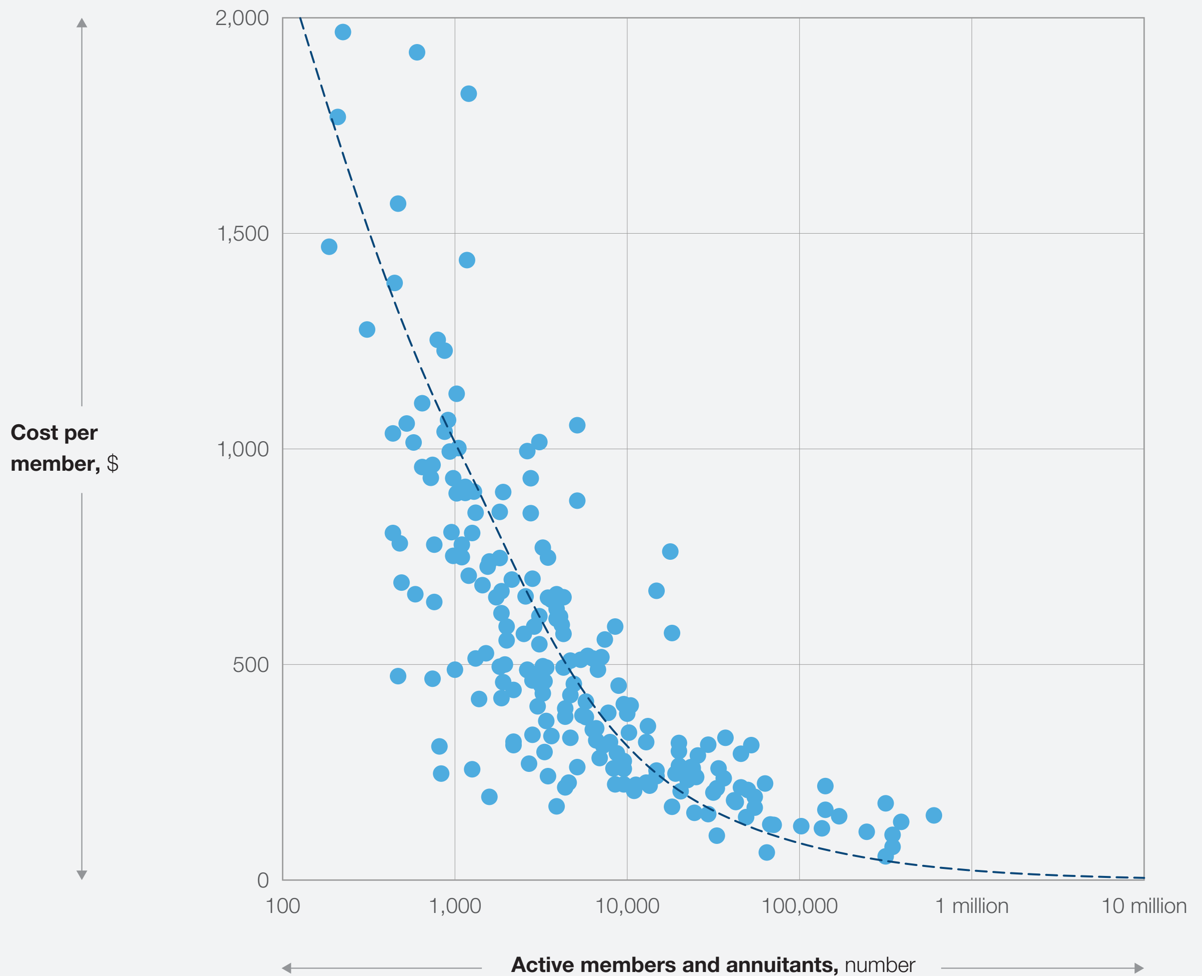
Source: *Pensions & Investments*; McKinsey analysis

economies of scale. In a 2018 analysis covering 280 DB plans[7] ranging from tiny (27 active members) to large (nearly six million active members), it found that for every tenfold increase in the number of fund members, administration costs per active member decrease by 61 percent (Exhibit 5).

For investment costs, there are also clear advantages for larger funds. However, these seem to result less from greater scale in processes and systems and more from use of more cost-efficient management and implementation practices. As funds get larger, they tend to shift to more cost-efficient implementation styles—for example, by avoiding fund-of-fund vehicles and increasing the share of internally managed assets (Exhibit 6). These savings are particularly meaningful in alternatives.

Exhibit 5 **Scale clearly lowers administrative costs at pensions.**

Pension administration, cost per member vs active members



Source: CEM Benchmarking

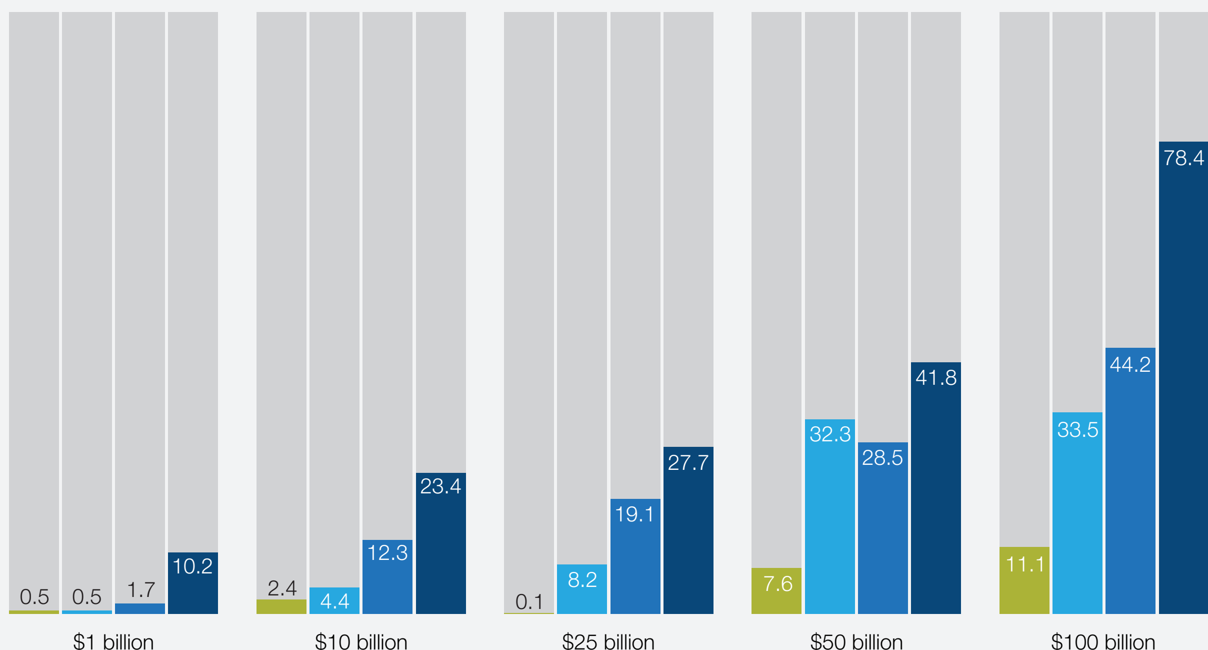
Using the proportions of investment management performed internally and externally that are typical of funds of different sizes,[8] we can calculate investment costs for a hypothetical allocation (Exhibit 7). We see a progressive cost advantage as funds get larger. A $100 billion fund that manages a typical portion of its portfolio internally saves 28 basis points (worth $280 million) compared with a $1 billion fund.

In sum, we see strong evidence that larger scale yields cost savings in both administration and investment management. Capturing them is neither automatic nor guaranteed, however. Administrative savings are slightly easier to achieve as a fund grows in scale. Investment-management savings, by far the larger of the two, require more comprehensive change. Pension funds need to make a conscious decision about their implementation style if they are to realize these potential savings.

Making the decision about the most effective management approach and practices for running the fund can be tough. And doing more work in-house also requires building up additional skills, which can be anything but trivial for an industry that still largely relies on third parties for many of its key activities. For example, moving the management of additional asset classes in-house would require adding primary and secondary due diligence, deal structuring and execution, portfolio-company management, and,

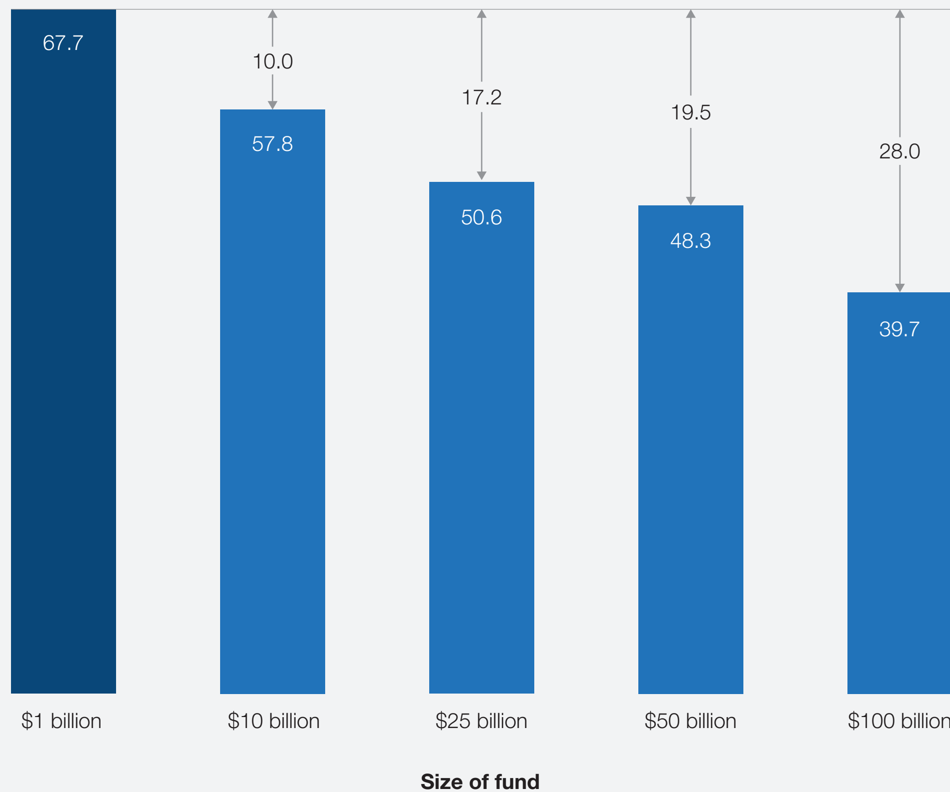
Exhibit 6 **Larger pension systems manage more assets in-house.**

Portion of pension-fund assets managed internally, by pension-fund asset size, %



Source: CEM Benchmarking; McKinsey analysis

Exhibit 7 **$100 billion funds save 28 bps on investment costs compared with $1 billion peers.**



Note: Numbers may not sum, because of rounding.

[1] Hypothetical portfolio allocation: 46% equities, 38% bonds, 8% real estate, 4% hedge funds, 4% private equity. Analysis assumes that a typical portion of the portfolio for each fund size is internally managed.

Source: McKinsey analysis

in some cases, deal-sourcing capabilities. None of these are easy to do and would require a carefully planned and executed strategy to deliver the expected benefits.

Argument 3: Scale improves governance and health

The proponents of consolidation also argue that larger funds can more easily establish stronger fund-governance practices, which reduce risks and therefore (all other things being equal) increase risk-adjusted returns. Larger funds, the thinking goes, can invest more heavily in professional risk management and oversight. They can build better capabilities to monitor and respond to changing regulations. And they can attract and retain stronger talent across all parts of their organization, from more professional, full-time pension trustees to high-caliber investment and oversight professionals.

An extensive body of research confirms that better governance is worth pursuing. Among others, Keith

Ambachtsheer, in *Pension Revolution: A Solution to the Pensions Crisis,* showed that good governance could drive up to 1 percent of fund value per year,[9] and Gordon Clark and Roger Unwin showed that pension funds with good governance delivered two percentage points of additional return over their benchmarks.[10]

We do not have evidence that larger funds are better at governance. However, astute observers have noted that there is greater variability in governance among smaller funds. The British Pension Regulator, for example, finds that smaller funds "tend to display poorer governance standards, for instance they place less focus on training arrangements, regular board assessments, effective internal controls and oversight of third parties," and that "significant issues also remain among DB schemes, in particular around integrated risk management."[11]

Our experience bears out this idea of greater variability among smaller funds—in both directions. We have seen several smaller funds that have established better governance processes than some of the larger funds. For example, the use of debiasing mechanisms at the investment-committee level does not require scale, and some smaller funds are using the techniques effectively. Our recent research with two active investment managers showed that about 30 percent of selling decisions were timed poorly, driven by biases such as the endowment effect, overconfidence, and loss aversion. Using debiasing techniques, such as conducting a "premortem" on investment decisions and assigning two independent groups to represent pro and counter perspectives, can significantly improve returns. These are not costly to implement and do not require an increase in scale.

When it comes to a broader ability to attract talent, we have seen several smaller funds attract top talent by effectively identifying and communicating their comparative advantages: greater responsibility and independence, wider roles, and more ability to shape the direction of the organization.

The verdict on Argument 3? Partially true. On average, larger funds tend to have better governance, or at least less variability, than smaller funds. However, while governance varies considerably at smaller funds, scale is not necessarily a barrier to reaping organizational benefits.

Can consolidation capture scale benefits?

Overall, we see good reasons to believe that larger pensions enjoy material benefits of scale, especially after fees. And better governance, which larger funds can more easily afford, makes it more likely that they will find such economies. But can consolidation

Other considerations to explore

Occasionally, other concerns crop up when pensions merge. These include the following:

- With greater scale comes greater visibility and scrutiny. Caution might set in, leading to greater conservatism in investment choices which can affect returns.
- As funds gets larger, it becomes increasingly challenging to "move the needle" through investments in asset classes with smaller ticket sizes, such as venture capital. This may lead pension funds to exit these asset classes. Similarly, the funds may get "sized out" by smaller investment managers that pursue certain niches.
- Consolidation may lead to the loss of the unique cultures within individual funds—cultures that may have served as a source of talent attraction and retention. Early-tenure employees especially may find fewer opportunities to take on additional responsibilities, and decide to leave.

capture them, or are they available only to funds that reached scale organically?

As funds consolidate, their ability to extract the expected benefits will depend on several factors. To begin with, M&A is notoriously difficult. A 2015 McKinsey Global Survey found plenty of executives who said that commercial M&A deals don't always deliver the synergies promised.[12] And three unique characteristics make mergers among pension funds more challenging. First, pension funds are highly regulated entities that guarantee long-term benefits to their members (especially in DB systems). Trustees have a fiduciary duty to members, which means that they should never accept a change in benefit structures that makes members worse off than before. This makes alignment among pension funds complicated, because one side will almost always have to accept a worse position than before.

Second, capturing the benefits in administration cost in a merger can be difficult, because it requires the merging funds either to align their benefit structures or to rely on flexible IT systems that can accommodate the differences. Neither is easy to achieve. Today, few pension funds have technology that is sufficiently flexible to manage two or more disparate plans.

Finally, a merger of pension funds is inherently political. Plan sponsors, trustees, and fund managers have different and conflicting interests. Add regulators, politicians, and labor representatives to the mix, and the result is a complex landscape that favors the status quo and is inimical to change.

Making consolidation work

Consolidation can only be successful with a deliberate approach. A clear strategy and mandate should underlie any merger of pension funds, and system managers should not expect to reap benefits simply by gaining larger scale. In our experience, five success factors determine whether a merger will deliver benefits. (Additional questions sometimes arise. See sidebar, "Other considerations to explore.")

1. Create a target model that clearly articulates the sources of value creation. It is critical to define clearly the extent of the merger, the areas it will cover, and the expected value creation in each function or business area. Pension funds are complex organizations, and combinations of two funds can take different forms. From a merger of back-office functions, or a selective grouping of investment activities, to a full merger of the funds (with aligned governance structures and aligned benefits), different approaches are available. It is critical to be thoughtful about the trade-offs between the expected benefits of each of these approaches and their associated challenges—and to pursue only those strategies for which the benefits will outweigh the challenges.

2. Maintain a rigorous focus on value creation. Once the funds have defined an overarching consolidation strategy and identified sources of value creation, they need to go after these sources without compromise. Experience shows that expected benefits often erode as multiple rounds of negotiations give rise to political compromises. Successful mergers require management to aim high by establishing ambitious value-creation targets at the outset, and to keep up this ambition throughout the whole transformation journey.

3. Ensure effective decision making. In general, merging pension funds are well-advised to establish a core group of senior decision-makers that drives the integration and that sits outside the management structures of the individual funds. Its members should take full responsibility for delivering against the agreed-upon strategy, and should have full authority to implement the identified value-creation levers. They will need the freedom to take most day-to-day decisions without interference from individual stakeholders or interest groups—and limit the time-

consuming decision making "by committee" that can end up stalling the whole integration process.

4. Build momentum to keep the integration moving. Ambitious timelines and positive momentum are important elements of almost all successful merger projects. If management succeeds in keeping up the speed of the integration process, they typically also find it easier to safeguard its initial value-creation targets. Very few difficult decisions become easier after they have been postponed several times, but with every round of discussion, the initial ambitions might be watered down. Mergers that tackle the most difficult questions early, on the other hand, typically benefit from the positive momentum created when these roadblocks are removed.

5. Overcommunicate to reduce uncertainty for all stakeholders as quickly as possible. Mergers are times of uncertainty for both employees and fund members. For the employees, uncertainty can manifest itself in loss of productivity and increased attrition. For members—at least in geographies where there is choice—a time of uncertainty would also be a time to consider their options. It is critical for merging funds to put together a clear stakeholder-management plan that covers both employees and fund members and communicates clearly the benefits each stakeholder group will get as a result of the merger.

Can big be beautiful for pension systems? Yes, provided they get the details right. Among other things, they need to define the consolidation mandate clearly and focus relentlessly on execution. It is a conversation worth having, not least because regulators will likely continue to push for efficiency. Pension leaders must evaluate their options and particular circumstances and then make sure that their approach will truly yield the desired benefits. ■

[1] *Pension Markets in Focus 2016*, Organisation for Economic Co-operation and Development, oecd.org.

[2] *Investment & Pensions Europe*, August 2017.

[3] Javier Espinoza, "Private equity: Flood of cash triggers buyout bubble fears," *Financial Times*, January 23, 2018, ft.com.

[4] The group changes every year, as not every firm raises a fund every year.

[5] For which there were data available for all five years.

[6] While the threshold for access appears low, achieving diversification within the asset class would be more challenging at the lower ticket sizes.

[7] Research covered publicly available data from funds' annual reports and the Global Pension Administration Database by CEM Benchmarking. Of the 280 funds, 218 were Dutch pension funds.

[8] We acknowledge that there are several other contributors to the cost base of a fund. Our example is based on only one component, which is internal versus external management.

[9] Keith P. Ambachtsheer, *Pension Revolution: A Solution to the Pensions Crisis*, Hoboken, NJ: John Wiley & Sons, 2007.

[10] Gordon L. Clark and Roger Unwin, "Best-practice pension fund governance," *Journal of Asset Management*, May 2008, Volume 9, Issue 1, pp. 2–21.

[11] "TPR sets out action to tackle gaps in scheme governance," Pensions Regulator, September 7, 2017, thepensionsregulator.gov.uk.

[12] "How M&A practitioners enable their success," October 2015, McKinsey.com.

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